Fulcrum issues

Examining the relative value of U.S. and emerging market equities looking forward

Some of the best opportunities to profit from active asset allocation occur when there is a great controversy in the capital markets. These opportunities develop because investors are conflicted as they weigh the probability of unknown outcomes. Usually, there are credible arguments on both sides of an issue. A mispricing develops because of overconfidence, extrapolation or some other bias that investors have.

> A cynic is someone who **"knows the price of everything and the value of nothing."**
>
> Oscar Wilde

Our active allocation process is based upon a suite of principles, beliefs and analytical tools designed to give us an edge in forecasting the resolution of these mispricings. Part of the edge comes from unique insight about the issue, and the other part is our own trading behaviour. In this article, we describe what we believe is a mispricing between the U.S. equity market and emerging market (EM) equities. We will provide a glimpse into the rich research our platform affords and, we hope, help the reader understand our active positioning.

While global equity markets often produce returns that are directionally similar, there can be meaningful dispersion in performance and valuation measures across regions, countries and the securities that make up their markets. In certain situations, this dispersion may be reasonable and justified: fundamental or structural changes can alter economies, industries and companies. More frequently, however, the dispersion is driven by elements that are unsustainable, leading to asset prices that are too high or too low, relative to their long-term fair value.

In the target date portfolios we manage, we have the ability to allocate more or less than the benchmark to certain asset classes, such as U.S., EAFE and EM equities, with the goal of improving risk/reward for shareholders. When we evaluate equity markets, we larger- or smaller-than-benchmark positions where we think cash flows or discounting conditions will emerge that differ from the expectations reflected in the current price. Over the past few years, we have positioned the target date portfolios to allocate more than the benchmark to EM equities and less than the benchmark to U.S. equities. This positioning has been a headwind for near-term results, as EM equity performance has come in fits and starts, while U.S. equities have delivered consistently strong performance for the past several years.[1]

One explanation for the difference in relative performance is that the realized results and future expectations for cash flows and discounting conditions have been better than originally expected for U.S. companies, compared with EM equities. Several catalysts have contributed to these changes in expectations, including pandemic-driven strength in U.S. technology companies benefiting from work-from-home trends, U.S. tax cuts improving cash flows for U.S. companies, low discount rates and increased regulatory controls in China and other emerging markets.

While our decisions on equity positioning have detracted recently, we find that many of the attributes that led us to our larger-than-benchmark position in EM equities and

[1] The S&P 500 has outperformed the MSCI EM Index by about 700 basis points annually for the last five years.

lower-than-benchmark exposure to U.S. equities remain intact. Our research frameworks indicate that valuations for U.S. equities remain high, with investors extrapolating strong cash flows and favourable discounting conditions, while EM equities remain inexpensive, with weak sentiment. In addition, there are improving longer-term structural forces for emerging markets that are perhaps overlooked. With this backdrop, we consider the relative value of U.S. and EM equities to be a "fulcrum issue" facing multi-asset investors in the years ahead.

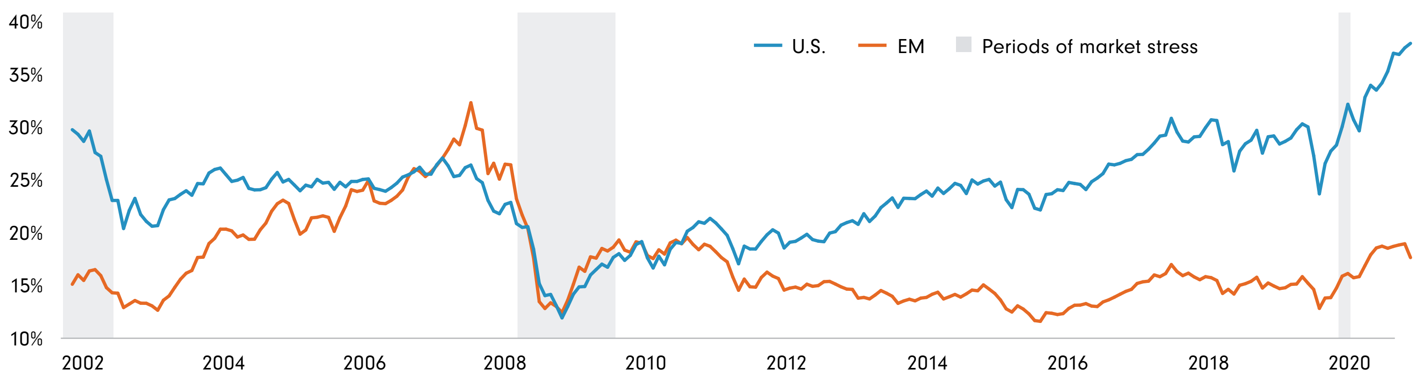
Although Oscar Wilde undoubtedly was focused on topics other than the capital markets when he wrote this gem, his statement is relevant to all investors. While most assets in the capital markets have stated prices, investors disagree about the true value of nearly every asset. Our investment process focuses on the elements that are the sources of these disagreements.

