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Weekly Intelligence Report

Our views on this week's investment events

05 April 2016

Overview

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Global financial markets continue to be driven by shifting perceptions of the efficacy of central bank monetary policy. The recent rehabilitation of risk assets owes much to increasing market participant confidence that the major central banks are fully aware of the downside risks facing global economies, understand the feedback loop between policy action and rhetoric on one hand, and business and consumer confidence on the other, and are determined to prevent these downside risks from materialising. The recent Federal Operating Market Committee (FOMC) statement, revisions to the Summary of Economic Projections (SEP) and Yellen testimony have been received positively by investors, part of an ongoing process of a partial reassessment of the –Federal Reserve's monetary reaction function on the part of markets.

In the first of this week's articles, Steve Friedman examines the **SEP revisions and recent Fed communications** for clues as to whether the Fed's reaction function is, indeed, shifting dovishly, as some investors perceive, or whether these subtle changes merely represent a shift in the Fed's own assessment of the macroeconomic environment.

Emerging market equities, as represented by the MSCI Emerging Markets Index, have now recovered a full 20% since their lows on the 21st January. Given this impressive rebound, Daniel Morris reviews **emerging market valuations**, and asks whether emerging market equities are cheap or not at current levels. He finds that the real story is not so much in the aggregate valuations (which appear moderately cheap but in a world in which emerging market valuation measures may be misleading) but in the very considerable valuation differences across regions, countries and sectors. The strong conclusion is a reaffirmation of the theme of abundant idiosyncratic opportunities for careful bottom-up stock pickers.

Happy reading!

Has the FOMC changed its tune on inflation?

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Investors have recently noticed a subtle but significant shift in tone in Federal Reserve communications on inflation. For the better part of 2015, policy makers regularly noted that once the economy approached full employment, policy normalization would be necessary to prevent inflation from overshooting the two percent objective. Chair Yellen made this point again at her December press briefing as she explained the rationale for commencing normalization. In contrast, more recent communications have dropped the references to the risks associated with higher inflation – Chair Yellen's March 29 speech, which investors interpreted in a very dovish light, did not at all highlight the need for policy to respond more forcefully in the event of an inflation overshoot. In fact most of her discussion on inflation focused on heightened uncertainty regarding the inflation outlook, despite the firming in both CPI and PCE inflation since the start of the year. And other Federal Open Market Committee (FOMC) members have made a point of highlighting that the two percent inflation objective is an average to be achieved over the medium term, implying that inflation could move above the objective for more than brief intervals[1].

This shift in communications, which appears deliberate and coordinated, raises the question of whether the FOMC is now truly more willing to tolerate inflation overshoots than it was just a few short months ago. Our view is that while the Committee's reaction function has not changed meaningfully, circumstances may have.. Specifically, risk management considerations have played an important role in the Committee's reaction function in recent years. When risks appear relatively balanced, these considerations play less of a role in the Committee's communications. However when downside risks are growing (or are larger than the Committee previously appreciated), it makes sense that these considerations would play a larger role in communications, as they would also influence policy decisions. And currently, the Committee's appreciation of risks related to inflation expectations and growth are more significant than they were at the time of liftoff in December.

In recent months, Committee members have increasingly focused on the possibility that inflation expectations have become or risk becoming unanchored to the downside. As we wrote last month, market-based measures of forward inflation compensation remain near all-time low levels. Survey-based measures of consumer inflation expectations have also drifted lower. Should inflation expectations become unanchored, the Committee would face greater challenges in bringing inflation back up to the two percent objective in the years ahead. Faced with this risk, FOMC members are going to some lengths to ensure that investors appreciate the Committee's willingness to tolerate inflation above two percent. The early returns on this communications tactic have been positive. While other factors are clearly at play (particularly the modest recovery in oil prices since mid-February) the change in emphasis on inflation risks appears to have supported a modest firming in market-implied inflation compensation.

The other factor contributing to the shift in communications on inflation is the growth outlook. The Committee has clearly downgraded its assessment of global growth since the December FOMC meeting, and also sees the global environment as posing additional risks to the U.S. outlook. More recently, economic data indicate that first quarter growth may come in below one percent, following lackluster growth at the end of last year. Should growth remain weak beyond the first quarter, the Committee will come to expect slower progress in reducing labor market slack and closing the output gap, which would reduce the likelihood of achieving the inflation objective. In this environment, continuing to signal concerns about inflation overshoots would only risk signaling an unduly restrictive policy stance, which would in turn raise real rates, tighten financial conditions and dampen the prospects for growth and inflation.

If the Committee has shifted its communications tactics on inflation, but the reaction function has remained unchanged, what are the implications for policy going forward? This is an important question for investors, especially if inflation continues to rise in the coming months. If the recent slowdown in growth proves to be a soft patch, and data for the second quarter appears consistent with growth moving back above two percent, the FOMC would likely respond to continued firming of inflation with a rate increase at the June meeting and an additional increase later in the year. More likely, however, is that growth continues to remain on the weak side and the pace of employment growth eventually slows, leaving the Committee more willing to tolerate an inflation overshoot and delay any additional rate increases at least until the fall. This is the key message from recent communications on inflation – overshoots are not only acceptable, but within a risk management framework may prove necessary if achieving and maintaining full employment looks to be at risk.

1. See, for example, John Williams' March 29 speech, "Trick of the Light? The U.S. Economy, Global Growth, and International Risks in Perspective". President Harker also discussed the symmetry of the inflation objective in the Q&A portion of his March 22 Money Marketeers speech. And in January, the FOMC also amended its Statement on Longer-Run Goals and Monetary Policy Strategy to clarify that it views its two percent inflation objective as symmetric. At the time, Governor Fischer noted that "the proposed language was intended to encompass situations in which deviations from the Committee's inflation objective were expected to continue for a time and had the potential to affect longer-run inflation expectations".

