ADVISOR PERSPECTIVES

Emerging Market Equities Set for Outperformance

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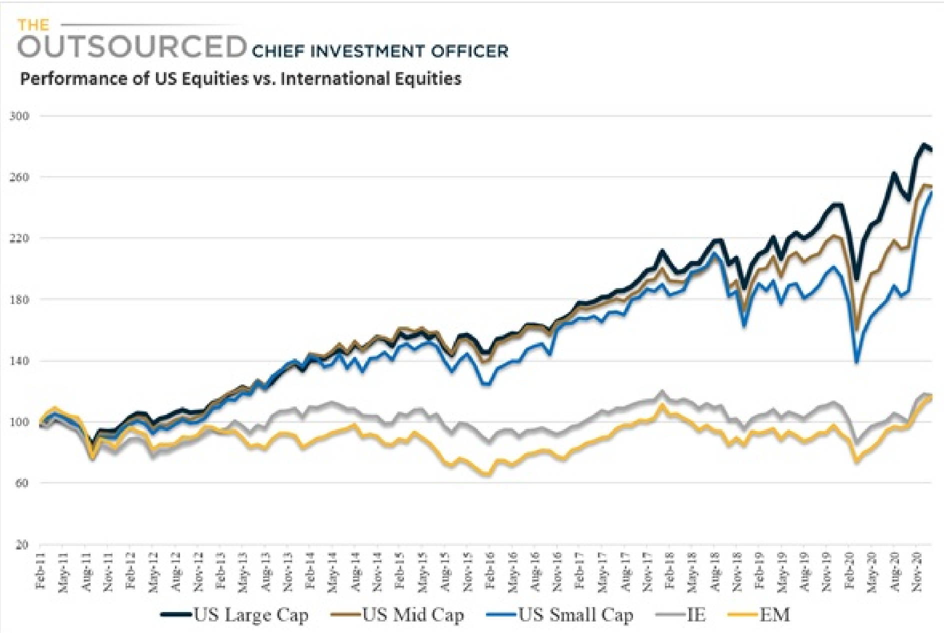
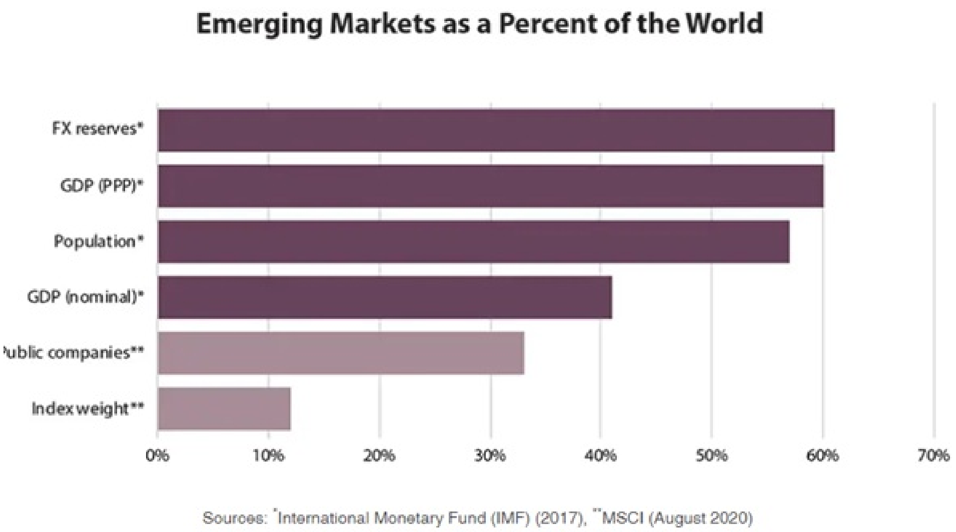
Most US investors tend to be underweight to international equities, shying away from both developed and emerging market equities, as this report from Davis Advisors highlights. The reasons for this consistent underweight can be attributed to familiarity bias, risk aversion, or strategic and tactical asset allocation. But the underweight might also be unintentional, as when a bottom-up stock-picking style results in unplanned overall portfolio asset allocations. Over longer time horizons, a consistent underweight to emerging market equities could hurt returns, as we will show, there are periods when emerging market equities considerably outperform US and other developed markets. Over the last 10 years at least, the underweight has worked out well as the US market has outperformed both international developed and emerging market equities by almost 2.5 times.



