ACADIAN

PERSPECTIVES

VIEWPOINTS FROM THE ACADIAN TEAM

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EMERGING MARKETS—SUBMERGING AGAIN?

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- **Investors in emerging equities are increasingly worried by rising U.S. interest rates, escalating trade wars, an appreciating dollar, slowing global growth, and high levels of dollar-denominated debt, all of which have contributed to weak year-to-date performance.**
- **While some emerging economies may be negatively impacted by recent conditions, we find reason to believe that, as a whole, emerging markets are better insulated from these risks than is generally perceived.**
- **In addition, emerging equities are trading at a discount to their long-term valuations, and well below the valuations of developed regions, especially the U.S.**

INTRODUCTION

In August of 1998, Russia devalued the ruble and defaulted on its debt. This was the culmination of a series of economic setbacks for emerging markets (EM) that took place during the mid- and late-1990s. But even before the problems with Russia, the term "submerging markets" was beginning to appear. By the early 1990s, these countries had begun to attract widespread investor attention due to their promising prospects. Thus the term "submerging" reflected disappointment at the poor equity returns following these crises. In the year to date through August, emerging equities have slumped nearly 8% in U.S. dollar terms. Increasing U.S. interest rates, an escalating trade war between China and the U.S., an appreciating dollar, an economic crisis in Turkey, and political problems elsewhere are beginning to resemble the crises of the 1990s. So are emerging markets again ready to "submerge?" While the challenges facing EM countries are not trivial, we believe they are more nuanced than headlines suggest, and that recent market volatility presents attractive opportunities for active management.

RECENT EMERGING MARKET PERFORMANCE

In 2017, the MSCI Emerging Markets equity index returned over 35% in U.S. dollar terms. This followed a strong 11% gain in 2016, which brought the index to record levels (Figure 1). These returns handily exceeded those of the MSCI World index of developed markets in both years, so some technical correction could be warranted. However, the extent of the correction year-to-date is worrying to a number of investors, particularly given uncertainty regarding certain aspects of the global economic and political backdrop. In the following sections we address several sources of this uncertainty, discuss how the implications for individual EM countries may vary, and highlight reasons for optimism regarding EM going forward.

RISING U.S. INTEREST RATES

There is a widespread perception that emerging economies are heavily dependent on investment flows from the U.S. to sustain their economic growth. If true, these flows could stop or reverse as U.S. interest rates rise, which could potentially lead to a significant curtailment of EM growth and equity market returns. While this description applies to several markets, such as Turkey, this scenario does not apply universally across emerging markets. In fact, over the last 30 years, whenever the 2-year U.S. Treasury yield rose by 25bps or more in a quarter, the MSCI EM index enjoyed above-average returns. Conversely, when U.S. rates decreased during a quarter, EM equities had poorer returns (Figure 2).

One interpretation of this data is that the fortunes of emerging markets depend at least partially on global growth. Further, we acknowledge that rising interest rates generally reflect strengthening economic conditions. Given that the Federal Reserve's current campaign of interest rate increases is being driven by strong growth in the U.S., this trend could be viewed as a positive for emerging markets.

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FIGURE 1: MSCI EMERGING MARKETS INDEX, IN USD, GROSS DIVIDENDS

Source: MSCI. For illustrative purposes only. It is not possible to invest directly in any index. Reference to the benchmark is for comparative purposes only. Investors have the opportunity for losses as well as profits. Past performance is no guarantee of future returns. Data source: MSCI. Index Source: MSCI Copyright MSCI 2018. All Rights Reserved. Unpublished. PROPRIETARY TO MSCI.

FIGURE 2: AVERAGE 3-MONTH EMERGING EQUITY RETURN

	Average 3-Month Return	Observations
Full Period	3.2%	366
Increasing U.S. Rates*	7.8%	96
Decreasing U.S. Rates*	-1.8%	94

*25bps or greater 3-month increase/decrease in 2-year U.S. Treasury yields

Source: MSCI, Federal Reserve Economic Data. For illustrative purposes only. It is not possible to invest directly in any index. Reference to the benchmark is for comparative purposes only. Investors have the opportunity for losses as well as profits. Past performance is no guarantee of future returns. Data source: MSCI. Index Source: MSCI Copyright MSCI 2018. All Rights Reserved. Unpublished. PROPRIETARY TO MSCI.

