Opportunities in Emerging Markets

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The U.S. stock market has significantly outperformed its global peers over the last decade. The table below compares the total annualized return of the S&P 500 to the MSCI All-country World Ex US (ACWI ex-USA) through February 2019. Over all time periods, the S&P 500 dominated, as shown below in Chart 1.

Chart 1. S&P 500 vs. MSCI ACWI ex-USA

	1 Year	3 Years	5 Years	10 Years
S&P 500	4.67%	15.27%	10.66%	16.67%
MSCI ACWI ex-USA	-6.46%	10.72%	2.50%	9.63%

Source: Bloomberg; ishares.com

There are many fundamental reasons that help to explain this outperformance:

- Superior U.S. corporate earnings growth.
- A higher mix of growth companies (Tech, Healthcare) relative to value companies in the S&P 500. Growth stocks in general have outperformed significantly, especially over the last few years.
- A dovish, market-friendly Federal Reserve.
- Lower sensitivity of U.S. firms to slowdowns in global growth and global trade. This applies more to the last year, especially with global trade being impacted by tariffs.

All of these fundamental factors are still in place, so it is unlikely that the S&P 500 will reverse its outperformance by the same degree anytime soon. That said, there are areas of the global stock market that look interesting from a valuation and fundamental perspective. One area where we see opportunity is in emerging markets (EMs).

Like the rest of the international markets, emerging markets have lagged the S&P 500 by a massive amount. Chart 2 below graphs the performance of iShares MSCI Emerging Markets Index (EEM), an ETF that holds all the stocks within the MSCI Emerging markets index, and the SPDR S&P 500 ETF (SPY) since 2011. SPY outgained EEM by 131% in cumulative returns, and EEM's cumulative price return was negative over that time period.

Chart 2. iShares MSCI Emerging Markets Index (EEM) vs. SPDR S&P 500 ETF (SPY) — Jan. 2011-Feb. 2019

Source: Bloomberg

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Chart 3 below shows that in the time period before 2011, the opposite occurred, but with even a larger magnitude of outperformance. From April 2003 (inception date of EEM) through 2010, EEM outgained SPY by 285% in cumulative returns!

Chart 3. iShares MSCI Emerging Markets Index (EEM) vs. SPDR S&P 500 ETF (SPY) — Apr. 2003 to Dec. 2010

Source: Bloomberg

We do not expect anywhere near this rate of outperformance for emerging markets going forward. But as the above chart shows, EMs are capable of long periods of consistent outperformance under certain macroeconomic environments. We expect EMs to be solid relative performers in the short and medium term for several reasons:

- Valuation: The MSCI Emerging Market Index (MXEF) trades at a P/E of 12.42x for 2019 earnings estimates. This is considerably cheaper than the S&P 500's P/E of 16.94.

- Stable USD and interest rates: One of the main reasons for the poor performance of EM last year was the strong USD and climbing interest rates. Most emerging market countries are vulnerable to both these factors due primarily to their externally financed debt. Thus, EM usually lags when the dollar is strong and rates are increasing. Rates and the USD are expected to be much more benign this year due to the extremely dovish pivot the Federal Reserve has taken since January. This is a positive backdrop for EM.

- Strong EPS growth: Earning per share growth for EM is expected to be higher than both the S&P 500 and MSCI Europe.

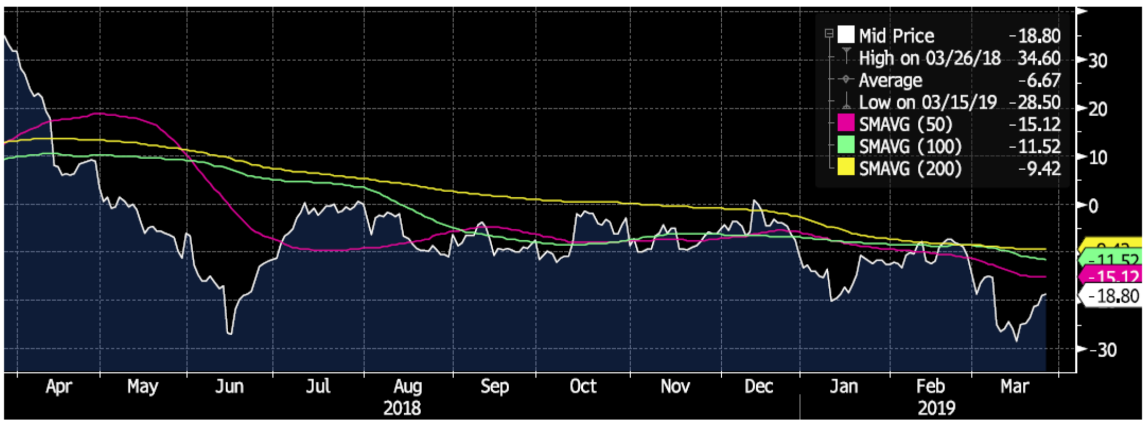
- Potential improvement in China: China is a very large part of EM, and, until very recently, its stock market performance has been very poor. A China-US trade deal, and/or signs that the government's recent stimulus is helping economic activity, would be big boosts to the Chinese stock market.