In our view, a neutral allocation should be representative of world equity market capitalizations. With the US equity market roughly 55% of the total world equity market value, international developed consisting of around 33%, and emerging markets making up the last 12%, we believe this is the starting point for long-term strategic asset allocations. This isn't always the case, as some investors consider a neutral allocation to emerging markets at say, 6%, which in their view means that an 8% allocation is overweight. We believe this approach might also contribute to the current EM underweight which we will describe below.

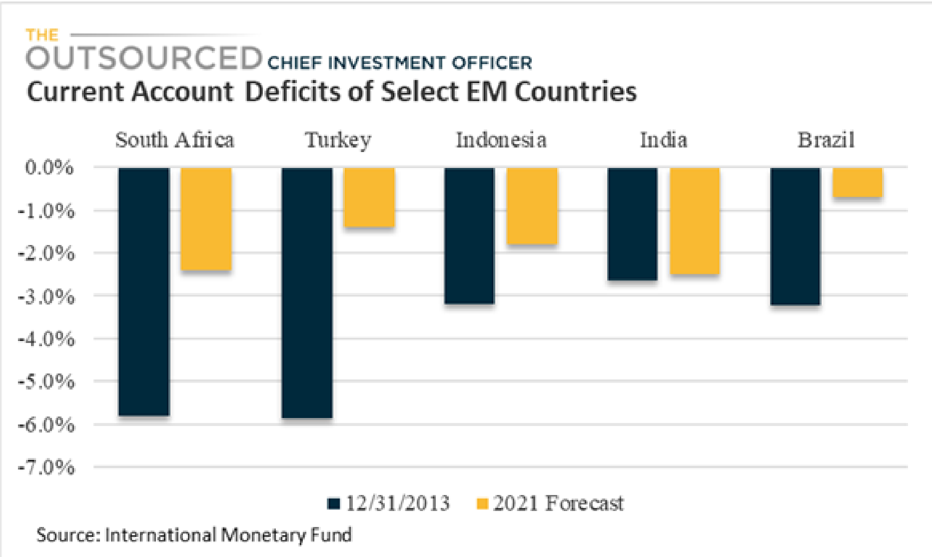
Emerging Market Equities Are a Growing Opportunity Set

As the share of global real GDP increasingly shifts to emerging market countries, the implication for outsized EM equity returns becomes more attractive. Emerging markets hold over 60% of foreign exchange reserves, generate around 60% of global GDP, and consists of over 55% of the population. Considering more than 30% of public companies are based in emerging markets while only representing 12% of the market capitalization of global equities, the divergence is striking. If the argument for pro-rate allocation based on market caps isn't enough, these statistics should bring to light an inconsistency in how global portfolios are positioned.



Despite these statistical discrepancies, however, during past stock market downturns, emerging markets have had a larger drawdown than their developed market peers, and were more volatile even under 'normal' market conditions. Perhaps this is one of the primary reasons why US investors shy away from exposure to EM. But there are two things investors should consider when evaluating emerging markets.

