Perspectives

SEPT
2018

Emerging Markets Equity — Reason for Concern?

After a strong 2017, emerging markets ("EM") equities have struggled to keep pace with their U.S. counterparts in 2018.

Year-to-date through August 31, 2018, the MSCI Emerging Markets equity index has underperformed the S&P 500 by 17.1%. EM equities gave up an 8.3% gain in January with a streak of weakness from February through August.

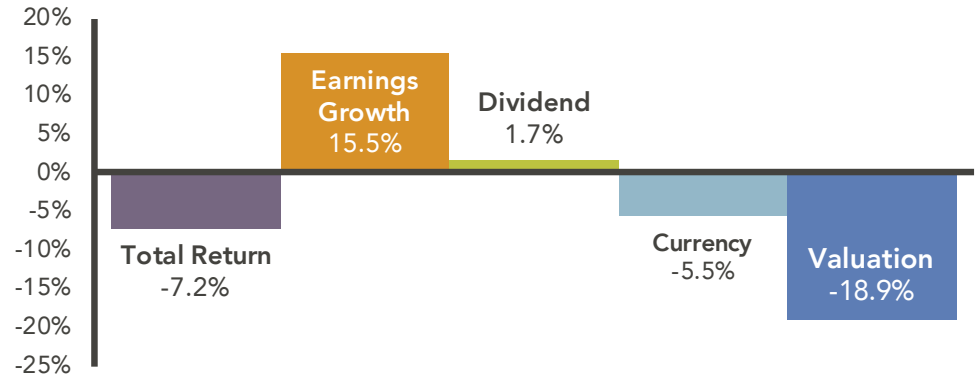
Exhibit 1: Performance of EM vs. U.S.

	MTD Return (%)	YTD Return (%)
S&P 500	+3.3	+9.9
MSCI Emerging Markets	-2.7	-7.2

Source: Bloomberg as of August 31, 2018

Decomposing the YTD return, the losses can be attributed to two things: currency and multiple contraction (downward price movement). Earnings growth and dividends have remained positive in 2018.

Exhibit 2: YTD Return Decomposition for EM Equity



Source: Bloomberg

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While the return discrepancies between EM and the U.S. may lead some investors to run for the exits, there are reasons to believe that a further sell-off in emerging markets may not be warranted, and we encourage investors to take a closer look at the underlying macroeconomic issues behind the underperformance. We believe there are three primary concerns which have fueled this year's market downturn:

- Strengthening of the U.S. dollar
- U.S./China trade conflict
- Turkey's monetary policy and possibility of contagion

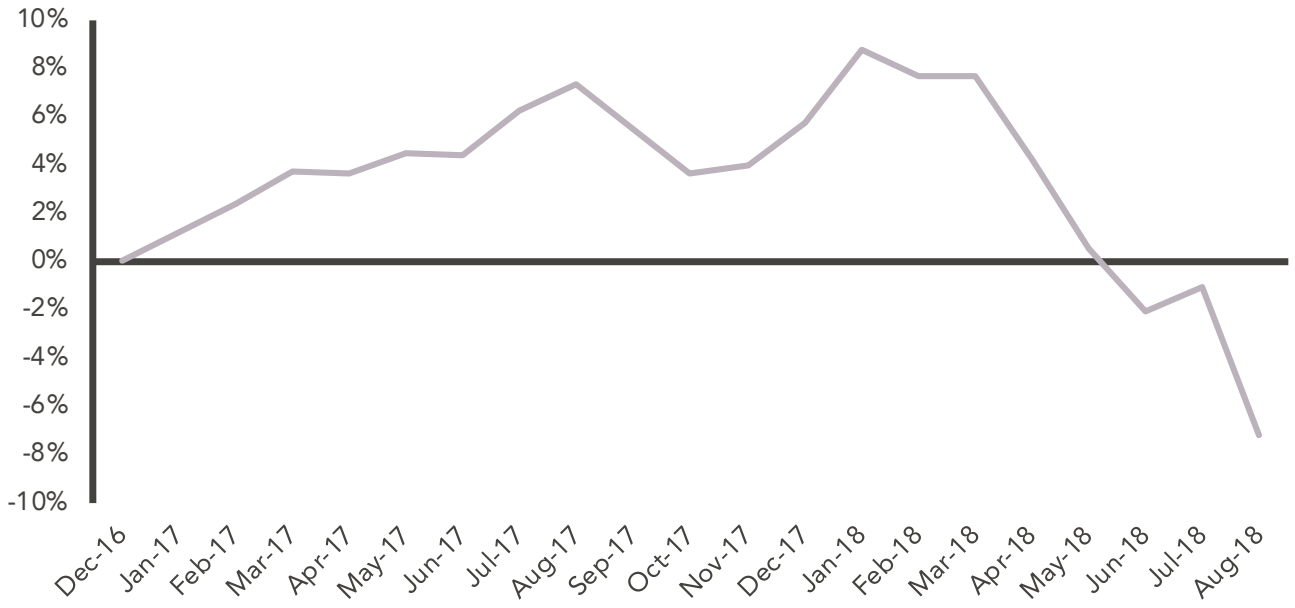
The remainder of this newsletter will address each of these three issues and provide a comparison to the Taper Tantrum of 2013, as well as our outlook for EM equities.