Like many investors, we strive to focus on the price paid in relation to the value of an asset. We recognize that other forces beyond cash flows and discount rates affect asset prices in the short term. For example, central banks buy bonds for reasons unrelated to their price or value, some individual investors buy assets based on fear or greed, and leveraged investors may be forced to sell assets for non-economic reasons. Macro shocks, geopolitical forces and human behaviour matter as investors work through the price discovery process. Because we have more confidence in simple measures of relative value than in our ability to forecast these other factors, we strive to be objective, to focus on durable principles and research and to avoid getting caught up in narratives for owning assets.

As we assess the relative value of equities across global markets, we begin by considering attributes of U.S. corporates that have contributed to exceptional returns. For example, over many time periods since 2002, U.S. companies have experienced superior return on equity (ROE),[2] demonstrated better free cash flow margins, have stronger corporate governance structures and are domiciled in a more stable political system. While we agree with these assertions, they are missing the primary questions that we face as investors. What price is reasonable for these "better" qualities? Is that price too high relative to the price for assets in other parts of the world? Are the expected cash flows and discount rates that are embedded in prices likely to be sustainable?

There are many ways to contemplate the future cash flows of equities. One simple way is to study history and adjust for the normal cycles that occur as companies move through periods of stronger and weaker earnings growth. The Shiller

EXHIBIT 1: Cyclically adjusted price-to-earnings (CAPE) ratio



Source: Fidelity Investments. Data as at July 31, 2021. The representative indexes are the S&P 500 Index and MSCI Emerging Markets Index.

[2] As represented by the S&P 500.

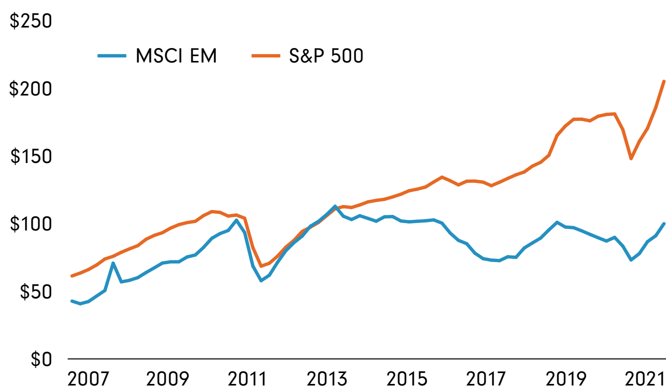
cyclically adjusted price-to-earnings (CAPE) is a useful starting point.

While there are numerous valid critiques of CAPE, it provides a good baseline measure of valuation and helps to establish the backdrop for the sustainability of cash flows relative to price. CAPE is constructed using a trailing measure of average real earnings relative to the current price. A central assumption is that the ten-year lookback accurately reflects the distribution of future earnings and cash flows. Historically, this assumption has been reasonable, in part because the economic and behavioural forces governing business cycles (e.g., business formation, competition, leverage) have aligned with this time horizon.

Exhibit 1 reveals that CAPE measures today suggest EM equities offer a value relative to U.S. equities that is as meaningful as at any point in recent history. Current prices for U.S. equities are predicated on the expectation that the superior earnings delivered relative to EM equities over the past several years (as illustrated by Exhibit 2) have potential to continue, or on potentially improving discounting conditions. On a longer-term basis, history shows these assumptions have not been realistic. Historically, higher returns have been achieved by allocating more than the benchmark to asset classes that are less expensive and less than the benchmark to asset classes that are more expensive, because high expectations for cash flows and growth have often been disappointed. Two examples of this dynamic are the valuation reversion that occurred between EAFE/Japan and the U.S. equity markets in the late 1980s, and the experience of technology, media and telecom (TMT) stocks in the U.S. nearly 20 years ago.

EXHIBIT 2: Earnings per share

Next twelve months



Source: Factset. Data as at June 6, 2021.