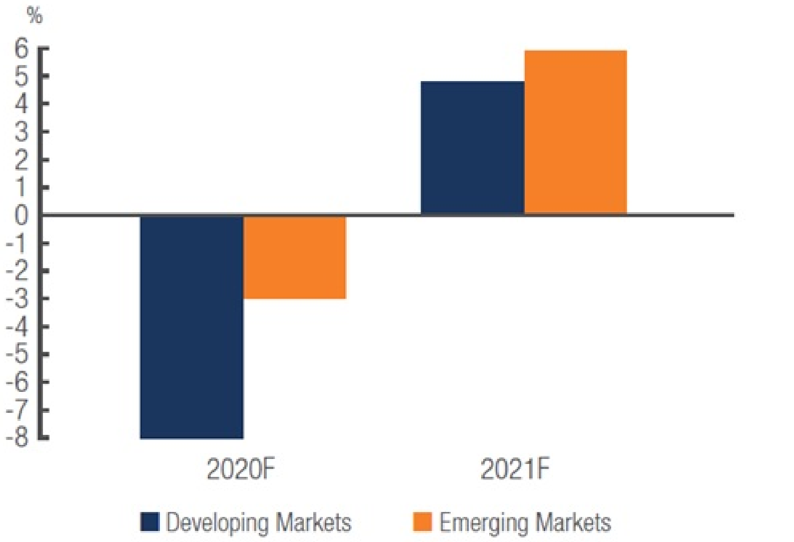
On the one hand, emerging markets have changed considerably in the last 10 years and the countries that make up the index are no longer the homogenous group that historically tended to move in tandem. Even the 'Fragile 5' have considerably improved their fiscal position since the taper tantrum in 2013. The differentiated characteristics of each country within the index and their diverse responses to global economic drivers leads to less correlated returns between equity markets of individual countries. This creates opportunities for active allocation within the asset class and lowers the volatility for portfolios with broad EM exposure.



Secondly, despite abrupt pullbacks, there have been periods when emerging markets have outperformed US markets by a substantial margin. Consider the periods between 1988-1994, 2003-2007, 2009-2011, and recent performance since April 2020.

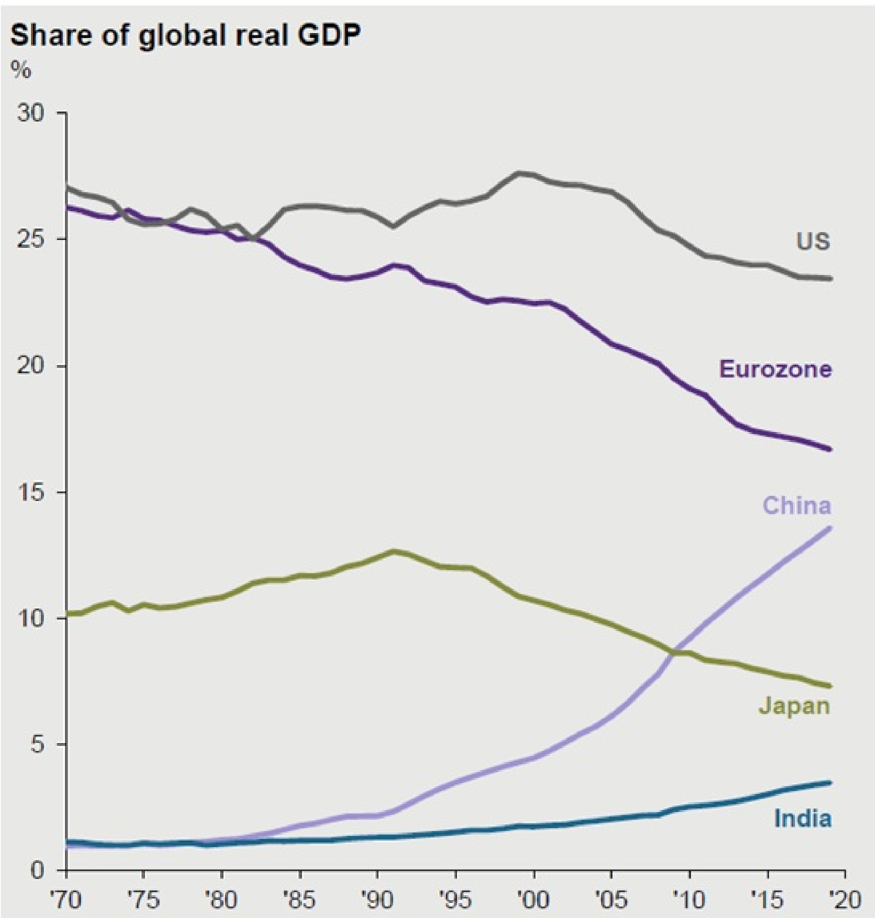
There was also some doubts as to how emerging markets were expected to withstand the global pandemic but preliminary GDP data suggests they have been less impacted by their developed market peers. Despite limited ability to implement fiscal or monetary stimulus to counteract business shutdowns and loss of consumer buying power, EM markets are expected to generate higher GDP growth in 2021 after a 2020 decline that was less than that experienced in developed markets.

