Key Questions

Wag the Dog

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What does recent EM equity underperformance portend for investors?

Emerging Markets (EM) countries are better equipped to navigate a strengthening U.S. dollar and rising interest rate environment relative to the past, and increased volatility lends an opportunistic backdrop for active investment within the asset class.

Equities of emerging countries have underperformed domestic equities so far in 2018 due to three factors: persistent geopolitical risk, individual country headline risks, and rising U.S. interest rates.

In terms of geopolitical concerns, the Trump administration's decision to withdraw from trade agreements, issue tariffs and back out of the Iran Nuclear Pact, has sparked fear amongst several investors, especially those invested in emerging markets. As the U.S. withdraws, though, China's influence is likely to rise, benefitting EM in the long run.

Earlier this month, Argentina and Turkey saw large drawdowns in their currencies and equity markets. Both are capital importers meaning they rely on other countries to provide capital. As U.S. yields increase, external financing becomes more expensive. That said, they are not representative of EM as a whole; the tail does not wag the dog. Commodity exporters, such as Russia, and fiscally sound economies like China and Taiwan, should benefit from the current environment.

Moreover, during the Financial Crisis of 2008, developed countries used quantitative easing as a tool to stimulate economic growth, and the impact on EM equity was swift. Some currencies lost as much as half of their value to the U.S. Dollar. This resulted in increased EM currency competitiveness, boosted current account balances and diminished the need to finance debt in dollars.

In recent years, in anticipation of future monetary tightening, EM countries have continued to decrease reliance upon foreign capital by developing local markets, borrowing money in local currency, and allowing greater exchange rate flexibility. They are no longer as correlated to rising interest rates and strengthening developed currencies as they have been in the past.

Despite the pockets of uncertainty plaguing EM returns this year, we believe the future remains bright. The IMF recently raised its EM economic growth forecast to 4.9% for 2018, nearly double the expected growth in developed markets (2.5%). Growth is fueled by stronger local consumer demand, higher commodity prices, restrained inflation and persistently low interest rates. Additionally, valuations remain attractive relative to the developed world, an added benefit.

Reduced sensitivity to developed market liquidity has allowed the EM economic cycle to move independently of the developed world. While the U.S. exhibits characteristics of late-cycle behavior, EM is mid-cycle, leaving room for continued economic expansion over the coming years. As a result, and in light of the recent volatility, EM stocks continue to exhibit high cross-sectional dispersion, suggesting that they present strong opportunities for active management.

For questions, please contact your Key Private Bank Portfolio Manager.

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