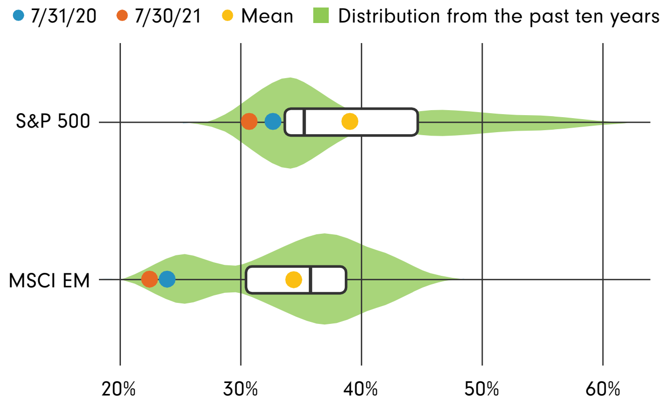
Peeling back the onion on CAPE

Because CAPE is a simple approach, we evaluate additional research to gain insight into the process by which corporates generate cash flows. At the most basic level, companies earn profits when they sell goods or services for more than the costs of production. Because a company's cash flows are also affected by the timing for realizing expenses and income, a point-in-time analysis can obscure the duration of cash flows and is too simplistic. For example, a single quarterly income statement or balance sheet might prove misleading to investors, because a company can flatter its financial profile through short-term creative accounting or the use of one-off financial transactions. While recognizing these limitations, we can consider the historical distributions of these types of basic measures to assess how companies generate earnings, to understand the bias in investors' expectations and to compare with our own views about the sustainability of the current environment.

Exhibits 3 and 4 depict a time series and box plot of two major drivers of return on equity (ROE). We study the distribution of these measures for evidence of extremes that could potentially revert to more normal levels. Today, we observe a stark contrast in the attributes of U.S. equities relative to EM equities. While aggregate sales have compounded at a higher rate for EM equities, they have been more volatile, and shifted lower over the last decade (Exhibit 5). Weaker sales growth has led to lower profitability and asset turnover, which has led to lower ROEs (Exhibit 6). In comparison, large U.S. companies have experienced

EXHIBIT 3: Asset turnover

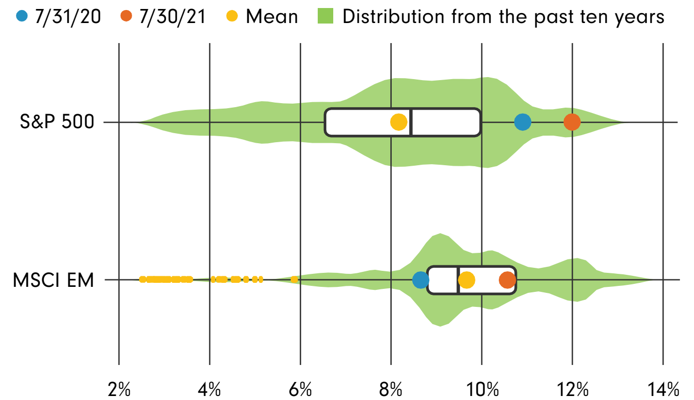
Last twelve months



Source: Factset. Data as at July 31, 2021.

EXHIBIT 4: Net margin

Last twelve months



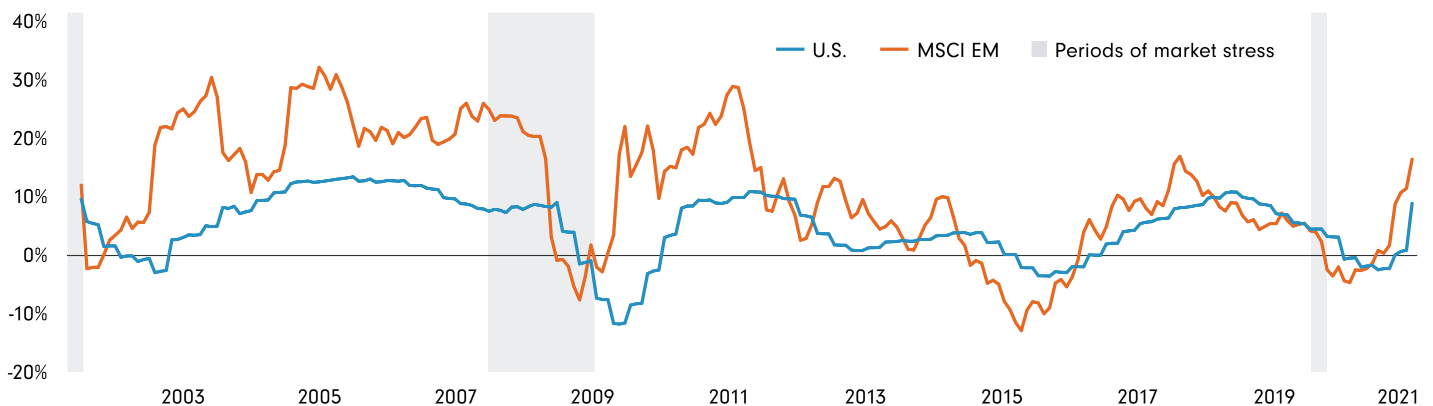
Source: Factset. Data as at July 31, 2021.

higher profits and used cash to buy back shares and boost returns. This has allowed many smaller U.S. companies to garner higher valuation multiples, based on similar expectations for future success.