Stronger GDP Growth Expected in EM



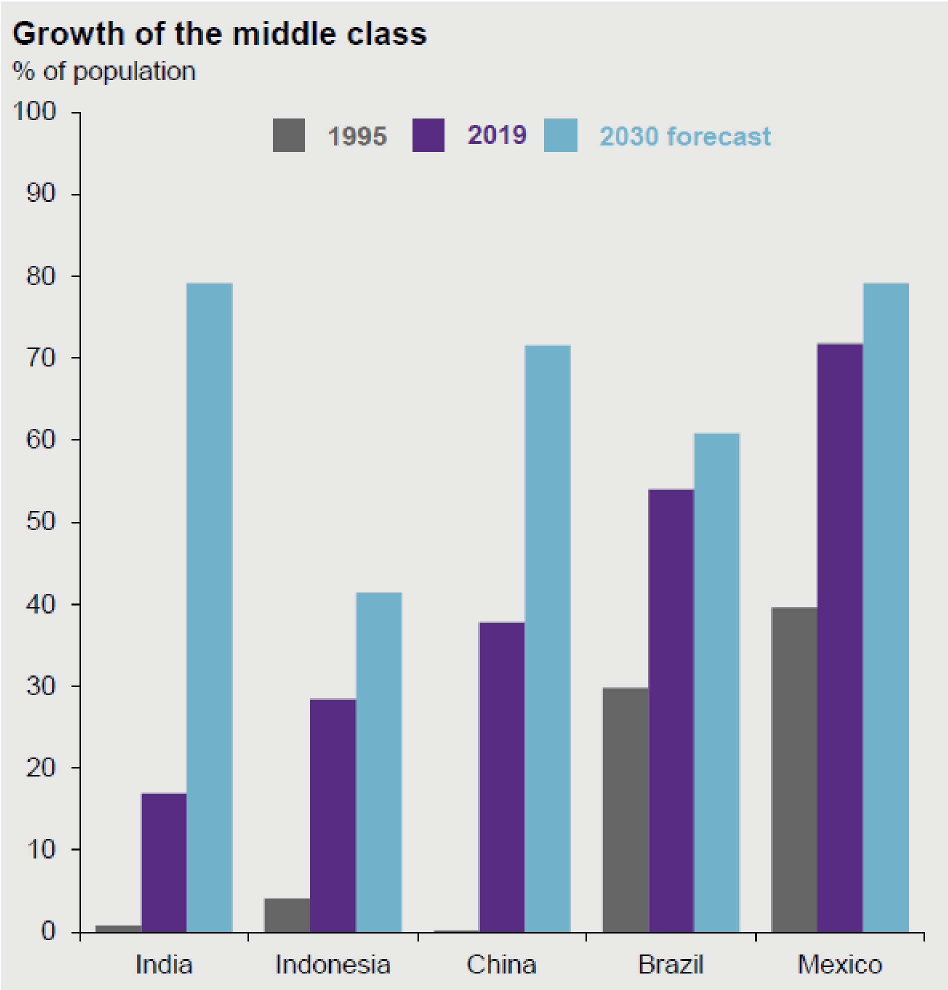
Source: IMF, World Economic Outlook Update, June 2020. F=Forecast. Forecast numbers are projections only and not guarantees.

The expected increase in GDP growth will not be uniform throughout all EM countries, however. It's noteworthy that the primary reason for EM's dominance in many statistics is the weight of China, the second largest economy behind the US. It now makes up almost 15% of global real GDP according to JP Morgan – and it has outpaced the US for the last 40 years with no sign of that trend reversing. Whether China should be included in the 'emerging market' category is also debatable, but for the moment, it is the largest wait in the MSCI EM Index.



