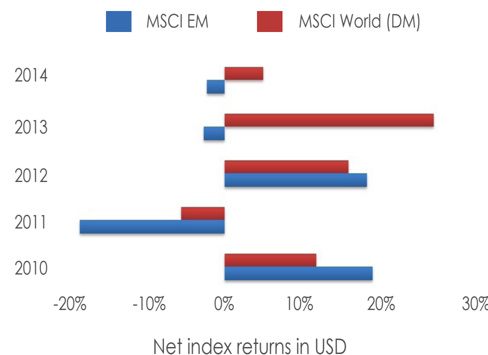
Emerging Markets: Ready For A Rebound?

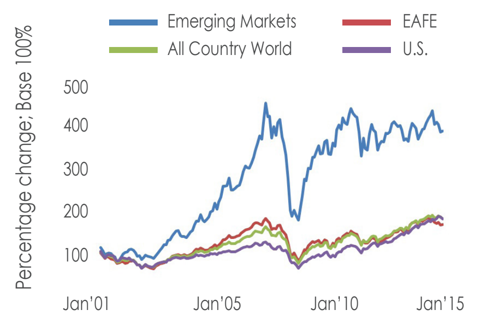
For emerging market investors more familiar with the warm summer glow of above normal returns, recent years have been an unusually long winter. Emerging markets, one of the most favored asset classes during the last decade, have lagged the developed markets in three out of the last four years. What's more, the extent of underperformance over this period has been so wide that even the most disciplined and experienced investors have become discouraged. It's no surprise that a good number of investors gave up on emerging markets, evidenced by the significant outflows from EM funds during the second half of 2014.

Emerging Markets have underperformed recently...



Data source: MSCI

...But long-term EM returns are well ahead



Data as of 1/31/2015. MSCI EAFE, MSCI Emerging Markets, MSCI ACWI, MSCI USA Index (net – USD), rebased January 1, 2001.

The MSCI EAFE Index (Europe, Australasia, Far East) is designed to measure the equity market performance of developed markets, excluding the US & Canada. The MSCI World Index is designed to measure the equity market performance of developed markets. The MSCI Emerging Markets Index is designed to measure the equity market performance of emerging markets. The MSCI All Country World Index is designed to measure the equity market performance of both developed and emerging markets. These indices are unmanaged, free float-adjusted market capitalization indices whose returns assume the reinvestment of dividends. It is not possible to invest directly in an index.

KEY TAKEAWAYS

From a high of 8.6% in 2007, aggregate economic growth in the developing countries slipped to 4.4% in 2014, according to IMF data. When viewed in isolation, the decline in growth appears alarming. Nevertheless, when analyzed from a global perspective and relative to the developed countries, the slowdown is not as disappointing.

Are they repeating the classic investment mistake of selling at the bottom of a market cycle? There are enough reasons to believe so. While it is often futile to predict short-term equity market returns, improvements in the macroeconomic environment as well as favorable political and policy developments could usher in brighter days for emerging markets. Let's look at some of these in more detail.

1. Emerging economies have slowed, but so has the rest of the world

The biggest disappointment most investors have had about emerging markets is the slower growth rate in most of these countries, when compared to the period of rapid growth before the 2008 global

financial crisis. From a high of 8.6% in 2007, aggregate economic growth in the developing countries slipped to 4.4% in 2014, according to IMF data. When viewed in isolation, the decline in growth appears alarming enough to most investors. Nevertheless, when analyzed from a global perspective and relative to the developed countries, the slowdown is not as disappointing.

The rest of the world has also seen a decline in aggregate economic growth. During the seven-year period starting from 2007, the developed countries went through a deep recession and their aggregate growth slowed from 2.8% to 1.8% in 2014. Several emerging countries are large exporters – China and Mexico in manufactured goods, Brazil and Russia in commodities and energy. When their major markets in the developed world have not fully recovered from recession, it is hardly surprising that the economies of these countries have also decelerated. The rout in international energy and commodity markets has made the environment more challenging for oil and commodity exporting countries.

It is only natural that the pace of growth moderates as an economy gains in size. The Chinese economy in 2014 was 80% larger than it was in 2007, after adjusting for inflation. It is perhaps not even desirable for the world's second largest economy to aim for maintaining double-digit growth, as it could lead to asset price bubbles and destabilization of the markets. This is true for other emerging markets as well, especially for the resource exporting countries where past growth rates were boosted by unsustainably high commodity prices.