In our view, investors are extrapolating these fundamental relationships into the future, which is contributing to the valuation premium associated with U.S. stocks and setting a high bar. Large profitable U.S. firms will need to be able to identify investments that produce high incremental returns to sustain their profitability and growth, and to further penetrate markets where they already command high market share. Meanwhile, smaller companies with limited or no earnings will have to compound sales at very high rates (20%+) for a decade, and reach levels of profitability that are in line with the average S&P 500 constituent, in order to justify today's market values.

The measures we have presented thus far consider aggregate index level data. Because aggregate data can mask details within the index, we find it useful to study a more granular level of valuation of components that are part of the major

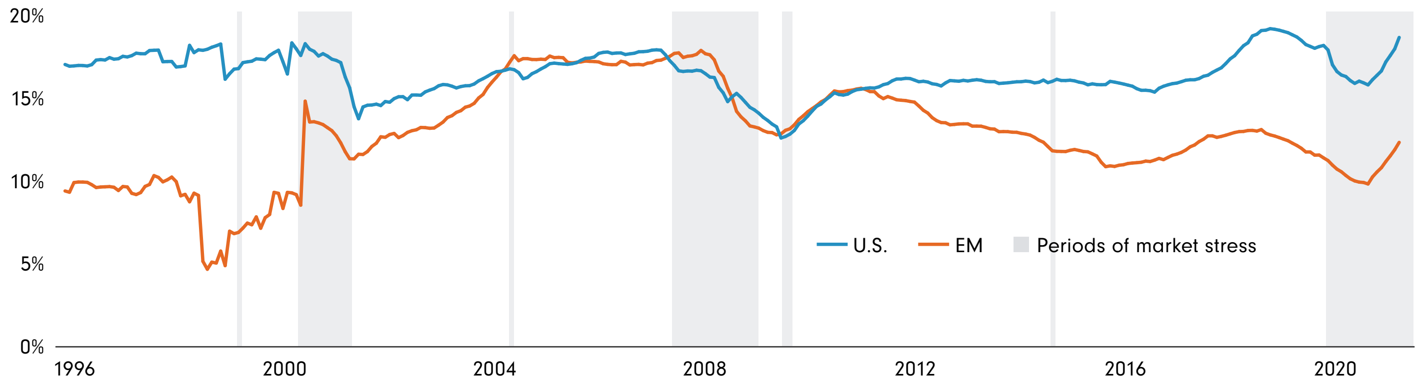
EXHIBIT 5: Sales growth



Source: Factset. Data as at August 23, 2021.

EXHIBIT 6: Return on equity

Last twelve months



Source: Factset. Data as at July 31, 2021.

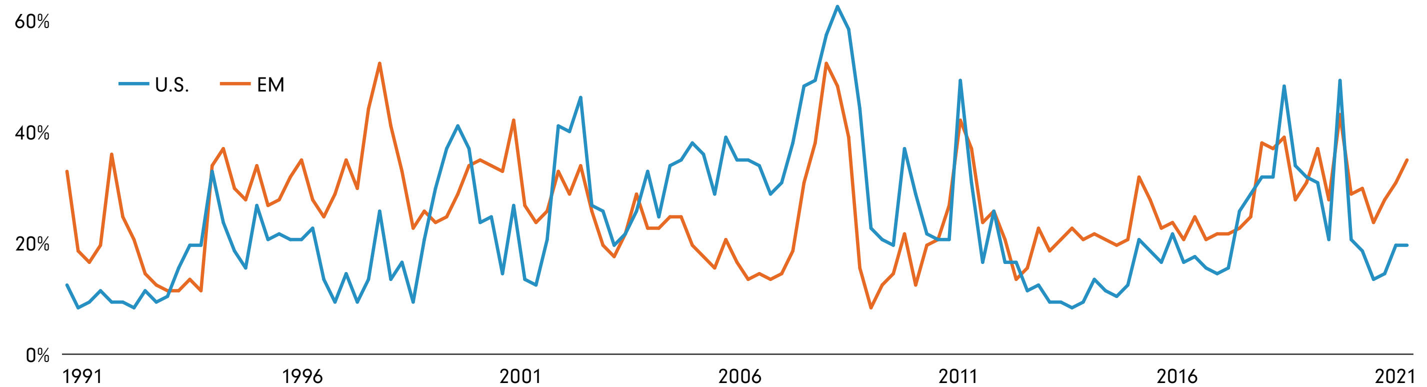
indexes. For example, Exhibit 7 shows the percentage of companies in the MSCI Emerging Markets Index and the S&P 500 Index whose earnings yield (inverse of P/E) is in the highest (least expensive) quintile of their own history, on a rolling five-year basis. The EM index has 34% of companies trading in the cheapest quintile of their own history, compared with 19% for the S&P 500. The spread between the indexes is currently 15%, which is the widest divergence since 2001.

