

September 29, 2014

Buy Your Straw Hats in Winter *The Current State of the Emerging Markets*

The old sage of Wall Street, Bernard Baruch once said: “buy your straw hats in the winter time.” On May 5th, I wrote on the issue of emerging economies’ capital markets:

Another risk-based asset class that holds interest is emerging markets – stocks of companies in those parts of the world where changes in demographic trends and potential productivity both point to higher economic growth rates. Along with higher potential economic (and profit) growth rates come the higher levels of societal and political risks prevalent in many of these countries.

Investing in the emerging markets isn’t for the faint of heart, as stock prices can move rapidly at times. But similar to the Russell 2000 Index (an index of smaller U.S.-based companies), the emerging markets have historically generated returns higher than those of their more mature, developed cousins. Over the last two years as the small-cap and emerging market returns have become divergent, political and economic risks have escalated within many of the emerging-market countries.

I concluded my piece by saying:

Buy your straw hats in the winter time. Frankly, it is currently feeling awfully cold outside for the emerging markets. Too cold, perhaps

Up to Date

Since that piece, how have the emerging stock markets performed? Simply utilizing the iShares MSCI Emerging Markets ETF, we can see the following:

	May 5 – Aug. 31	Aug. 31 – Sep. 23	May 5 – Sep. 23
Emerging Markets	+8.9%	-5.5%	+2.9%
ACWI (all-world)	+3.7%	-2.2%	+1.4%
S&P 500	+6.3%	-1.0%	+5.2%
Russell 2000	+4.3%	-4.7%	-0.6%

As can be seen, following the piece on May 5th, the emerging markets rallied by almost 9% in

value over the next 4 months, outperforming the ACWI (all-country world index), S&P 500 and Russell 2000 indexes. So far this month, quite a bit of that outperformance has been given back, as the U.S. dollar has rallied and the Fed has continued hinting of interest rate increases sometime after the first of the year.

Longer-Term Perspective

In my readings, I recently ran into some data showing relative performance of the emerging vs. the developed markets since 1987. Here are some salient facts as to how these markets have performed relative to each other over the last 27 years.

- Over the last 27 years, on average the emerging markets have outperformed the world's developed markets (local currency).
- The emerging markets have outperformed the developed markets in 18 of the 27 years under observation – a “batting average” of .666 – again, in local currency terms.
- The years of 1995-1998 showed a period of strong outperformance by the developed markets – as the emerging space underperformed the developed markets four years in a row.
- From 2001-2010 the emerging markets reversed that 4-year trend by outperforming the developed space over a 7-year stretch.
- From 2010 – current the emerging markets have underperformed their developed cousins in 3 of the last 4 years.

Why the Recent Underperformance

The three issues that most pundits point towards for driving emerging market outperformance or underperformance, relative to larger, more developed markets are:

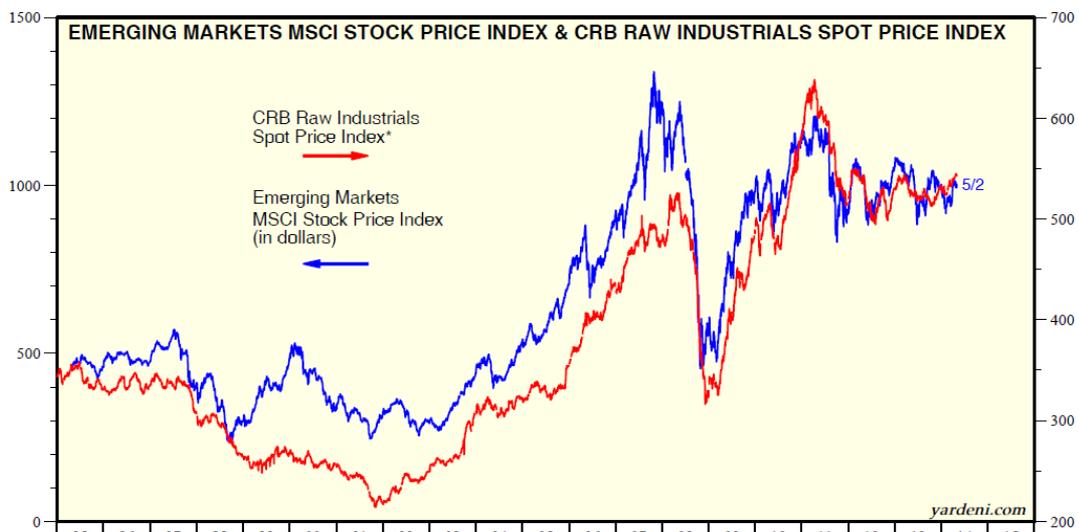
1. **Interest Rate Environment and Fed Policy.** Many emerging economies are “absorbers” of capital. The economies are growing more rapidly than their developed cousins. Consequently, many tend to need capital inflows to maintain strong growth rates. Central bank policies can either be “dovish” (loose) or “hawkish” (restrictive). Significant speculation currently is that the Fed is going to start raising short-term interest rates sometime next year - we concur with this opinion. Consequently, many are concerned that the emerging space will underperform the developed markets because of a lack of positive capital flow, which will keep growth stunted.
2. **Central bank policies are one determinant of a country's monetary exchange rate.** Everything else being equal, if a country's central bank is dovish in their monetary policies, this tends to lead towards their currency exchange rate coming under pressure. On the other hand, a hawkish monetary policy tends to lead towards rising interest rates and a stronger currency. If a country's perceived exchange rate is going to come under downward pressure, foreign investors tend to shy away from moving capital towards that economy.
3. **Many emerging economies are major commodity producers and exporters.** Therefore, domestic economic strength of these countries tends to go hand-in-hand with commodity prices. If the world's investors perceive that commodity prices are going to be weak, they may forego investing capital in those countries whose overall economic growth relies heavily on certain commodity price activity.