- Emerging market currencies should be stable in 2019 after a volatile 2018. All EM currencies depreciated against USD last year, which hurt total returns for U.S. investors. The biggest decliners were the Argentina Peso at -49% and the Turkish Lira at -24%. While they are not meaningful parts of the EM index, nevertheless, their sharp declines surely lowered sentiment and raised fears for the entire emerging markets asset class.

Not everything in the current market environment is bullish for EM. As stated previously, global growth prospects have been declining over the last 12 months. The global manufacturing PMI has declined 10 consecutive months (through Feb'19). Global growth estimates continue to be lowered. Emerging markets are more sensitive to global growth prospects than the S&P 500. Therefore, unless global growth improves, the current macroeconomic environment will continue to be a headwind for EMs.

Economic data for emerging markets has not been very strong of late. The Citi Economic Surprise Index (CESI) for emerging markets is shown below in Chart 4. It measures the degree to which economic data comes in ahead of or behind expectations. To be fair, the CESI for the U.S., Europe, and Japan are all more negative than that of the EMs.

Chart 4. Citi Economic Surprise Index (CESI)



Source: Bloomberg

MSCI EM Index Country Weights:

The MSCI Emerging Markets Index is the main index for emerging markets. On Feb 28th of this year, a few changes were announced to the index that will be implemented in three steps (June, Sept, and Dec of this year). Saudi Arabia and Argentina will be added to the index, and the weight for the China A-shares (these are shares that trade on the domestic Shanghai and Shenzhen stock exchanges) will increase.

China:

With the recent index change, Chinese stocks will constitute approximately 33.12% of the MSCI EM index by Dec'19 compared to a current weight of 32.38%. One could also include Taiwan stocks into this group, since Taiwanese stocks have a high correlation to Chinese stocks, and the Taiwanese economy is deeply integrated with China. In this case, the total weight would be over 43% by Dec'19. Clearly, China has the biggest direct impact on the EM index. The overall impact is even larger because the economic growth of many EM countries is dependent on their trade with China.

The Chinese stock market (Shanghai Composite Index) was one of the worst performers in 2018, returning -22.44%. This was primarily due to the U.S. – China trade war and the economic slowdown in China that started even before the trade war. This year, the market has rebounded nicely, and is up +20.10% YTD through 3/28/19. The breadth of the market has been impressive as well (roughly 98% of stocks trading above their 50 day moving average) – the highest in almost 4 years. The index still trades at an attractive valuation, with a P/E ratio of 11.19 (on estimated 2019 earnings).

Whether or not China and the U.S. can agree on a trade deal obviously will have a huge impact on Chinese stocks. The probability of a deal getting done has increased over the last couple of months, and this has been the primary driver of Chinese stock's superior returns. But it still remains to be seen if a deal does get done and if so, how comprehensive the agreement is.

What might be even more important than a trade deal for Chinese stocks is whether or not the recent economic stimulus provided by the government will prove effective. Due to concerns over too much debt, the Chinese government decided to deleverage the economy and sacrifice some economic growth. This proved effective as Debt/GDP flattened in 2017 and dipped slightly in 2018.

However, the impact to economic growth and corporate earnings has been more severe than expected. Last year, GDP growth declined to 6.6%[1], and most other economic indicators also deteriorated. China just lowered their GDP growth target for 2019 to 6.0% - 6.5%. Corporate defaults reached a record high in 2018. Small private companies were impacted the most because of the restrictions placed on shadow financing.

The Chinese government started introducing stimulus about 6-9 months ago, but it has been more incremental in nature than previous stimulus programs in 2008-09 and 2015-16. Previous wholesale stimulus programs included enormous infrastructure spending and interest rate cuts. These actions resulted in large increases in credit growth and economic activity. This time around, it has been more about tax cuts, RRR (reserve required ratio) cuts, and directives to banks to lend more to private companies. Until very recently, it didn't seem that these measure were having any positive impact on the economy. The government continues to add incremental measures, and its focus has clearly shifted back to economic growth over deleveraging.

Recently, there are some signs that the stimulus is having an impact. The Chinese Credit Impulse Index (see Chart 6 below), which measures the amount of credit that has been created as a percentage of GDP over the past twelve months, has picked up. Historically, this index has been a good forward indicator of China's future growth trajectory.

Chart 6. Chinese Credit Impulse Index

Source: Bloomberg

Bank loans for the combined first two months of the year were better than expected. Also, shadow financing rose for the first in 11 months in January. Wealth management and new trust product launches spiked in January. This is important financing for small and medium companies so it is welcomed news.

Another encouraging data point is the Caixin China manufacturing PMI, which increased to 49.9 in February from 48.3 last month. More confirmation is needed before we can say that the stimulus is boosting the economy, but the most recent indicators are encouraging.