We find that this is a useful way to understand the breadth of the discounts and premia in an index. Like the CAPE illustration above, these valuation differences have historically led to multi-year periods of outperformance for EM equities. While the timing of these periods is always difficult to evaluate or forecast, the environment, from a relative value standpoint, is compelling.

Evaluating global assets also requires consideration of potential currency movements that can affect relative performance. We like to consider the value of currency through the lens of relative purchasing power parity (PPP). In particular, we assume that changes in exchange rates mainly reflect movements in price levels between two countries. For example, if the inflation rate in South Korea

EXHIBIT 7: Percentage of companies with earnings yield in cheapest quintile

Rolling five-year basis

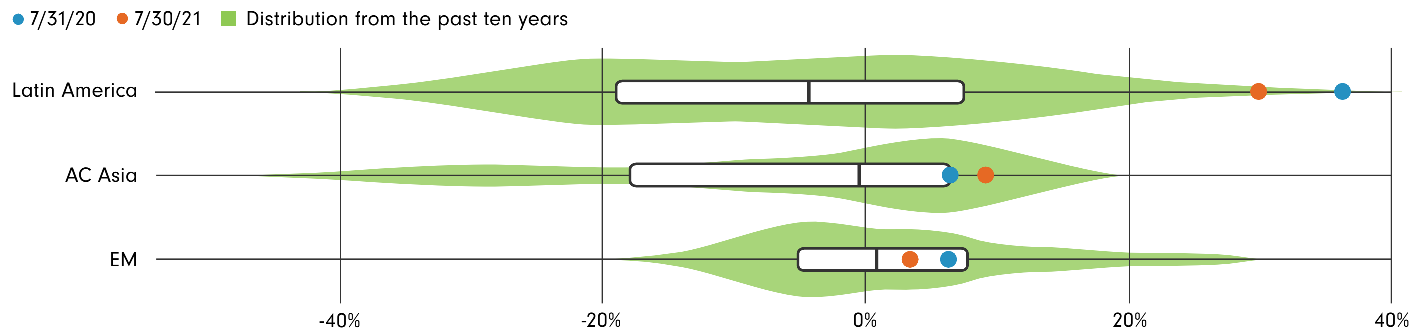


Source: Factset. Data as at August 12, 2021.

were persistently one percentage point lower than in the U.S., then – all else being equal – we would expect the dollar value of one South Korean won to rise 1% per year. We treat deviations from this baseline as our measure of over- or undervaluation. While PPP frameworks are imperfect, they typically provide a good starting point for assessing relative value. In our frameworks today, we observe that the U.S. dollar is expensive relative to a weighted basket of EM currencies, as shown in Exhibit 8. If currencies revert to our view of fair value, this convergence would serve as a tailwind for equity returns in non-U.S. markets.

EXHIBIT 8: FX return to fair value relative to USD

July 2021 vs. July 2020

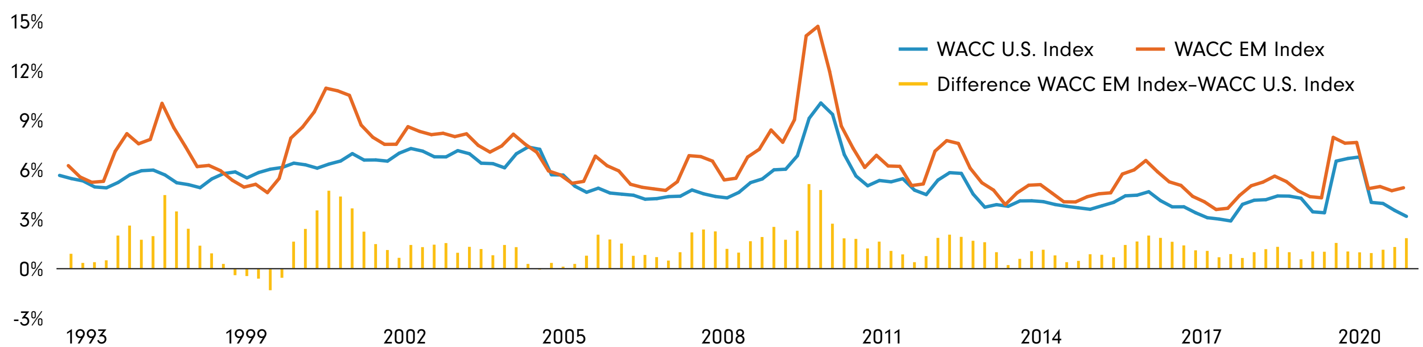


Source: Fidelity Investments. Data as at July 31, 2021.