Source: JP Morgan Guide to the Markets

Meanwhile, the growth of the middle class – arguably the bulk of the population that will drive a consumer-driven emerging economy – is forecast to make up more than 60% of most of the major emerging markets – from current levels below 50%. The growth of the middle class in the two most populous countries in the world, China and India, is expected to double and quadruple, respectively by 2030.



Source: JP Morgan Guide to the Markets

Yet another metric that favors emerging markets is the Purchasing Managers Index comparing EM to developed markets. The PMI for emerging markets declined much less than developed markets in 2020 and now stands at the widest gap since both indexes began to indicate expansion in the middle of 2020.

Source: Lazard

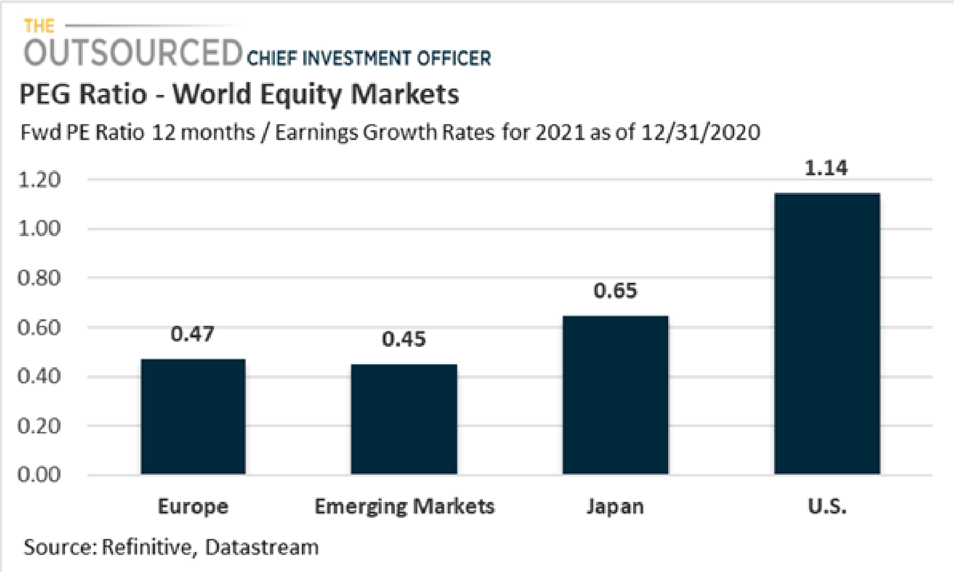
Might This be the Same Disappointing Story All Over Again

Emerging market equities have historically provided investors with outsized returns but have also disappointed during periods of global and regional turmoil. It's relative underperformance versus US markets may continue for some time, but we believe the fundamentals are in place for the trend to reverse and there are several metrics that favor EM equity markets over the intermediate term. Not only are relative valuations at extreme levels, but earnings growth rates are forecast to be higher for EM, and the asset class is underrepresented in global portfolios.

The average historical Price to Book discount for emerging markets relative to developed markets is about 20%, reflecting investor interest in paying a higher price for earnings generated by developed market companies. However, the current relative discount is at extreme levels of over 35%. A simple reversion to the mean might result in significant outperformance for EM.

A similar relative discount is evident from comparing PE multiples as well. To clarify, however, emerging market equities aren't cheap on an absolute basis. The current PE is slightly above the average multiple EM has traded at since 1990. But compared to the US and Europe ex-UK, the PE multiple is well below the historical average.

