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Emerging Market Equities: Separating the Wheat from the Chaff

Highlights

- Since 2011 emerging market (EM) equities have lagged U.S. equites considerably, and the valuation for the MSCI Emerging Markets index has fallen to a record low recently. While this could signal a buying opportunity, our view is an underweighting of the asset class is warranted amid a significant slowing in credit growth and uncertainty about how EMs will fare when the Fed tightens policy.
- Nonetheless, this is a good time to formulate a strategy for investing once conditions stabilize. Because there is likely to be considerable variation in the performance of individual markets in the future, careful country selection will be critical to success.
- The challenges are formidable, because the nature of emerging market crises has evolved and countries confront a myriad of problems with differing policy choices. For example, the build-up in debt since the Global Financial Crisis has been greatest in China and other Asian economies, but they also have leeway to ease monetary policies because inflation is low. By comparison, countries such as Brazil, Russia, and Turkey have less latitude to ease policies with inflation high.
- An ongoing challenge is to assess whether expectations that are priced into markets will be met, which is not easy. A noteworthy example: The BRICs concept became popular when China's emergence contributed to a commodity boom, but it has lost relevance today as expectations proved to be unrealistic.

EM Equity Underperformance: Secular Forces

Over the past year, investors have increasingly become concerned about the ongoing slowdown of China's economy and the spill-over it has had on other emerging economies. The combination of plummeting commodity prices and currencies and deteriorating corporate profits resulted in emerging market equities posting an overall decline of 9.4% through the end of October. At the end of September, when returns were minus 15%, equity valuations based on the MSCI index had fallen to a record low of 12.8 times 10-year average earnings, or roughly one half the long-term average.[1]

Considering how far EM equities and currencies have fallen, it is reasonable to consider whether the asset class is attractive now. The key deterrent in my view is that the problems confronting emerging market economies are predominantly structural in nature. Thus, while a rapid expansion in domestic credit and a large influx of foreign capital helped emerging economies rebound from the 2008-09 Financial Crisis, growth rates have slowed considerably since 2011. China's economy, for example, is projected to grow at less than 7% this year, and the official growth target for the remainder of this decade has been lowered to 6.5%. Other formerly rapid-growing economies in the Asia/Pacific region have slowed as well. Conditions in Latin America are worse, with Brazil and Venezuela in severe recession, and most other countries in the region feeling the fallout from soft commodity prices.

[1] *See Financial Times, "Caution reigns as EM valuations hit new low," November 20, 2015.*

The outlook, moreover, does not call for a quick turnaround considering the burden of debt that has been accumulated by corporations and households in emerging economies. According to J.P. Morgan, corporate debt has ballooned from less than 50% of GDP in 2008 to almost 75% by 2014, while total private sector debt (including households) rose to 107% of GDP last year and to 127% if debt owed to shadow banks is included.[2] Faced with such a rapid buildup in debt, many companies now confront the prospect of servicing it when conditions are unfavorable. According to Morgan's economists, the growth of EM private, non-financial credit has slowed materially in the past year, reflecting a weakening in both credit demand and supply, as well as net capital outflows. One concern is that these conditions could worsen as the Federal Reserve tightens monetary policy, which could add to pressures on EM currencies.

Differentiating Among EMs

Among the challenges confronting investors is how to think about the array of problems confronting emerging economies. During the 1970s and 1980s, the task of identifying problem countries was straight-forward. For the most part, the countries that experienced debt-servicing problems were ones that ran large budget and current account deficits and which were prone to high inflation. The respective central banks typically would defend the exchange rate by selling foreign exchange reserves, but once reserves were depleted a full-blow currency crisis ensued. The most dramatic was the LDC debt crisis that surfaced in 1982, where the epi-center was Latin America. While most countries in Latin America have done a good job containing inflation in recent years, Argentina and Venezuela are plagued with very high inflation today, and Brazil's inflation has been running in the high single digits. As a result, policymakers are forced to keep interest rates high. (note: The same is true for other countries with high inflation such as Russia, South Africa, and Turkey.)

The Asian Financial Crisis in 1997-98 represented a different situation, as the region experienced a wave of currency depreciations in countries where inflation was relatively low and public sector finances were in good shape. In this instance, the problems stemmed from a boom in commercial real estate, in which banks borrowed from abroad to finance their loans to developers. When the construction boom faded, capital flowed out of the region and Asian currencies plummeted. Central banks responded by tightening monetary policies, but the banking systems were threatened, because banks suffered declines in asset values while their foreign borrowing costs increased. In looking back at this experience, Rudiger Dornbusch referred to it as a "new-style" EM crisis that involved "doubt of the creditworthiness of the balance sheet – public or private – and the exchange rate".[3]

If anything, the current situation is even more complex, as China and other countries in Asia have experienced a rapid build-up of debt that has been financed domestically. With many Asian countries having acquired massive foreign exchange reserves over the past 15 years and inflation very low, they do not confront a traditional currency crisis. The debt build-up, however, has given rise to excess capacity in real estate and manufacturing that could become a full-fledged asset bubble at some point. For the time being, China's policymakers have the flexibility to postpone the day of reckoning by easing monetary policy and pursuing added fiscal stimulus. However, to the extent bad loans are being rolled over by government edict, a further slowing of China's economy seems inevitable.

Keeping Expectations in Check: BRICs Concept R.I.P.

An ongoing challenge for investors is to gauge the expectations that are priced into markets and to assess whether they will be met. This is not always easy to do, however. Common mistakes include extrapolating past trends into the future and ignoring changes in valuations.

[2] *Ibid.*
[3] *See Rudiger Dornbusch, "A Primer on Emerging Market Crises," NBER Working Paper 8326, June 2001.*

An example is the BRIC concept that researchers at Goldman Sachs developed in the early 2000s to describe the growing importance of Brazil, Russia, India, and China. The initial recommendation to invest in these countries proved to be well-timed, and the concept gained widespread popularity owing to their strong economic growth and stellar investment returns throughout the decade. In 2010, however, Goldman's researchers produced a report entitled "Is This the BRIC Decade?"[4] that claimed investment returns were likely to remain stellar, because high growth trends would continue, driven by the rise of the middle class and consumer spending.

In a white paper on this topic written in May of 2011, I critiqued Goldman's return projections on grounds there were pitfalls in extrapolating growth trends and also that valuations in EM equities were no longer cheap based on implied discount rates. I also maintained the four economies were more heterogeneous than homogenous, and they faced diverse challenges: "Because there are vast differences among the four countries, investors need to assess the risks and rewards associated with each of them separately, rather than banking on momentum (or slogans) to carry the day." My conclusion was the BRIC idea was a marketing concept rather than an investment strategy.

Based on results over the past four years (see table below), my assessment if anything proved to be too guarded, as the performance of the BRICs has been far worse than I expected. That said, it's possible these markets may exceed the low expectations that are now priced into them now. Nonetheless, I stand by my conclusion that to be successful investing in the asset class, there is no alternative to in-depth analysis of the respective economies and markets.

Annualized Equity Returns (in percent)

(in U.S. Dollars)	2000 – 2010	2011 – 2015Q3
China	9.2%	0.1%
India	14.7%	-2.4%
Brazil	18.8%	-20.0%
Russia	15.9%	-11.7%
BRIC Composite	13.8%	-6.8%
U.S. (S&P)	0.4%	11.7%

Source: MSCI and S&P.

[4]*See BRICs Monthly, May 20, 2010.*

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