STRONG DOLLAR

For U.S.-based investors, an EM investment requires conversion of dollars to the local country currency. Performance calculations require a conversion back to U.S. dollars, and as such, weak EM currency leads to a lower total return. After a decline in 2017, the U.S. dollar has appreciated in 2018. The dollar rally has been aided in part by gradual tightening of U.S. monetary policy and the rising Fed Funds rate. The dollar has also benefitted from the Tax Cuts and Jobs Act of 2017 and Bipartisan Budget Act of 2018. These pro-cyclical fiscal policies have been a key factor in boosting U.S. economic growth, with first and second quarter GDP increasing by 2.2% and 4.1% respectively.

The current surge in the dollar, increasing U.S. interest rates, and some idiosyncratic macro issues in select emerging countries have caused a sell-off in EM currencies, as global investors have started shifting their capital away from emerging markets and towards the U.S. From the end of January 2018 to August 2018, the JPM EM Currency Index declined by 14.7%, predominately driven by currency declines in a handful of large current account deficit EM countries.

Exhibit 3: JP Morgan EM Currency Index Performance January 2017 – August 2018



Source: Bloomberg

TARIFFS & SANCTIONS

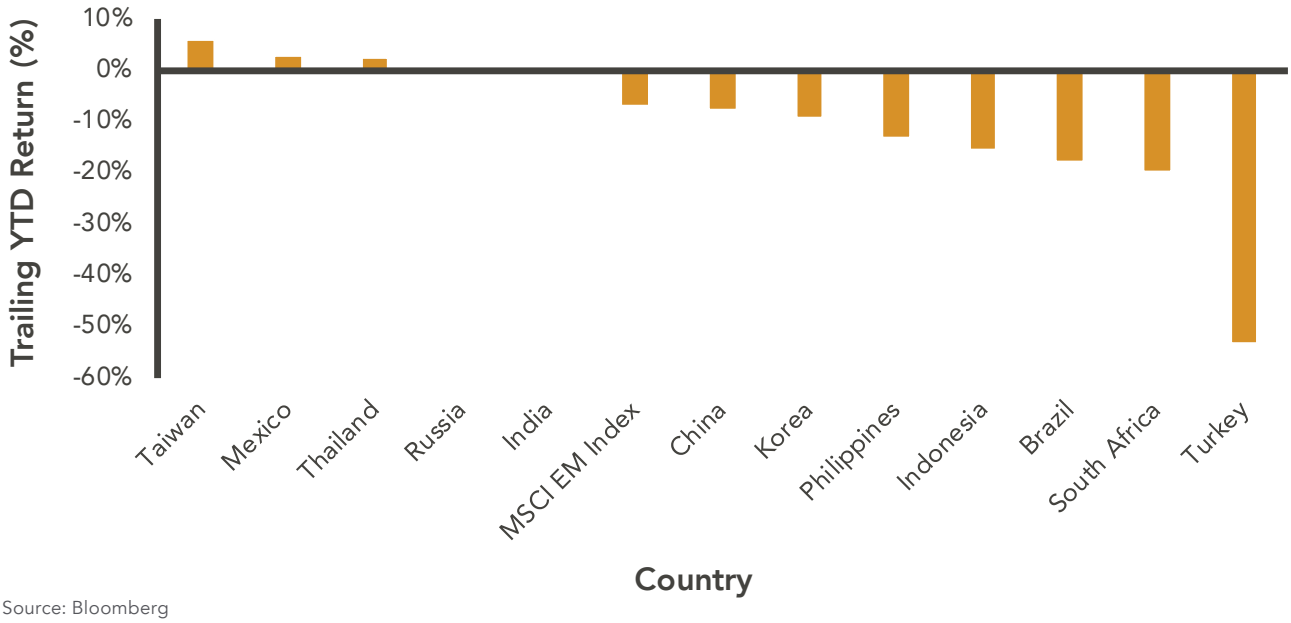
The current U.S. administration has demonstrated a significant deviation in foreign policy from its predecessors, particularly with respect to greater usage of trade tariffs and sanctions against major trading partners. A significant focus and headwind for EM has been the tough posturing and barrage of tariffs between U.S. and China. As detailed in our July 2018 *Perspectives*, further escalation in trade tariffs between the U.S. and China will increase market volatility for international equities in the near-term. Continued tit-for-tat tariff escalation will cause both the Chinese and U.S. economies to suffer, as China's exports to the U.S. constitute a significant portion of its GDP and inflation in the U.S. could rise due to higher prices of imported goods caused by the U.S.-imposed tariffs.

Given that the primary target of U.S. protectionist tariffs is China, the overall effect of the U.S.-China trade tensions should be limited for the other investable EM countries. While China accounts for a large share of EM in GDP terms, China trades more with developed countries and only accounts for 8% of EM trade.[1] Furthermore, China's economy benefits from a growing domestic demand and reforms in place that reduce its reliance on trade as a basis for growth.

TURKEY & CONTAGION

On August 13th, the Turkish lira hit a record low against the U.S. dollar, down over 35% for the year. The Turkish economy is plagued by double-digit inflation due to increasing oil prices, which is the country's largest import. Yet, its central bank has refused to raise interest rates and the government has yet to develop an economic plan to address the current account deficit. Adding an additional layer of uncertainty are recent diplomatic quarrels with the U.S. and subsequent U.S.-imposed sanctions, which sent further shocks into the market.

