UNCOMMON SENSE

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Summer Swoon?
There's Emerging Opportunity in August Waves

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> August, the summer's last messenger of misery, is a hollow actor.
> — Henry Rollins

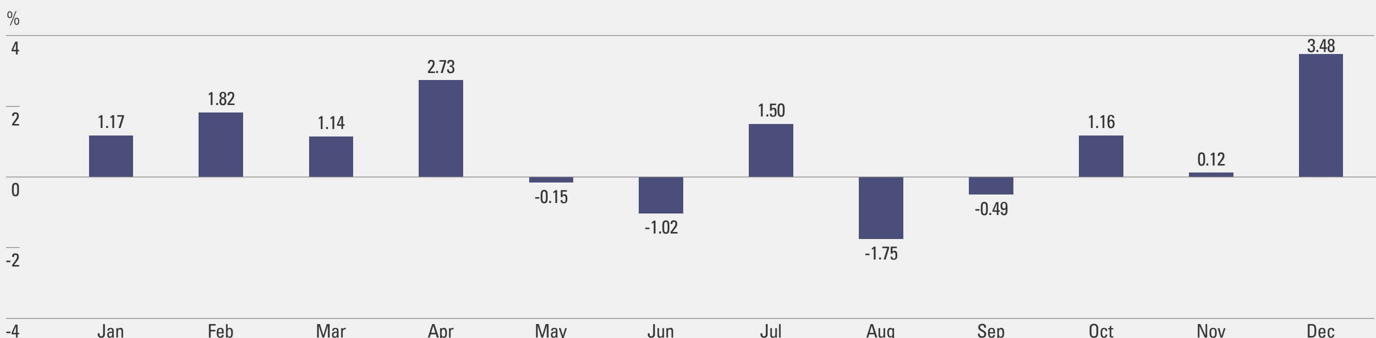
Woe is me. Being a chief investment strategist may seem glamorous — attending conferences at swanky 5-star resorts in great locations, appearing on television and, of course, basking in social media stardom — but it also has some drawbacks. For most folks, August is a lazy time spent hitting the beach, riding the trail or finishing the Bruce Springsteen biography they have been plodding through all summer. Alas, for chief investment strategists, August is often a month defined by market mayhem, from the Russian Debt Crisis in 1998 to China's Black Monday in 2015.

With most US benchmarks sitting near all-time highs, it was difficult to envision an August upset this year. Then, as if on cue, in mid-August the MSCI Emerging Markets Index entered bear market territory, falling more than 20 percent from its January 26 peak.

Emerging markets have faced a number of challenges in the last few months. Most notably, the tit-for-tat trade conflict between the US and China has weighed heavily on emerging market stocks, particularly Chinese shares. Rising US interest rates and a resurgent US dollar also dented enthusiasm for emerging market investments. And several weeks ago, the normally sanguine relationship between the US and Turkey exploded, sending the Turkish currency, the lira, plummeting.

However, although fanned by sensational headlines, fears of emerging market contagion similar to what occurred in the Southeast Asian financial crisis of 1997 are overblown. Today's challenges are much smaller in size and affect far fewer emerging market economies. There may be isolated challenges in a handful of countries, but not enough to spread panic among global investors. Sorry, Bruce, but I have to stop reading *Born to Run*, if only long enough to highlight the timely opportunity of investing in emerging markets.

Figure 1: On Average, August Has Been Emerging Market Equity's Worst Month Over the Past 30 Years
Average Monthly Return (1989–2018)



Source: Bloomberg Finance L.P., as of 08/22/2018. EM represented by the MSCI EM Index.