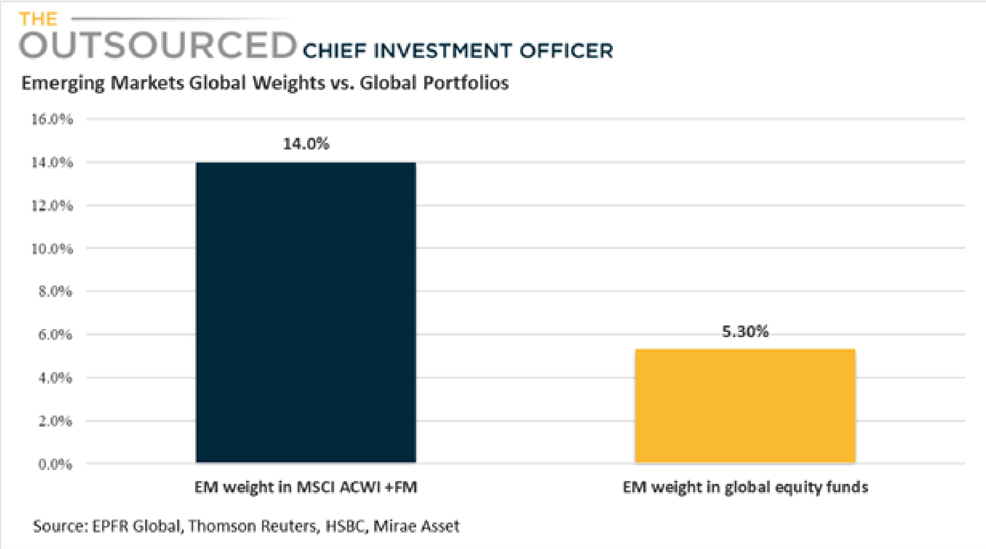
Furthermore, projected earnings per share growth for EM is 33.6%, compared to 20.4% for the US. At a PE multiple of around 15, the PEG ratio for emerging markets is 0.45. It compares favorably with Europe and Japan and is less than half that of the US.



Home Bias Advantage May be Coming to an End

As previously mentioned, the overweight to US equities worked well over the last 10 years but it has further widened the allocations between US and EM equities within global portfolios. According to data compiled by Mirae Asset, EM weight in the MSCI ACWI + Frontier markets is 14% – yet the current allocation to EM equities is just 5.3%.

This may lead to an increase in inflows as fund flows out of those asset classes that have outperformed over the last 10 years and are redirected towards asset classes better positioned to perform going forward, whether due to valuation or growth prospects. In our opinion, emerging markets look promising on both counts.



Already fund flows into EM equities have increased, with flows over the last three months showing outflows from S&P 500 ETFs and into broad international equity markets and emerging market equities.

Flows for 11/04/2020 - 02/03/2021

Top 10 Creations (All ETFs)

Ticker	Fund Name	Net Flows*	Details
VTI	Vanguard Total Stock Market ETF	13,484.52	
IEMG	iShares Core MSCI Emerging Markets ETF	8,471.79	
ARKK	ARK Innovation ETF	7,963.53	
XLF	Financial Select Sector SPDR Fund	7,297.61	
BND	Vanguard Total Bond Market ETF	6,982.01	
ARKG	ARK Genomic Revolution ETF	6,349.97	
VXUS	Vanguard Total International Stock ETF	5,770.50	
AGG	iShares Core U.S. Aggregate Bond ETF	5,142.36	
BNDX	Vanguard Total International Bond ETF	4,601.57	
VCIT	Vanguard Intermediate-Term Corporate Bond ETF	4,244.41	

Top 10 Redemptions (All ETFs)

Ticker	Fund Name	Net Flows*	Details
SPY	SPDR S&P 500 ETF Trust	-8,387.80	
GLD	SPDR Gold Trust	-5,797.63	
IEF	iShares 7-10 Year Treasury Bond ETF	-5,532.46	
IVV	iShares Core S&P 500 ETF	-4,983.50	
USMV	iShares MSCI USA Min Vol Factor ETF	-4,829.59	
LQD	iShares iBoxx USD Investment Grade Corporate Bond ETF	-4,161.82	
SHV	iShares Short Treasury Bond ETF	-3,318.94	
XLP	Consumer Staples Select Sector SPDR Fund	-2,441.94	
QUAL	iShares MSCI USA Quality Factor ETF	-2,267.09	
TQQQ	ProShares UltraPro QQQ	-2,205.62	

* Net Flows in USD Millions

Data Powered by FACTSET

A Brief Comment on Risks for Emerging Market Equities

Investing in emerging market equities is not without it's ownset of risks. Key risks in the quarters ahead include the ongoing effects of COVID-19, protectionism, and trade war escalation, not to mention political, regulatory, and unforeseen risks that seem to pertain only to EM countries – Myanmar is a great example.