Exhibit 4: Select EM Country Returns Year-To-Date Through August 31, 2018



Source: Bloomberg

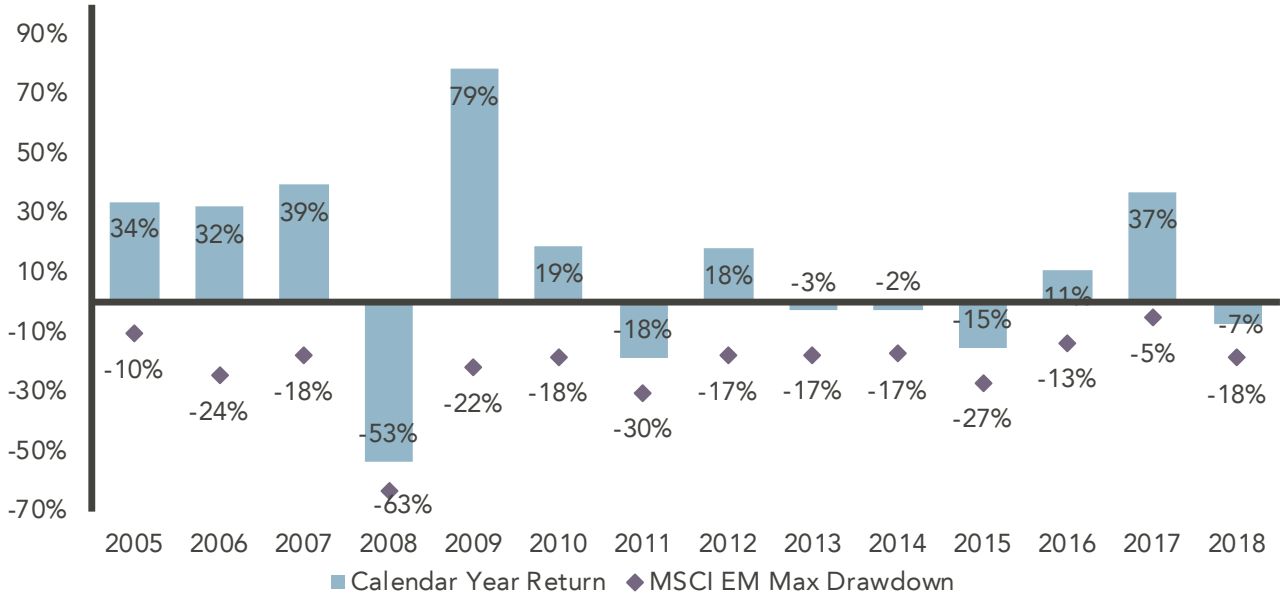
As such, investors are reasonably leery of Turkey's future, and we have seen considerable downward pressure on Turkish equities, which have posted a YTD return of -53.4%. Will Turkey's challenges spread to other EM countries? Not likely. While Turkey may be heading into recessionary territory with further expected declines in its currency, Turkey's turmoil is predominately self-inflicted, and as such, will have limited impact

on other emerging market countries. Additionally, investors should note that Turkey constitutes less than 1% of the MSCI Emerging Markets Equity Index.[2]

COMPARISON TO TAPER TANTRUM