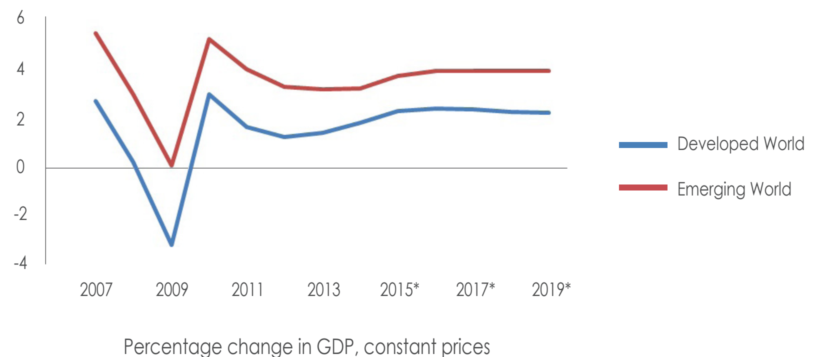
The IMF estimates that the emerging countries may grow much faster than their developed peers in the coming years. Relatively low cost of labor should help emerging countries remain as attractive manufacturing locations. In addition, if these countries can maintain current growth rates, their low consumer demand base leaves a lot of room for domestic consumption to expand for several years to come.

Also, countries such as China are now in a transition phase where their economies shift from export-led growth to a model more reliant on domestic consumption. This is a gradual process that requires a lot of structural adjustments, aided by appropriate government policy initiatives. While a country is moving down this path, it is very likely that economic growth will moderate before eventually settling at a more sustainable pace.

2. Emerging economies to drive much of future global economic growth

The IMF estimates that the emerging countries are likely to grow much faster than the developed world in the coming years. These countries hold several structural advantages that make it possible to sustain high growth rates for extended periods. Several emerging countries, most notably India and Turkey, have young populations that should help maintain future labor supplies. This is in stark contrast to many developed countries that are already facing labor shortages. The relatively low cost of labor should help the emerging countries remain as attractive manufacturing locations. In addition, the level of consumption of most goods and services in these countries is much lower than the developed world. If these countries can maintain current growth rates, the low consumer demand base leaves a lot of room for domestic consumption to expand for several years to come.

Emerging countries are expected to retain growth advantage



*Estimates
Data source: IMF

Even in the medium term, some of the emerging countries that are not dependent on commodity exports could possibly to see moderate gains in growth rates. The IMF estimates that the developing countries could see aggregate economic growth of close to 5% in 2016, twice as fast as the developed world. India is expected to see the most gains among the larger emerging countries, followed by the South East Asian countries such as Indonesia and Thailand. While the Chinese economy could moderate further, annual growth of close to 7% in an environment where global demand is still not robust enough should be considered healthy.

3. Cheap oil should boost China, India, and Korea

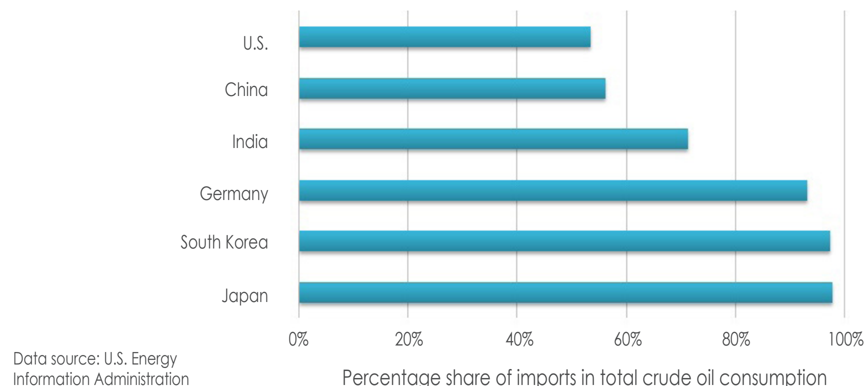
The boost to domestic consumption from lower oil prices is well understood. Consumers in countries where fuel prices are market driven should see substantial savings, which could lead to increased demand for other products and services. With oil prices nearly half of what they were during the first six months of 2014, the more vigorous consumer demand is likely to be one of the biggest growth drivers for the global economy this year. For some emerging countries such as China and Mexico, this could be a double bonanza. In addition to higher domestic demand, these countries should also benefit from consumption growth in the U.S. and other developed countries.

Lower oil prices should lead to a substantial fall in import costs for many emerging countries, especially China, India and Korea. For countries such as China and Mexico, lower oil prices could be a double bonanza. In addition to higher domestic demand, these countries should also benefit from consumption growth in the U.S. and other developed countries.