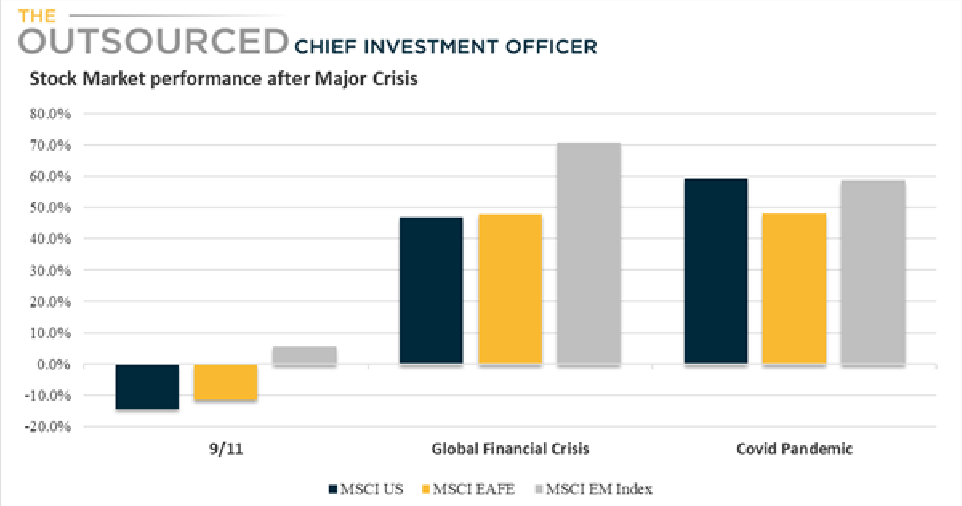
While the Biden administration may be more predictable and less retaliatory than the Trump administration towards perceived unfair trade practices, it remains to be seen how trade tariffs will be affected and what other restrictions imposed by the previous administration will be reversed.

There are differing opinions on the impact of Covid on emerging market economies as well. While some analysts fear the pandemic might widen the inequalities between DM and EM, others believe that EM markets are better positioned for a solid rebound. The former highlight the inability of some countries to implement fiscal or monetary policies to alleviate the pressure on workers displaced by a decline in economic activity, while the latter have focused on the First-in, First out assumptions regarding the pandemic, and how well some countries have weathered the second and third waves that have decimated other countries. Preliminary GDP reports suggest EM countries did indeed weather the storm well.

With Trump out of office, one would also expect US-China relations to warm, but Biden has so far remained moot on reversing any of the tariffs imposed during the previous administration – keeping heightened risks that the US-China trade war could remain limiting.