On the surface, there are similarities between the current EM environment and the 2013–2015 Taper Tantrum. As U.S. interest rates rose and the dollar strengthened in response to Fed tapering, EM currencies declined and global investors shifted capital away from EM countries. The Fragile Five nations — Brazil, India, South Africa, Turkey and Indonesia — were under pressure to establish economic reforms necessary to slow inflation and reduce their current account deficits, which were heavily dependent on foreign capital. From 2013 to 2015, MSCI Emerging Markets calendar year returns were negative, with max drawdowns of 17% each year. It is worth noting that indices can feature significant max drawdowns but still end up with a strong return calendar year, as shown in Exhibit 5.

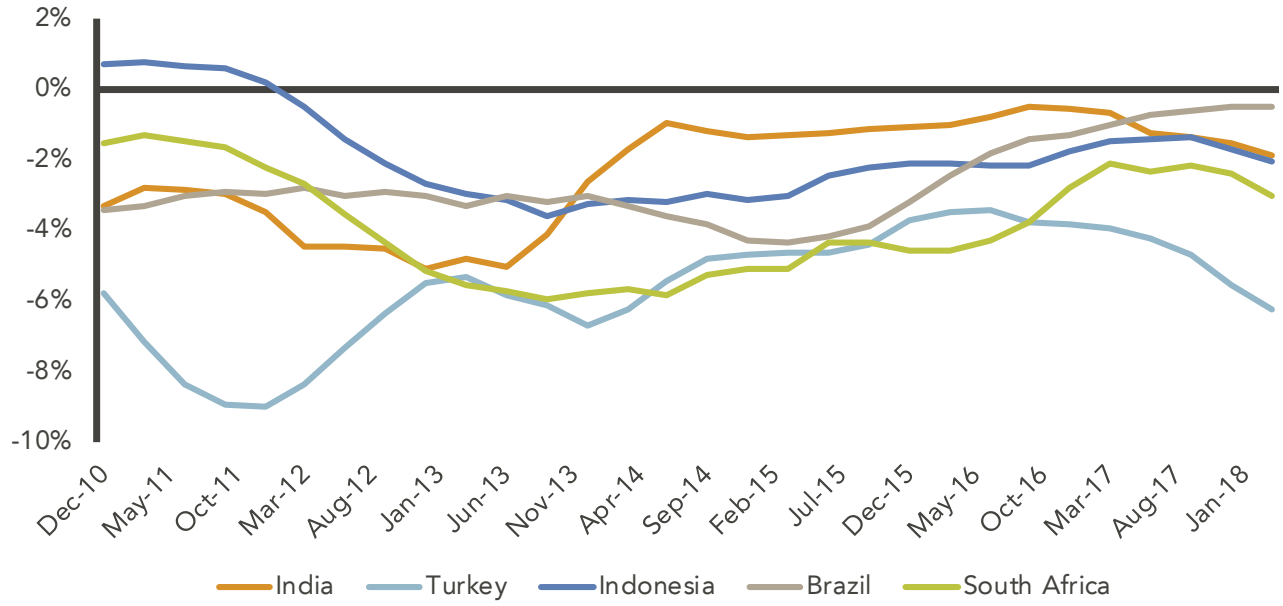
Exhibit 5: EM Calendar Year Returns and Max Drawdown