Lower oil prices should also lead to a substantial fall in import costs for many emerging countries, especially China, India and Korea, that import most of their energy requirements. This should help widen the trade surpluses of China and other exporting countries, and narrow the trade deficits of net importers such as India. The improvement in trade balance should go a long way in easing investor worries about the large current account deficits of these countries.

In addition, the fall in oil prices should also help governments in India, Indonesia and select other countries to reduce their spending on fuel subsidies. Their budget deficits could narrow as a result and help boost credit rating outlook as well as investor confidence.

The biggest oil importers are likely to gain the most



Data source: U.S. Energy Information Administration

4. Equity valuations appear attractive

What should also encourage long-term investors looking at increasing their emerging market allocations is the relatively lower valuations of these markets. The growth slowdown in emerging economies, elevated geopolitical risks in Eastern Europe and other regions, as well as fears about the negative fallout from the end of quantitative easing in the U.S. have all contributed to the depressed valuation of emerging market equities. The average trailing price to earnings (P/E) ratio for the MSCI Emerging Markets Index was slightly above 12 at the end of 2014. In comparison, the MSCI U.S. Index P/E ratio was nearly 20 while the MSCI EAFE Index, which measures developed market performance

outside the U.S. and Canada, was over 16. The Emerging Markets Index's P/E ratio is currently lower than its historical average over the last 15 years.

5. The strong U.S. dollar has made Emerging Markets cheaper

The U.S. dollar's gains against other currencies have forced many investors to stay away from emerging market equities. They reckon that, even if these markets do well, further weakening of emerging market currencies could make dollar returns unattractive. While this is indeed true, it could also be argued that after the sustained fall against the dollar in recent years, the risk of further steep declines in emerging market currencies may be limited. On the other hand, the strong dollar has made emerging market equities much cheaper. Even healthy businesses have seen their U.S. dollar valuations decline appreciably since 2013 due to weaker currencies.

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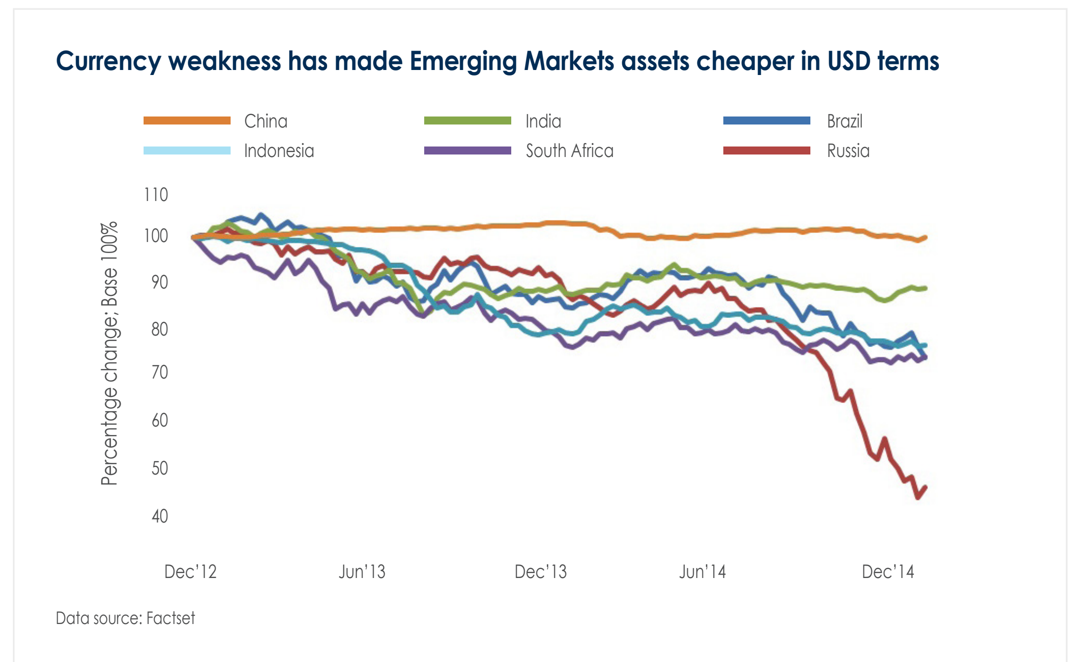

Data source: Factset

Increasing the allocation to an asset class that has underperformed for a while and remains out of favor among most investors is not easy. Nevertheless, we believe emerging market equities merit increased investor attention as some of the macroeconomic headwinds are easing. The cheaper valuations of emerging markets, relative to their own historic trends as well as the developed markets, make them potentially even more attractive for long-term investors.

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