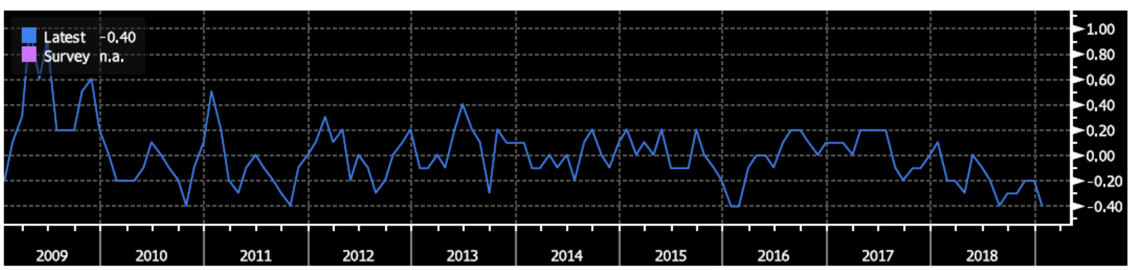
The longer-term implications of this shift from deleveraging to stimulus are not positive. With total debt/GDP over 250%, China can't continually rely on credit growth to stimulate the economy. At some point in the future, there is the risk that the credit bubble will pop. When and how likely this is to happen is a discussion for another day. But, in the short and medium term, the current stimulus is likely to have a positive impact on the Chinese economy and Chinese stocks.

Korea:

The second largest weight in the MSCI EM Index is South Korea at 13.15%. Korea is the cheapest of the major EM indices, trading at a P/E of only 11.12. Korea almost always trades at a discount, primarily due to corporate governance issues and also because its index is made up of more cyclical companies than most other countries. Samsung alone comprises 21.7% of the index.

The Korean stock market has been a laggard of late, with a 12 month return of -10.03% (through 3/28/19). The downturn in global growth and global trade has had an outsized impact on Korean stocks. As of yet, there are few signs of a pickup in the Korean economy. Its manufacturing PMI continues to drop. Also, the South Korea Cyclical Component of Leading Index is negative and trending the wrong way, as depicted in Chart 7 below:

Chart 7. South Korea Cyclical Component of Leading Index



Source: Bloomberg

However, if global growth can stabilize, the Korean market is poised for strong returns due to its cyclical exposure and its very low valuation.

India:

India makes up 9.12% of the MSCI EM Index. Year-to-date, the S&P BSE Sensex 30 (Bombay Stock Exchange) has lagged most other emerging markets, although it has had a strong month of March. Uncertainty over the general election to be held in April-May has had an impact. The Indian market has also been hurt by the default of IL&FS, a large infrastructure lending company, last September. This, along with the overall bad loan problems at the state banks, has been a weight on the market.

Despite this, India's economy has grown faster of late than any other sizable emerging market. Since Prime Minister Narendra Modi came to power in 2014, GDP growth has averaged roughly 7%[2]. Modi has also been successful in reducing corruption and red tape. India has risen 65 spots in the World Bank's ranking of the ease of doing business since 2014.

Longer-term, India looks very promising. It is the largest democracy in the world. Its demographics compare favorably to China, as its working population will continue to grow and the portion of its population above 64 years old is only 6%. There are also significant opportunities for improvement in infrastructure and productivity.

Brazil:

The last of the large weights in the MSCI EM Index is Brazil at 7.26%. The Ibovespa (the main Brazilian index) has outperformed all other large EMs over the last 12 months with a return of +13.05% (through 3/28/19). The market benefited from the election of Jair Bolsonaro last October. The naming of Paulo Guedes, a market friendly modernizer, as economic minister was also a huge boost for market sentiment.

Brazil was in a deep recession from 2014-2016 where the cumulative loss of GDP was 7.4%[3]. The recovery since has been U-shaped rather than the typical V-shaped recovery. Inflation has dipped of late, so there is the prospects of lower interest rates that could help boost economic growth. Commodity exports is a meaningful part of the Brazilian economy, so the recent boost in commodity prices is positive.

President Bolsonaro ran on the promise of reducing crime and corruption – two issues that have plagued Brazil for years. Prospects look favorable for improvements in both areas. The other main issue that the markets are focused on is pension reform. The current pension system is unsustainable, with the average Brazilian beginning to draw a pension in their mid-50s. Previous attempts at reform have failed, but the current proposal has a decent chance of passing – with some changes from Congress. Passing meaningful pension reform would be a big boost to market and economic optimism.

Summary:

Emerging market stocks look interesting at current levels due to attractive relative valuations and the prospects of improved fundamentals. Volatility is always higher relative to the S&P 500, so EMs should not be a very large portion of an overall portfolio. Nevertheless, a small portion of EM equities makes sense in a portfolio for the possibility that it reverses some of the extreme relative underperformance over the last 8 years and also for the diversification benefits.

Note: Performance/quantitative data throughout the body of the paper is sourced from Bloomberg, with the exception of the country weights sourced from ishares.com (as of 3/26/2019).

[1] *Tradingeconomics.com*
[2] *Ibid*
[3] *Economic Commission for Latin American and the Caribbean (ECLAC)*

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