Are emerging market equities cheap?

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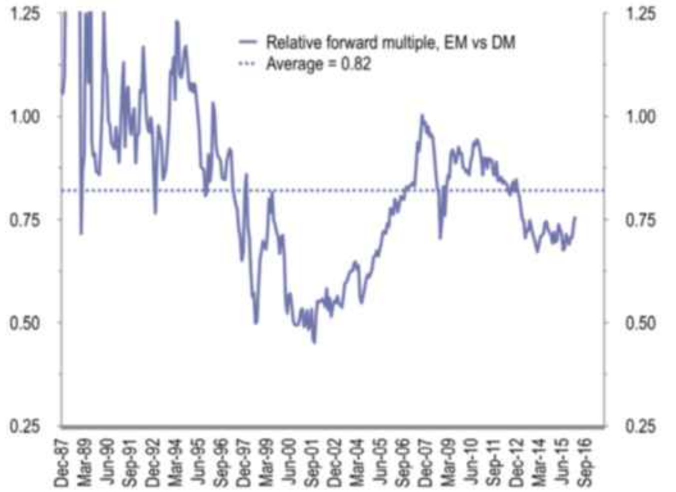
With the 20% gain in the MSCI Emerging Markets Index since its low on 21 January 2016, investors may worry that the opportunity to invest in emerging market equities at the point where valuations are the most attractive has been lost. Forward price-earnings ratios have indeed jumped significantly, with the Index now trading at 12.0x next-twelve-month earnings estimates based on IBES consensus data, compared to 10.4x in January. But even at the January level, it is not clear that emerging market equities are necessarily "cheap", given that the previous low multiple was 6.3x in October 2008.

Relative to the MSCI World Index, emerging market equities would appear attractive. Emerging market equities have almost always traded at a discount to developed market equities thanks to the higher volatility and uncertainty around corporate earnings, but that discount is greater today than it has been historically. Currently the relative forward multiple is 0.7 compared to a long-run average of 0.8 (see chart).

Next-twelve-month price-earnings ratio of MSCI Emerging Market Index compared to MSCI World Index



Source: IBS, BNP Paribas Investment Partners

Another measure that suggests that emerging market equities are undervalued is the price-to-book ratio, which was 1.4x as at the end of April compared to the average since 1987 of 1.8x. The problems with these metrics are two-fold. One is that they give you little indication of when any valuation gap might be closed; the price-to-book for the MSCI Emerging Markets Index has been trading below average since August 2011. Two is that the numerator may not be all it seems to be. For the price-to-book ratio to be a relevant indicator, the book-value-per-share has to be a valid estimate of the underlying value of the business. But given the severe challenges facing the energy and materials sectors, and the exposure of the financial sector to these industries, the current price-to-book ratio may be overstating the discount of emerging market companies relative to the underlying assets.

There are yet two more concerns. First is that, as is always the case with an average measure, it ignores the variation in the components, and the variation today is significant. While the MSCI Emerging Markets Index is trading at a slight premium to its long-run average, the valuations for the regions are quite different. The price-earnings ratio for the Latin America index is currently 26% above average and for EMEA index is 16% above average. That is to say, the low valuations in emerging market equities are solely in Asia.

Breaking up the Asia index shows further variation in the country multiples, with most countries trading well above average (India, Indonesia, Philippines, Thailand), and just China and Taiwan below average. Even within China (which accounts for nearly one-fourth of the MSCI Emerging Markets Index), there is a significant dispersion of valuations. Concerns about the true level of non-performing loans in the financial sector are reflected in its very low multiple, 44% below average. The cloudy outlook for state-owned enterprises is likely a reason that multiples for the utilities and industrial sectors are also well below average. Those sectors which reflect the "new" China economy, for example consumer discretionary and information technology, are trading at price-earnings ratios that are well above historical norms.

The apparently low valuations in emerging markets are at least partly due to significant discounts for Chinese financials and other sectors where state-owned enterprises play a dominant role, while the parts of the emerging markets universe where the growth outlook is better (e.g., India or information technology), multiples are high. As always there are opportunities in emerging markets, but finding the true bargains requires looking far below the surface.

More of our thoughts on the market

Papers

FFTW weekly commentary
by Tom Philips, Global Head of Investment Risk
04 April, 2016

Asset allocation monthly
by Joost van Leenders, CFA, Chief Economist
April 2016

Weekly strategy update
by Joost van Leenders, CFA, Chief Economist
31 March, 2016

Choices to address foreign currency exposure
by Momtchil Pojarliev, CFA, Senior Portfolio Manager
22 March, 2016

March FOMC: Global risks come to the fore
by Steven Friedman, Senior Investment Strategist
16 March, 2016

ECB: Trying the big bang
by Reinhold Knaus, Senior Economist
10 March, 2016

How much has China repaid its foreign corporate debt?
by Chi Lo, Senior Economist Greater China
9 March, 2016

Central Bank Watch
by Richard Barwell, Senior Economist
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2 March, 2016

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by Richard Barwell, Senior Economist
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featuring Geoff Daily, CFA, Senior Equity Resarch Analyst
and Eric McLaughlin, CFA, Investment Specialist
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ECB and Fed policy outlook discussion
featuring Richard Barwell, Senior Economist
Daniel Morris, Senior Investment Strategist
and Steven Friedman, Senior Investment Strategist
3 March 2015

Global Emerging Market Equities Small Caps
featuring Rick Wetmore, CFA, Deputy CIO, Global Emerging Market Equities
and Christine McQuillan, CFA, Investment Specialist
17 February 2016

Absolute Return
An Alternative Fixed Income Strategy
featuring Alex Johnson, Head of Absolute Return, FFTW
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