Discount rates

Valuation methods require assumptions about how to discount future cash flows to the present, while considering the uncertainties that are embedded in the process. As the discount rate increases, the present value of future cash flows decreases, with the decline more precipitous for cash flows farther in the future. Because discounting conditions must be estimated, we consider composite measures that reflect both the risk-free discount rates and the risk appetite. The weighted average cost of capital (WACC) represents a discount rate that combines the cost of debt and equity capital into one measure for valuing a firm. In practice, the WACC is not observable, and must be estimated. The primary drivers of this measure of discounting conditions are interest rates, credit spreads and aggregate volatility.

EXHIBIT 9: Estimated weighted average cost of capital and difference



Source: Factset. Data as at August 23, 2021.

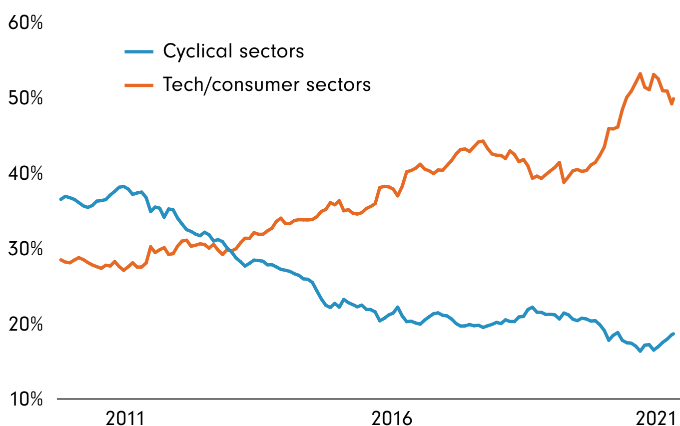
When we compare discount rates in the U.S. and emerging markets (see Exhibit 9), both asset classes are currently experiencing lower (easier) discounting conditions than the average of their respective histories. Declines in interest rates due to the great moderation of inflation in the 1980s, coupled with successful countercyclical monetary and fiscal policy, have led to a longer-term trend of easier conditions. The improvement in the fiscal positions of many EM countries, combined with floating exchange rate regimes, has caused discounting conditions to become more cointegrated with the developed economies over time. As the global economy continues to improve, we expect EM equity discounting conditions to converge toward those of the U.S. Historically, this type of change has supported EM equity outperformance, assuming the expected cash flows are realized.

As these illustrations highlight, we need to distill, assess and estimate the various forces that impact asset prices. This process requires judgment and assumptions, because the data are volatile and "noisy." Because we see cash flows and discount rates as probabilistic distributions, our frameworks are designed to assess the distribution of potential future outcomes. Based on our assessment, asset prices reflect investors' expectations for continued U.S. exceptionalism. Conversely, expectations for EM equites are more balanced. We view EM equities as having a more favourable distribution of potential outcomes, while U.S. equities are starting from a higher valuation point, and have a less favourable distribution of future returns.

Beyond valuation

In addition to compelling valuations, there are longer-term structural forces that may benefit EM equities, and which we believe have been overlooked. For example, the composition of the EM equity index has evolved considerably over the past twenty years. Historically, emerging markets have been viewed as having cyclical attributes, with meaningful exposure to commodity and industrial companies. Today, as illustrated by Exhibit 10, the MSCI EM Index has become more representative of the transformation of EM economies themselves, with technology and consumer sectors taking a larger share of the Index. This shift in composition has led to lower levels of capital intensity, as measured by capex relative to sales (Exhibit 11), and an improvement in the underlying quality of EM equity companies ranked relative to global peers, as illustrated by the consistency of positive free cash flows and earnings variability.

EXHIBIT 10: EM index composition by sector



Source: Factset. Data as at July 31, 2021.

