FOOD FOR THOUGHT
MAN OF STEEL

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Emerging and Asian markets are trading at a deep 30% discount to developed markets. However, a large part of the discount can be explained by sector composition. Emerging markets and Asia have a higher weight in financial and basic material stocks. Adjusting for the sector weight, emerging markets trade at 18.7 times trailing earnings, compared to 20 times trailing earnings for developed markets.

To be fair, the discount based on the median price to earnings ratio is larger, as are other measures such as price to book. Of course, this reflects the fact that earnings are depressed relative to trend. From my perch, the key question is whether profits are cyclically or structurally depressed and when will there be mean reversion in returns?

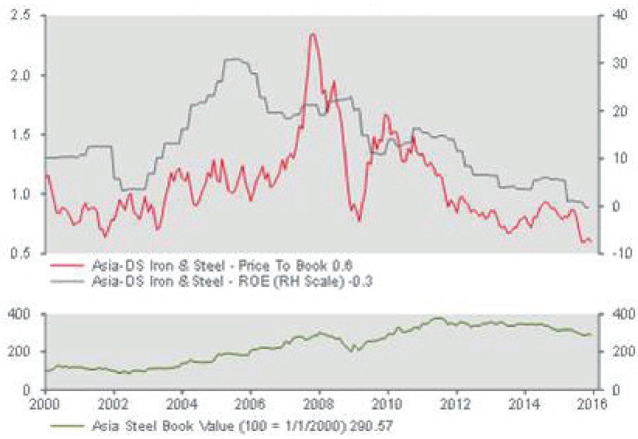
Asian steel companies are an excellent example of the structural challenge. Profits and growth were very high during China's infrastructure boom post 2001 (Fig.1). Indeed, China's steel and cement production expanded at a 20-30% pace during that phase, considerably faster than GDP. Asian steel companies responded to the boom by expanding capacity or their assets by around 300% from 2000 to 2008.

Fig.1. China Steel, Cement Production and GDP

Source: Thomson Reuters Datastream, as at November 2015

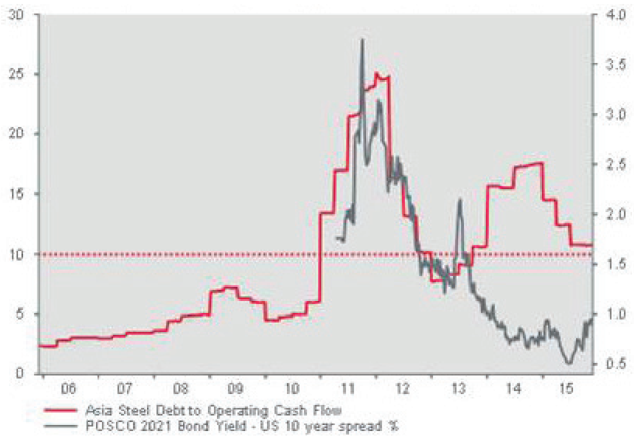
However, the slowdown in China's infrastructure growth over the past five years, the increase in capacity and in supply has crushed returns. The Asian steel sector return on equity is now -0.3% (Fig.2). At the same time, debt to operating cash flow sector is 11 times. That is, if the sector cut capital expenditure to zero, it would take 11 years to repay debt out of operating cash flow. Moreover, excess capacity is being kept alive by the low global cost of debt. For example, POSCO can still borrow at 1% over US Treasuries (Fig.3). Put simply, it is plausible that a large proportion of the sector is not solvent unless there is a miraculous recovery in steel prices and demand.

Fig.2. Asian Steel Sector, ROE, P/B and BV



Source: Thomson Reuters Datastream, as at 30 November 2015

Fig.3. Asia Streel debt to operating cash flow and POSCO spread



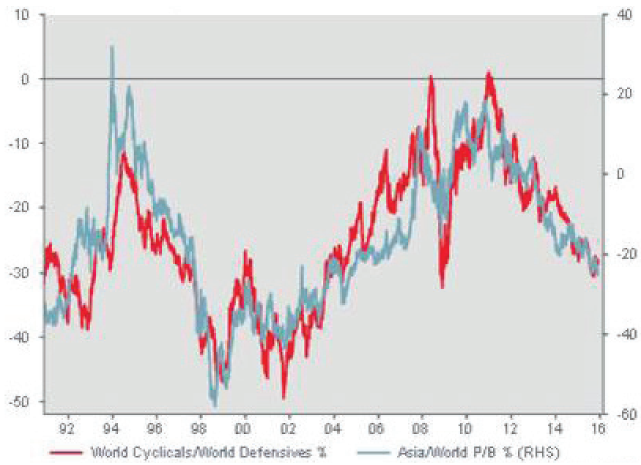
Source: Thomson Reuters Datastream, as at 1 December 2015

IN CONCLUSION

Asian steel companies trade at 0.6 times book. However, the book has expanded by 300% over the past 15 years when returns have been crushed. More broadly, the deterioration in returns in Asia and EM has been underway for five years. That suggests that it is a secular deterioration rather than a rapid and emotional shift in beliefs.

As I noted a few weeks ago, Asia and EM under performance is also probably connected or consistent with the underperformance of global cyclical stocks relative to defensive and value versus growth (Fig.4). While the valuation gap is compelling, mean reversion in trend returns has been challenged by the factors above. The good news is that we might be approaching the phase of the cycle where the deterioration in price becomes rapid and emotional and investors capitulate.

Fig.4. Global Cyclicals vs Defensive and Asia vs World P/B



Source: Thomson Reuters Datastream, as at 3 December 2015

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