ESCALATING TRADE WARS

For much of the period since 1985, trade has increased as a proportion of world GDP (Figure 3). Beginning in May 2018, the U.S. initiated tariffs on a range of raw materials and finished products imported from trading partners including Canada, Germany, and China. So, will a drop in global trade disproportionally harm emerging economies? In reality, trade as a percent of world GDP has been in decline for the last decade. There are several reasons for this, including sluggish global growth following the 2008 financial crisis and a shift towards more domestic growth within emerging countries. Over the same time period, trade as a percent of GDP among emerging countries has varied, with many major emerging economies now with trade levels below that of the world average. For example, China's trade as a percent of GDP was 38% in 2017, down from its peak of 64% in 2006 and well below the current global average of 56%. This decline has been driven by a greater focus on domestic consumption. Although Chinese equities have lagged YTD, they have returned 6.7% annually over the last decade, handily outperforming the MSCI EM index and most developed markets. So declining trade as a percent of GDP is not necessarily associated with weaker economic growth or poorer equity performance.

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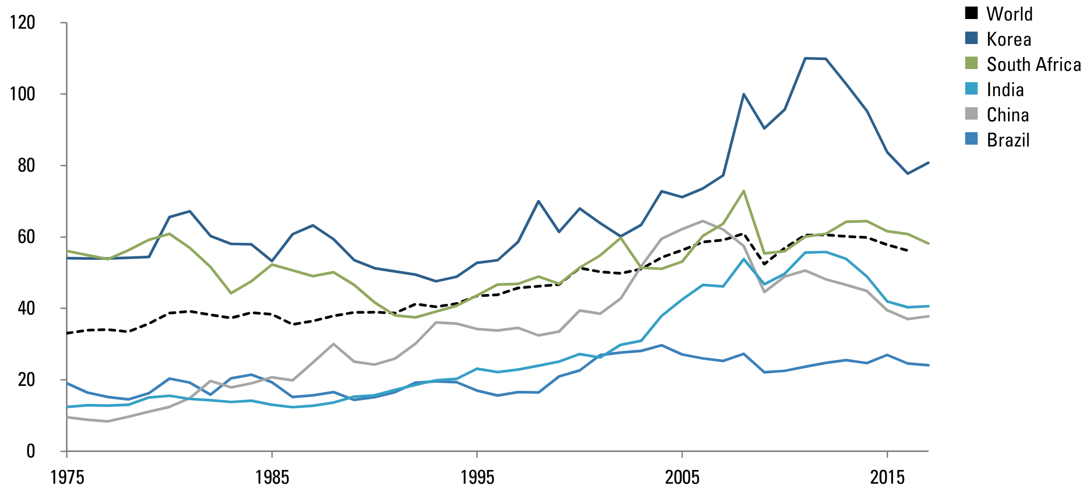
FIGURE 3: TRADE AS A PERCENTAGE OF WORLD AND COUNTRY GDP



Source: The World Bank-World Development Indicators. For illustrative purposes only.

FIGURE 4: TRADE WEIGHTED U.S. DOLLAR INDEX

Source: Federal Reserve Economic Data. For illustrative purposes only.

This is not to say that the escalating global tariffs and trade restrictions should be brushed off. Tariffs act as a tax, both within a supply chain and to end consumers, leading to depressed demand. If tariffs persist or increase, they could negatively impact economic activity and equity prices worldwide. However, this impact is likely to vary among EM countries—and individual companies within those countries.

STRENGTHENING U.S. DOLLAR

The U.S. dollar has been rising strongly in recent months after losing ground to most currencies in 2017 (Figure 4). This has depressed the value of assets and earnings denominated in other currencies to U.S.-based investors.

