Daily Themes

31 July 2009

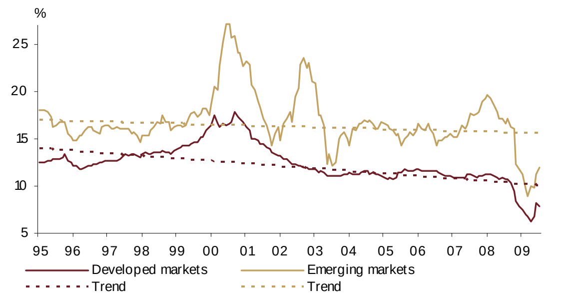
Earnings growth argues for emerging equities

In previous *Daily Themes* (such as Equities – earnings hold the key, 3rd July), we touched on the importance of medium-term profit growth when assessing equity markets' valuations. Today, we delve into the subject in more detail and analyse the latest trends.

In calculating equity market valuations, investors usually look at price-earnings ratios (PEs) and dividend yields. Those indicators are a good starting point. But, when investing in a stock, you are buying the right to a share in a company's future profits and dividends. So you should consider not only reported earnings but also future earnings growth. You may be willing to pay a high price relative to reported earnings if you expect earnings to soar.

Equity analysts' expectations for medium-term (three to five years) earnings growth are available for regional and country stock market indices (see below for developed and emerging markets).

Medium-term earnings growth expectations



Source: Datastream, Coutts

Profits growth is intrinsically related to economic activity, and expectations for emerging markets (where trend growth is faster) have always been higher than for developed markets, with medians of 16.3% and 12.2% respectively. That would argue that, even if developed and emerging markets trade on similar forward PEs (as now), emerging markets look more attractive as they should offer better prospects. That is one of the arguments behind our current preference for this sub-asset class.

Analysts expect developed markets' medium-term profits growth to remain in its structural downward trend, and forecasts have been revised even lower over the past 12 months, as those regions face four structural headwinds: fiscal tightening; muted growth in bank lending; consumer de-leveraging; and greater regulation and state planning of the economy. For emerging markets, too, earnings growth expectations have been revised lower of late but are not in a significant downward trend, and analysts' expectations have historically been much more volatile than for developed markets, which puts the recent dip in perspective. This volatility (which looks correlated to global activity) may be due to analysts' difficulties in differentiating between short-term cyclical and long-term structural trends.

Regional medium-term earnings growth

	Current	Median*	Trend**
Developed Markets	7.8	12.2	10.1
USA	9.3	12.6	11.9
United Kingdom	3.4	9.3	7.4
Europe ex UK	6.6	11.4	7.0
Japan	8.3	13.2	10.8
Pacific ex Japan	3.4	10.1	7.7
Emerging markets	11.9	16.3	15.5
Emerging Asia	12.6	17.0	16.4
Emerging Latam	12.0	15.4	16.2
Emerging Europe	4.8	12.8	10.4

* Historical median since 1995

** Linear regression since 1995 (ex. 18 months during the TMT bubble)

Source: Datastream, Coutts

Getting rid of this cyclical 'noise' helps in assessing what is an adjusted assumption for medium-term earnings growth globally (see trend column in the table above). Emerging equities' earnings are still expected to grow faster than developed (15.5%, versus 10.1%), led by emerging Asia and Latin America (Eastern Europe trails, with only 10.4%). That expectation is partly explained by the very low growth prospects for continental Europe and the UK (both around 7%). Of developed markets, the US still has the best prospects (11.9%), reflecting the economic trend over the past 50 years, with US growth averaging 3.3% a year, versus the UK's 2.4%.

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