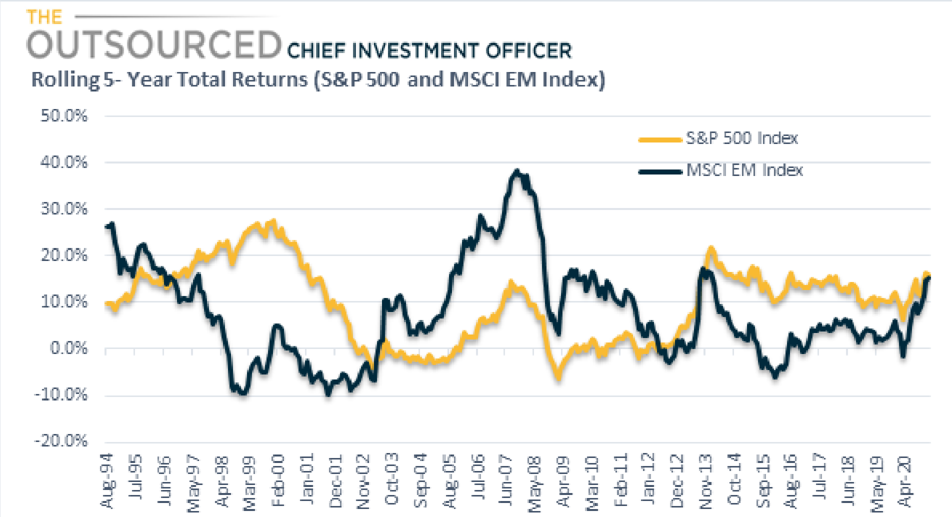
Conclusion

Emerging markets have often declined precipitously during previous crisis and the sharp pullback during the Covid pandemic was no exception. However, emerging market equities have historically recovered quickly from previous crisis and so far the current recovery has outpaced those of US and International Developed Market equities. The figure below shows the equity market performance for the MSCI US Index, the MSCI EAFE Index, and the MSCI EM index. After both the 9/11 attacks and the Great Financial Crisis, EM equities outperformed other equity indexes over the following two years. Just under one year after the bottom of the markets reached in March 2020 and EM equities have so far outperformed yet again.

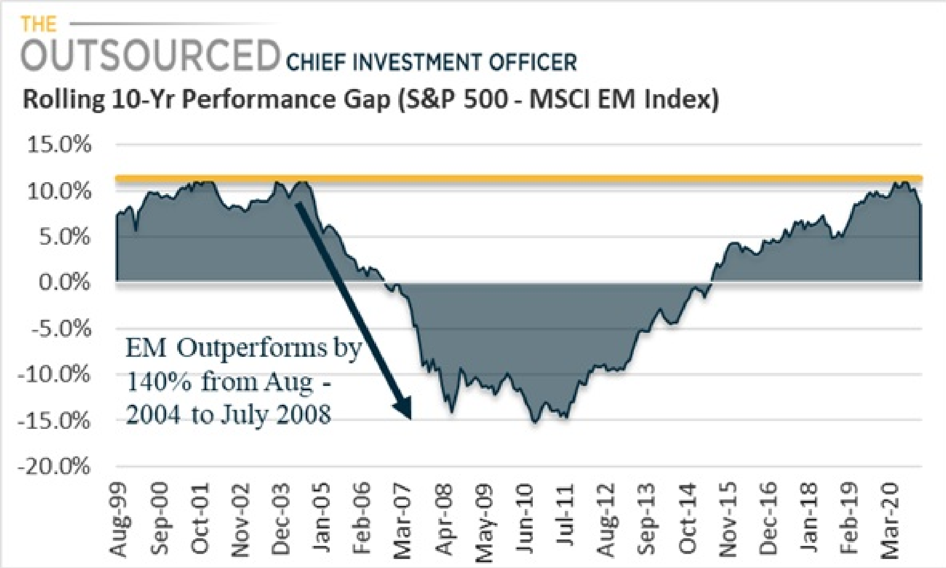


Source: ycharts. 9/11: 9/10/2001 to 9/10/2002. GFC: 3/2/2009 to 3/2/2010. Covid Pandemic 3/23/2020 to 2/5/2001

Further analyzing historical equity market performance, leadership tends to shift from one asset class to another and over the past 5- and 10-year rolling periods, US markets have outperformed EM. However, the 5-year rolling returns for both the S&P 500 and MSCI EM Index are currently about equal due to EM's outperformance over the past year. As the chart below indicates, the previous period of S&P 500 outperformance was followed by a decade of EM outperformance before the US market regained leadership in 2013. We believe that the next period of EM outperformance is just beginning.



Meanwhile, the gap between US and EM 10-year rolling performance still remains wide, but it has peaked at it's historical widest and now seems to be in decline. From the end of the last period of S&P 500 leadership to the peak of EM outperformance in early 2008, emerging markets outperformed the S&P 500 by 140%.



We believe strongly that the 10-year rolling return gap will continue to narrow and that EM equities are set to outperform over the next 10 years. With valuations at extreme discounts, earnings growth accelerating, and potential inflows into the asset class, we strongly favor an overweight to emerging market equities and have positioned our portfolios accordingly.