Of the 8% decline in the MSCI EM index since January 1, over 5% has come from dollar appreciation. Although painful for investors during its rise, a stronger U.S. dollar presents a longer-term opportunity for emerging markets. A strong dollar makes imports cheaper for U.S. consumers, boosting exports and earnings from other markets. And cheaper EM currencies partially reverse the impact of recent tariff increases. In addition, currencies often exhibit some degree of mean reversion, so the recent rise of the dollar may reverse in the future, delivering further gains from EM assets for U.S.-based investors. Currently the U.S. dollar is near its long-term peak on a trade-weighted basis.

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TOO MUCH DEBT?

Global debt recently surpassed (USD)$164 trillion, a record level. This increase has come from issuance on the part of both advanced and developing economies, driven by a decade of low interest rates and expansionary central bank policies. In the U.S., for example, non-financial borrowing has surpassed $48 trillion, a near-50% increase over the last 10 years and now exceeding 250% of GDP. Emerging markets have not been immune to this trend, and, to varying degrees, EM countries have taken advantage of lower U.S. interest rates to borrow in dollars. However, the recent appreciation of the dollar has made this debt harder for emerging market governments and corporations to service. The extent of this problem varies materially across markets (Figure 5). Countries with the highest dollar debt to GDP include Chile, Mexico, and Turkey, which have seen U.S. dollar debt increase significantly over the last 10 years. In contrast, other major emerging economies have considerably lower exposure. Nearly all have increased their U.S. dollar debt over this period, but most still total less than 15% of GDP. While the ability to manage dollar-denominated debt depends on a range of factors, including currency reserves, type and duration of the debt and export levels, not all emerging markets countries are similarly exposed to this risk.

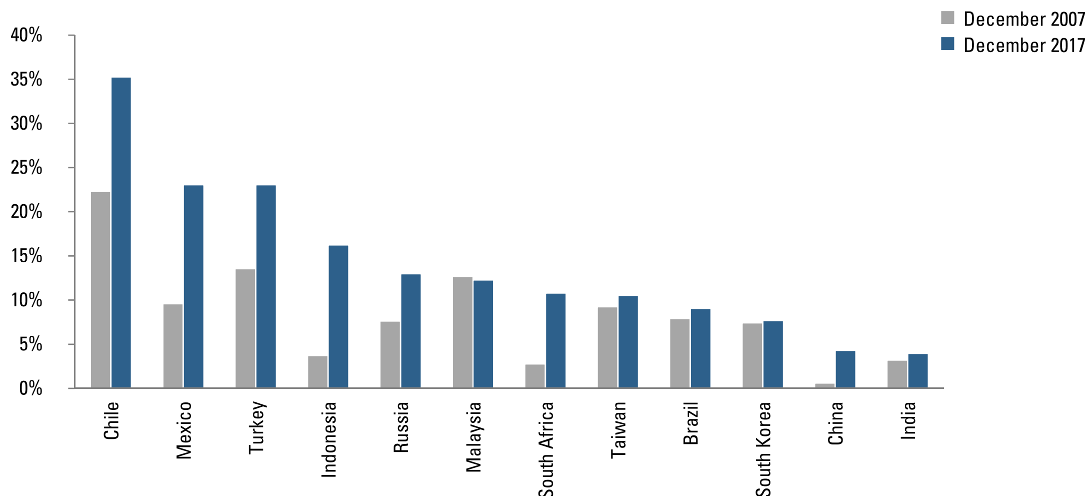
EM ECONOMIES ARE STILL EXPECTED TO OUTPACE DEVELOPED MARKETS

The July 2018 IMF World Economic Outlook raised a number of concerns, including escalating trade tensions, higher U.S. yields, and uneven economic growth across the globe. Despite these issues, the IMF's latest GDP growth projection for advanced economies is still a respectable 2.4% for 2018, slowing to 2.2% for 2019. This decline in growth expectations is partly due to higher inflation in the U.S. and political uncertainty in Europe. For emerging and developing economies, the IMF forecasts growth of 4.9% in 2018, accelerating to 5.1% in 2019, driven in part by higher domestic demand in markets such as India. These forecasts are counter to the view that growth is slowing among the emerging economies. Even if the acceleration of EM growth were to slow, overall growth rates are still forecast to be more than double those in the developed world.