Source: Bloomberg

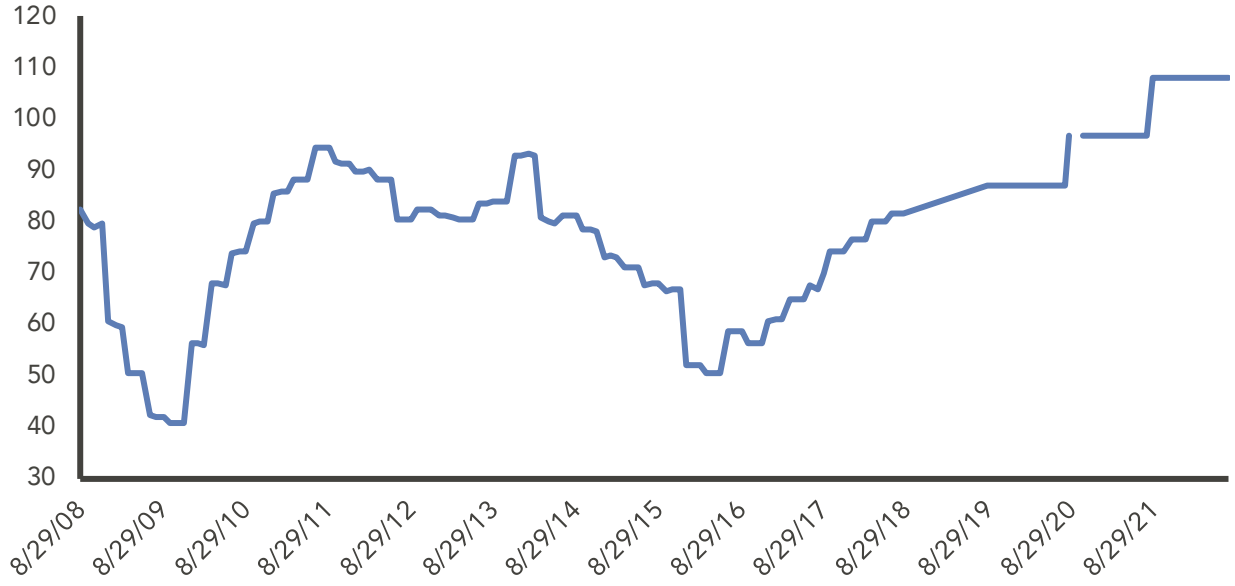
However, there are key structural differences between the Taper Tantrum and today's EM environment. To begin with, the macroeconomic conditions for EM are much better. Inflation has been moderate in most EM countries, with many reporting high real yields and declining current account deficits. India, Indonesia, Brazil, and South Africa all have lower inflation rates today; Turkey has been the only "Fragile Five" country to take a hard tumble. Additionally, the earnings cycle has improved since 2013, with EM earnings growth expected to be in the double digits over the next two years.