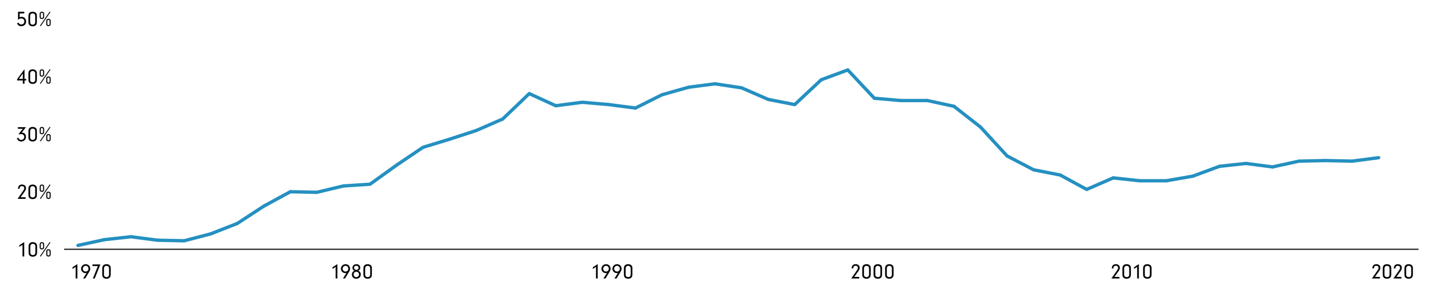
EXHIBIT 11: CAPEX as percentage of sales

Source: Factset. Data as at June 30, 2021.

Typically, consumer/service and technology sectors garner valuation multiples that are above average for the broad market, given their higher and more consistent rates of growth and profitability. Interestingly, valuations in EM equities have moved in the opposite direction during recent periods. While there may be sound reasons for U.S. equities to command a long-term valuation premium over EM equities, such as a more capitalistic system and more benign regulation, we believe the improved underlying business mix should be recognized in asset prices over time.

Another positive long-term trend in emerging markets has been the improved fiscal health of government finances, as measured by ratios such as external debt-to-GDP, or current account balances, as shown in Exhibit 12. The history of EM economies has been marked by a high sensitivity to developed market interest rates. Increases in developed market interest rates often led to fiscal and currency crises, because EM countries were unable to finance large dollar-denominated debt balances. Previous financial crises have taught EM companies and governments to apply a more prudent approach to financing, relying less on foreign currency-denominated debt.

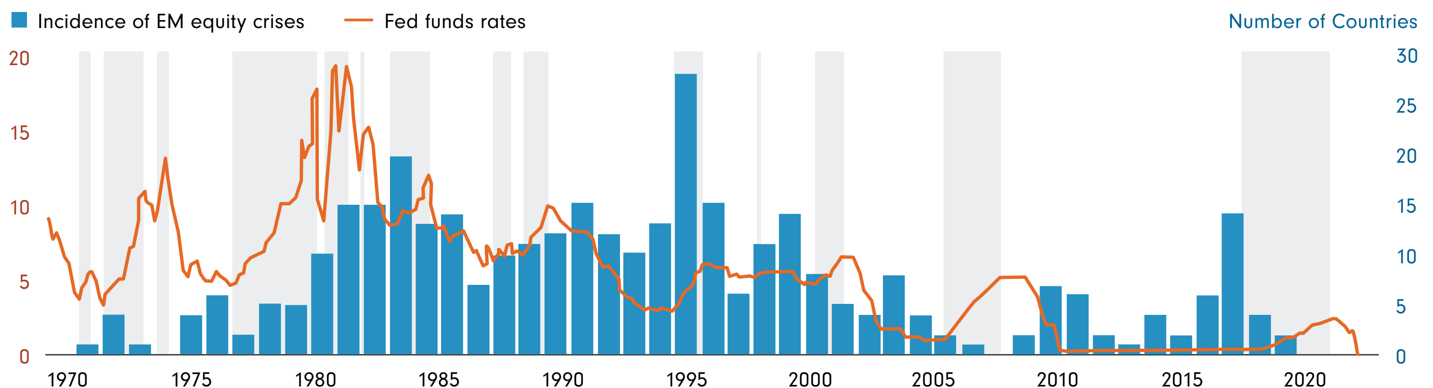
EXHIBIT 12: Developing countries' debt-to-income ratio



Sources: World Bank/Haver Analytics. Data as at December 31, 2020.

A recent study by the Federal Reserve addressed the improved resiliency of emerging markets to interest rate increases. As we compare the Fed funds rate to the number of EM equity "crises" since 1970, it is evident that the resiliency of EM equities has improved markedly over the past decade, with a reduced sensitivity to developed market interest rates (Exhibit 13).

EXHIBIT 13: Federal funds rate vs. incidence of financial crises in emerging markets



Sources: Fed funds rate (FFR) data are from Haver, as at December 31, 2020. Crisis data are from Laeven and Valencia (2018) and run through 2017.
Gray areas are times when the FFR is increasing.