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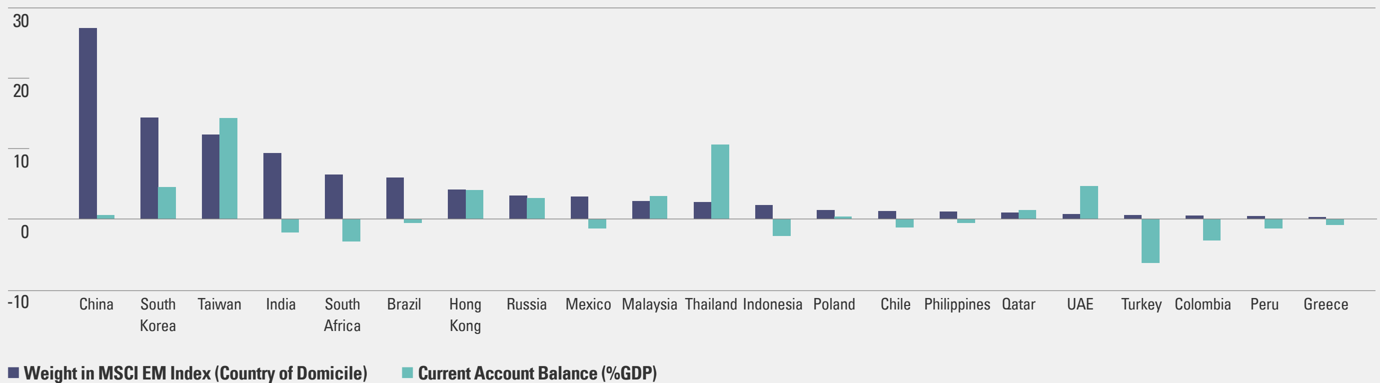
Figure 2: On A Weighted Basis, the MSCI Emerging Markets Index Has a Current Account Balance of 2.59% GDP, with Most Exposed Countries Comprising a Small Share of the Index



Source: Bloomberg Finance L.P., as of 08/22/2018.

Let's Talk Turkey: Too Small to Cause a Global Panic

Why did a well-known, but isolated economic crisis in Turkey take a turn for the worse in early August? Over the years, Turkish economic growth has been fueled by heavy external financing, mostly in US dollar debt. Inflation in Turkey has reached 16 percent, well above the central bank's 5 percent target. Central banks usually raise rates to keep inflation in check. However, Turkey's president Recep Tayyip Erdogan has opted to keep rates low in an effort to drive economic growth. This has been tough for Turkey, but for the rest of the world, it hasn't been a problem.

Recently, tensions between the US and Turkey intensified after a Turkish delegation returned from Washington with no progress on the release of US pastor Andrew Brunson, who is charged with supporting a group blamed for an attempted Turkish coup in 2016. As a result, President Trump announced plans to double metals tariffs on Turkey, sending the lira spiraling — and making all that US dollar debt that much more expensive to pay back. And news that the European Central Bank had growing concerns about how much Turkish debt was held at European banks in Italy and Spain sent a chill through markets.

Of course, Turkey isn't the only country that has relied heavily on external financing using US dollar debt to spur growth. Investors still fear a repeat of the Southeast Asian financial crisis in 1997–1998 that ended violently with the Russian debt crisis. Between August 1997 and August 1998, the MSCI Emerging Markets Index lost more than half its value. Back then, the economic crisis brought on by too much external US dollar debt spread from one emerging market country to the next. This August, similar fears sent many emerging market countries like Turkey into a tailspin.

However, Turkey is too small to spark global contagion. While Turkey has a fairly large economy of US $850 billion,[1] its equity market only accounts for a small proportion of global equities. Turkish stocks represent just 0.5% of the MSCI Emerging Markets Index and just 0.05% of the MSCI World Index.