Exhibit 6: Current Account Balance as a Percent of GDP for Fragile Five



Source: Bloomberg as of March 31, 2018

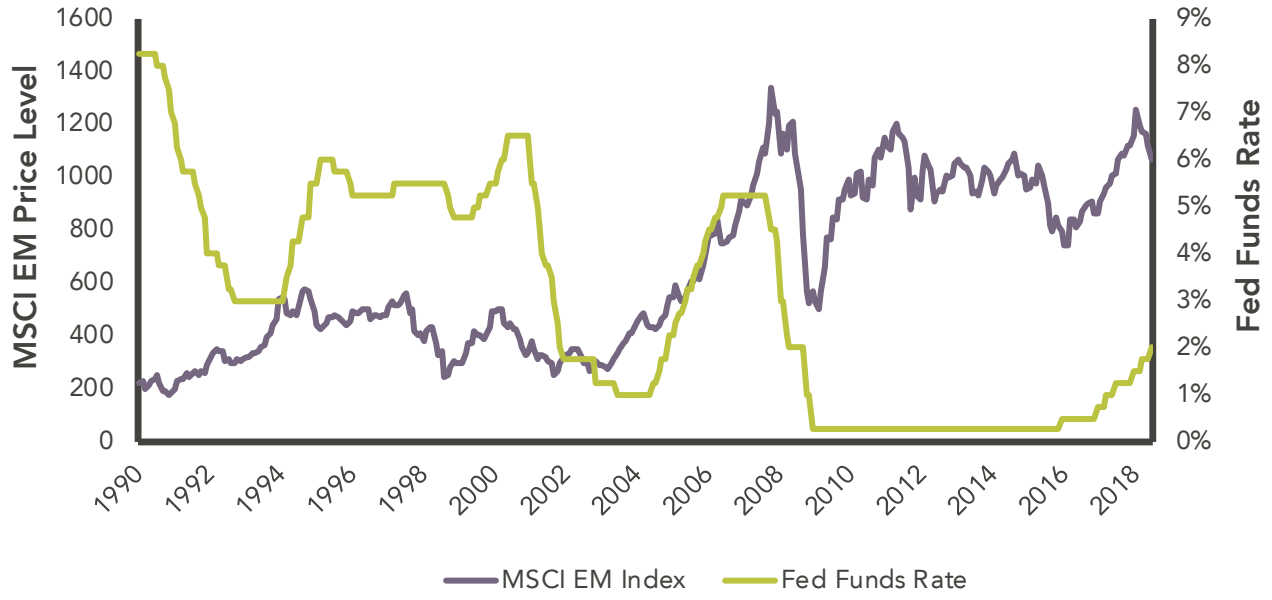
Exhibit 7: MSCI EM Earnings Per Share History and Projections



Source: Bloomberg

An additional concern for many investors is how rising rates in the U.S. could negatively impact EM equity returns. Perhaps surprisingly, historical data suggests that rising rates have not meant doom for EM equities. As an example, between June 2004 and June 2006, the Fed Funds Rate moved from 1.0% to 5.3%. During that time, annualized emerging markets equity returns were 30.2%. Certainly, there are other variables that can influence EM returns such as earnings growth, valuations, and other macro-economic data. Generally speaking, though, a rise in U.S. interest rates signals a stable if not strong growth environment, and emerging markets typically benefit from strong global growth.

Exhibit 8: EM Equity Performance In Rising Rate Environments



Source: Bloomberg

CONCLUSION

After a strong 2017, emerging markets have struggled year-to-date in 2018, and big swings in performance are common for this asset class. Despite the poor performance, EM broadly remains on strong footing with double digit earnings growth and a positive economic outlook. With the recent sell-off, valuations have become more attractive and this may present a compelling rebalancing opportunity for investors. The long-term investment case for emerging markets centers on growth and diversification, with investors looking to capitalize on the favorable demographics, urbanization trend, and expansion of the middle class consumer. We believe this long-term case remains intact.

NOTES

[1] Dehn, Jan. 25 June 2018. "How will Trump's Trade War with China impact EM FX and rates?" Ashmore Investment Limited. http://www.ashmoregroup.com/insights/research/how-will-trump's-trade-war-china-impact-em-fx-and-rates

[2] As of June 30, 2018.

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