Risks

While we have identified meaningful opportunities across equity markets, we are "eyes wide open" to the current risks facing emerging markets. One of the most notable risks to our thesis is the current regulatory oversight and controls that the Chinese government is placing on a number of industries (e.g., large consumer/ technology platforms and education companies). We believe that recent volatility and price movements reflect investors working to "price" these emergent risks. Based on insights from our global researchers with expertise in asset allocation, equity and fixed income, we view many of the EM stocks to be priced at a discount relative to comparable global peers. Our base case remains that the historical precedent set by regulators will be realized: an initial policy that is relatively unconstrained, followed by tighter regulation, which ultimately ebbs to reach a more balanced position. While the threat of regulation is present in all countries, the speed and impact often vary.

Another area of concern is resurgent COVID risks that could lead to a differentiated impact on emerging markets relative to the rest of world. Vaccine penetration is notably lower in EM countries, and health care systems are underdeveloped in many regions. As we monitor the developments of the variants, our research indicates that these risks are embedded in the difference in prices that we observe across global equity markets. Because the situation is fluid, we will continue to monitor and research new information closely.

While there is a tendency to focus on downside risks, there are also potential positive risks that merit consideration. For example, the global economy has a strong foundation for trade among countries, with trade surpluses surging in exporting nations. This backdrop can provide a tailwind for EM economies, because the global trade boom could persist longer than expected.

Conclusion

The quote from Oscar Wilde seems especially apropos when considering prices for U.S. and EM equities in today's market environment. We see value in EM equities from multiple perspectives: attractive relative CAPEs, improving structural trends and contrarian sentiment signals. Investors are often rewarded for being patient and taking a longer-term view. As target date investors with a multi-year investment horizon, we take patience to be a virtue aligned with our long-term investment approach. We look forward to realizing value for shareholders by applying our principles, process and patience in the years ahead.

Written by: Fidelity's Target Date Investment Team

We acknowledge that certain assets (e.g., commodities, alternatives, etc.) have distinct attributes related to cash flows (or lack thereof), market structure, valuation practices and other factors that can affect prices.

Information provided in this document is for informational and educational purposes only. To the extent any investment information in this material is deemed to be a recommendation, it is not meant to be impartial investment advice or advice in a fiduciary capacity and is not intended to be used as a primary basis for you or your client's investment decisions. Fidelity and its representatives may have a conflict of interest in the products or services mentioned in this material because they have a financial interest in them, and receive compensation, directly or indirectly, in connection with the management, distribution, and/or servicing of these products or services, including Fidelity Funds, certain third-party funds and products and certain investment services.

Past performance is no guarantee of future results. An investment may be risky and may not be suitable for an investor's goals, objectives and risk tolerance. Investors should be aware that an investment's value may be volatile and any investment involves the risk that you may lose money.

The investment risk of each Fidelity ClearPath® Portfolio with a target date changes over time as its asset allocation changes. The nature of these risks will depend on the asset allocation decisions made in respect of these Portfolios. Due to the potential use of an active asset allocation strategy, investors may be subject to a different risk profile compared to the portfolio's neutral asset allocation strategy shown in its Glide Path. The portfolios are subject to the volatility of the financial markets, including that of equity and fixed income investments in Canada, the U.S. and abroad, and may be subject to risks associated with investing in high-yield, small-cap, commodity-linked, and foreign securities. No target date portfolio is considered a complete retirement program and there is no guarantee any single portfolio will provide sufficient retirement income at or through retirement. Amounts invested are not guaranteed at any time, including at or after the portfolios' target dates.

Diversification does not ensure a profit or guarantee against a loss.

These materials may contain statements that are "forward-looking statements," which are based on certain assumptions of future events. Forward-looking statements are based on information available on the date hereof, and Fidelity Investments Canada ULC ("FIC") does not assume any duty to update any forward-looking statement. Actual events may differ from those assumed by FIC when developing forward-looking statements. There can be no assurance that forward-looking statements, including any projected returns, will materialize or that actual market conditions and/or performance results will not be materially different or worse than those presented.

"Fidelity Investments" and/or "Fidelity" refers collectively to: i) FMR LLC, a US company, and its subsidiaries, such as Fidelity Management & Research Company (FMR Co.) and FIAM LLC ("FIAM"); and ii) FIC and its affiliates.

Third party trademarks and service marks are the property of their respective owners. All other trademarks and service marks are the property of Fidelity Investments Canada ULC or its affiliated companies. FIC does not provide legal or tax advice and we encourage you to consult your own lawyer, accountant or other advisor before making an investment.

© 2021 Fidelity Investments Canada ULC. All rights reserved.

981010.2.0 1.9904314.100

649852-v20211110 10/21 FCI 647607

FIDELITY CANADA INSTITUTIONAL™