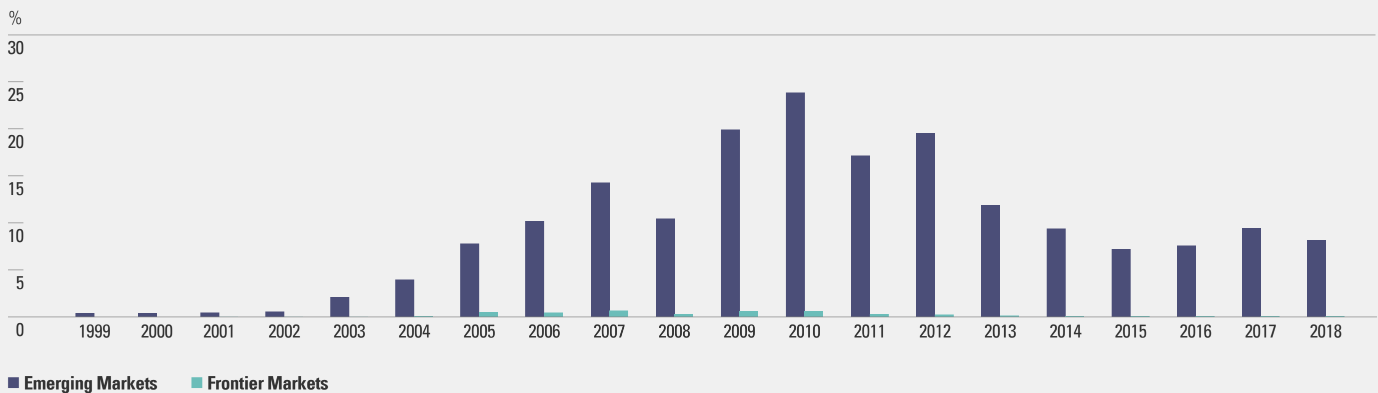
The 800-Pound Panda: Something to Watch

Turkey's challenges may be isolated and small, but the same cannot be said of China. As the second largest economy in the world, China is the largest country in every emerging market benchmark. Over the last year, President Xi Jinping has focused on addressing some of China's most egregious growth strategies. This has resulted in a slowing of the Chinese economy.

The impact of this purposeful deleveraging was displayed in mid-August when tech giant, Tencent, a social media and video gaming group, reported its first drop in profits in over a decade. Year to date, shares in Tencent have dropped as much as 20 percent.[2] Similar to FAANG stocks in the US, the three tech behemoths in China — Baidu, Alibaba and Tencent — are known as "BAT." Not surprisingly, BAT suffered mightily after the Tencent profits shortfall. And that weighed heavily on emerging market benchmarks and even briefly infected the US technology sector.

Weakening economic data combined with growing investor fears that a trade war could hurt the domestic economy have resulted in a bear market in Chinese stocks. Given China's massive influence on emerging market performance, this has been difficult for investors to stomach.

Figure 3: Despite Growing at a 48% CAGR in the 21st Century, Emerging Market ETF Assets as a Percent of Developed Market Focused ETFs Have Fallen from 25% in 2010 to Just 8% Today as Investors Continue to Favor Developed Country Equities
EM and Frontier Assets as a % of Developed Market Assets



Source: Bloomberg Finance L.P., as of 08/22/2018.

Emerging Markets: Won't Be Ignored

Together, Turkish turbulence, contagion concerns, China's economic deleveraging disturbances and trade tumult have conspired to send emerging markets to the trash heap. Yet, in the waning light of August, US stock market benchmarks continue to party like it's 1999.

On August 22, the longest running bull market in history reached 3,453 days and counting. The Atlanta Federal Reserve GDPNow model forecasts third quarter US economic growth of 4.6 percent.[3] Companies in the S&P 500 Index posted 25 percent year-over-year earnings-per-share growth in the recently concluded second quarter reporting season. Lower taxes, less regulation and increasing government spending have bolstered business and consumer confidence to multi-decade highs. These powerful tailwinds should continue to support US stocks in the coming quarters.

Against this backdrop, it's no wonder that, to date, US investors have largely ignored emerging market stocks. However, there remain several structural advantages to emerging market economies. Relative to developed market economies, emerging markets have higher GDP growth rates, a quickly developing middle class, growing consumer markets, more structural reforms and rising populations.

Whether you use real effective exchange rates or purchasing power parity, emerging market countries contribute roughly 60 percent to global GDP growth. And, that figure increases each year as emerging economies are growing more quickly than developed markets.[4] Currently, emerging markets' equity market capitalization is about 10 percent of the world's total equity market capitalization.[5]

Time for a Cool Change: Yes, I Mean You

Investor interest in emerging markets isn't an issue. I have the great privilege of meeting with so many investors and their financial advisors — and they all want to know more about investing in emerging markets. Gripping headlines, fascinating tales from far-away lands and the promise of tapping into some outsized returns all pique their curiosity. However, when it comes to putting their money where their mouth is, most allocate just 0 percent to 5 percent of their portfolio to emerging markets — an amount too small to matter.

In fact, our ETF fund flows research indicates that investors have withdrawn $6.6 billion from emerging market equity ETFs over the last three months. And, as illustrated in Figure 3, despite the phenomenal growth in emerging market ETFs, emerging market ETF assets as a percentage of developed market ETF assets have fallen from a high of 25 percent in 2010 to just 8 percent today.