EM EQUITIES ARE ATTRACTIVELY PRICED

The MSCI USA index has a trailing 12-month Price/Earnings ratio of 23, which represents a 24% premium versus its average P/E of 18 since 1995. In contrast, emerging equities currently trade at a modest discount to their historical valuations. The MSCI EM index is currently priced at 14 times earnings, versus a long-term average of 15. Versus other regions, current emerging market equity valuations are even more compelling. Figure 6 shows the U.S. versus EM Price/Earnings premium. This premium is currently above 60%, a level only occasionally—and temporarily—exceeded over the last two decades, and well above the long-term premium average of 35%.

FIGURE 5: US DOLLAR DEBT FOR NON-FINANCIAL BORROWERS TO GDP



Source: Bank for International Settlements, World Bank. For illustrative purposes only.

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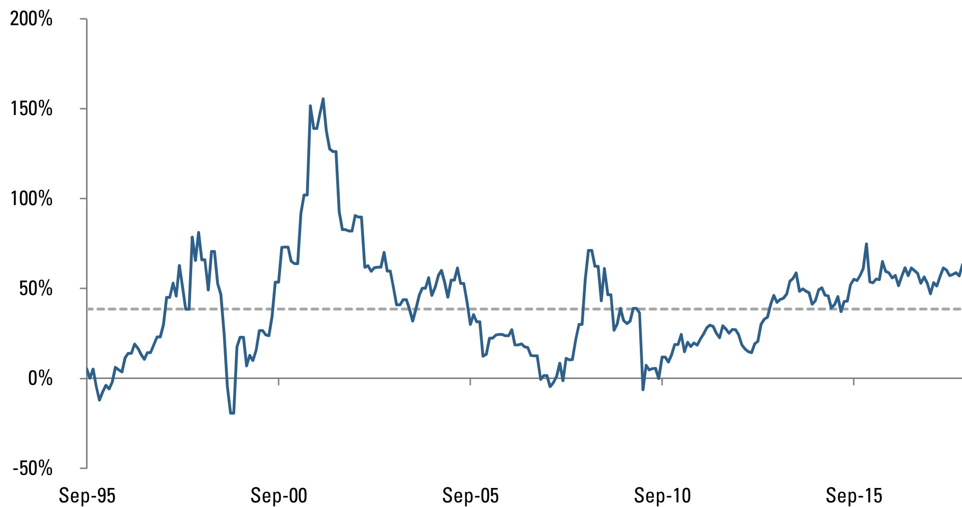
FIGURE 6: MSCI U.S.A. PRICE/EARNINGS PREMIUM VERSUS MSCI EMERGING MARKETS



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CONCLUSION

There is a range of risks that could impact returns not just for emerging markets, but for equities globally. These include higher U.S. interest rates, a stronger dollar, escalating trade wars, and high levels of dollar-denominated debt. However, the impact of these risks is likely to vary among individual EM countries and companies, leading to attractive stock and market selection opportunities. In addition, emerging markets are attractively valued versus stocks elsewhere in the world, especially in comparison to the U.S.

As most investors know, prices often over- or undershoot their longer-term fundamentals. Contagion effects, where investors extrapolate the difficulties of one market to others perceived—correctly or not—as similar, exacerbate the overreaction of pricing of an asset class. But prices typically adjust to more reasonable levels over time. For example, after reaching a five-year trough immediately following Russia's default in 1998, the EM index gained over 70% in the following 12 months. Although we are not likely to see such performance from current prices, the evidence suggests that emerging markets will continue to offer compelling investment opportunities.

BIOGRAPHY

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Brian joined Acadian in 1990. Prior to his current role as Senior Portfolio Manager, he served as director of Portfolio Management, overseeing portfolio management policy as well as co-director of Research, responsible for developing and applying investment techniques to evaluate markets and securities. Before joining Acadian, Brian worked in systems planning at Bank of New England and as a senior systems analyst at Mars Incorporated. Brian obtained an M.S. in management from MIT and a B.S. in accounting from Lehigh University. He is a CFA charterholder and a member of CFA Society Boston.

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