In today's environment, I suggest investors increase their emerging market equity allocations to at least a strategically neutral position of 10 percent of equity investments.

Why invest more now? US stocks are near all-time highs, valuations are elevated and investor sentiment has rarely been stronger. What catalyst could propel US stocks higher? In contrast, emerging market stocks are currently in a bear market, valuations are compelling and investor sentiment is awful. As a result, the short- and intermediate-term performance gap between US and emerging market stocks is as wide as it has been in years.

According to Bloomberg, short sellers are piling on positions in emerging market stocks, the most since 2016. Short interest on a popular emerging market ETF as a percentage of shares outstanding is at 12 percent, near the highest since 2016.[6] The last time short positions were this high, emerging market stocks went on a two-year rally.

In addition, research from Jefferies Group LLC finds that the number of news stories about emerging markets are at a three-year high — not surprising given the Turkey and China headlines in August. Jefferies notes further that previous spikes in emerging market news stories have often marked the bottom for the benchmark.[7] And take another look at Figure 1. While performance is lowest in August, emerging markets have tended to rebound in the fourth quarter and post solid performance in the first quarter.

Perhaps most encouraging for the outlook for emerging markets are the steps China has taken over the last several months to protect its economy against a trade war and slow down the deleveraging process. As a result, the two largest economies in the world are simultaneously implementing massive fiscal stimulus packages. China has reduced the reserve requirement ratio several times in 2018. Similar to the US, China has lowered taxes. Officials also have encouraged municipal governments to take measures to boost local growth.

Additionally, the Chinese currency, the yuan, has declined roughly 6 percent which should help offset some of the challenges that US tariffs pose on Chinese goods.[8] The trade conflict with the US may also be thawing. A Chinese delegation visited Washington at the end of August to restart discussions on a trade deal. The intent of the meeting was to lay the groundwork for a productive meeting between President Trump and President Xi Jinping in November that could result in a trade deal. The implementation of a massive fiscal stimulus combined with a resolution on trade would bolster the Chinese economy, potentially improving the performance of emerging market stocks. Could this be the catalyst investors have been waiting for?

Labor Day Takeaway: The Time is Now

Often the greatest investments are overlooked by investors who are chasing performance elsewhere. US stocks have vastly outperformed the rest of the world, most impressively versus emerging market stocks. A decade of fabulously easy US monetary policy and more recently a huge US fiscal policy boost have brought financial asset returns forward for many years. As a result, US stock returns are likely to be lower in the coming years.

Therefore, US investors will need to search far and wide for investments that can help them reach their long-term financial goals. Now just might be the right time for US-based investors to increase their emerging market allocations to at least a strategically neutral position of 10 percent. That's something to think about whether you spend these last few summer days at the beach, on the trail or with the Boss.

[1] The World Bank, as of December 2017.

[2] Bloomberg Finance L.P., as of 08/24/2018.

[3] GDP Now, Federal Reserve Bank of Atlanta, as of 08/24/2018.

[4] "World Economic Outlook," International Monetary Fund, April 2018.

[5] Bloomberg Finance L.P., as of 08/24/2018.

[6] Bloomberg Finance L.P., as of 08/24/2018.

[7] "Opining From the Office-Emerging Markets," Jefferies Equity Research, 08/24/2018.

[8] Bloomberg Finance L.P., as of 08/24/2018.

Glossary

Earnings per Share (EPS) The portion of a company's profit allocated to each outstanding share of common stock.

Gross Domestic Product (GDP) The monetary value of all the finished goods and services produced within a country's borders in a specific time period.

MSCI Emerging Markets Index A free float-adjusted market capitalization index designed to measure equity market performance in 23 global emerging market economies: Brazil, Chile, China, Colombia, Czech Republic, Egypt, Greece, Hungary, India, Indonesia, Korea, Malaysia, Mexico, Peru, Philippines, Poland, Qatar, Russia, South Africa, Taiwan, Thailand, Turkey and the United Arab Emirates.

MSCI World Index A broad global equity benchmark that represents large and mid-cap equity performance across 23 developed markets countries. It covers approximately 85% of the free float-adjusted market capitalization in each country and does not offer exposure to emerging markets.

S&P 500 Index A popular benchmark for U.S. large-cap equities that includes 500 companies from leading industries and captures approximately 80% coverage of available market capitalization.

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