Let's provide some quick thoughts as to each of the above issues.

- I understand why investors view the issue of the direction of Fed policy as helping drive currency valuation. But, it is also interesting to note that **since 1995 there has been little**

annual correlation between 10-Year Treasury yields and the relative performance of emerging stock markets as compared to the developed markets. For example, from 12/94 – 12/98, the emerging markets underperformed the developed markets in each of those 4 years, while interest rates in the U.S. *declined from 7.6% to 4.7%*. Additionally, from 12/00 to 12/07, the emerging markets *outperformed the developed markets 7 years in a row, while interest rates declined from 5.0% to 3.6%*. So, over longer periods, it appears 10-year Treasury yields have had little direct impact on relative performance of emerging markets, as compared to their developed cousins.

- While longer-term interest rate changes may not have had a direct impact on relative performance of emerging markets to their larger cousins, ***the same can't be said about currency exchange rates***. During the periods mentioned in the bullet point above, from 12/94 – 12/98, the exchange rate of the U.S. dollar (U.S. Dollar Index) rose by 6.1%, during which time the emerging markets underperformed the developed markets. Then, from 12/00 to 12/07, the emerging markets outperformed the developed markets, during which time the dollar fell by 23.5% in value to other currencies. Lastly, from 12/11 to current, on balance the emerging markets have underperformed the developed markets, during which time the U.S. dollar has risen by 7.3% in value to foreign currencies. ***History shows that the emerging space has a difficult period when the value of the U.S. dollar is rising.***



* Includes copper scrap, lead scrap, steel scrap, tin, zinc, burlap, cotton, print cloth, wool tops, hides, rosin, rubber, and tallow.
Source: Morgan Stanley Capital International and Commodity Research Bureau.

- Finally, let's take a look at commodity price changes and the correlation of those changes to periods of relative outperformance/underperformance of emerging markets to developed markets. I decided to use the time frames mentioned above with this relative analysis. ***In all three multi-year periods under question, commodity prices appear to have had an impact on relative performance of the emerging markets. The chart above overlays the CRB Raw Industrials Spot Price Index (red line) on top of the Emerging Markets MSCI Stock Price Index (blue line). A picture says a thousand words.***

Diversify

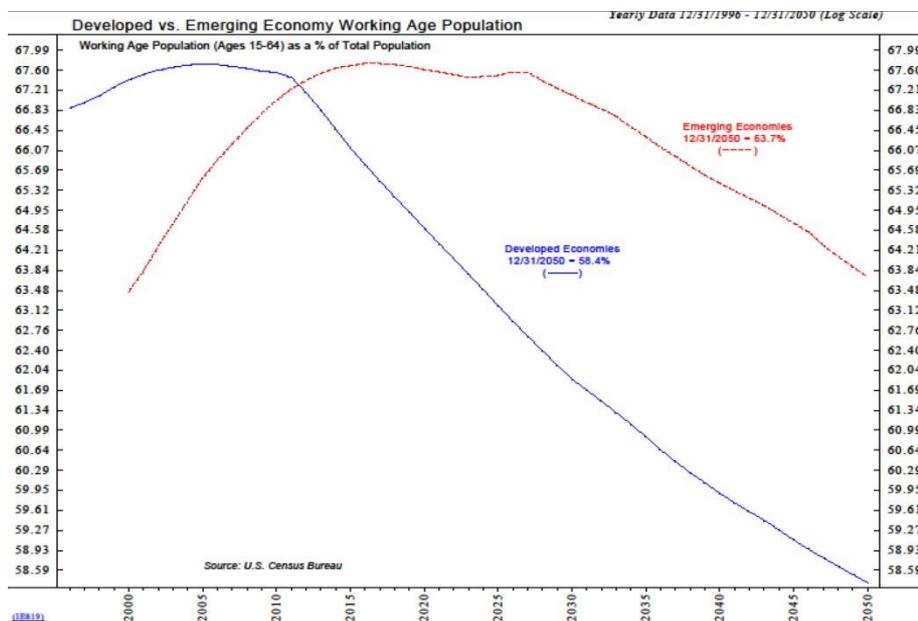
Our work shows that over longer periods of time, commodity prices and currency exchange rates have been a stronger determinant of the relative performance of the emerging equity markets than have interest rates. So, where are commodity prices and currency exchange rates heading? Obviously, nobody truly knows. But, to the degree that ***an investor wishes to diversify his portfolio into commodity exposure and doesn't wish to deal with the oddities of the***

commodity trading pits, it may make sense for that investor to consider placing capital into the emerging markets. Additionally, if an investor is convinced that the value of the U.S. dollar will eventually enter a phase of decline, the emerging markets may indeed hold promise.

There is perhaps an overriding reason for investors to consider placing capital into the emerging markets – that being growth. From either a “real” or “nominal” GDP growth profile, many emerging markets are growing, and probably will continue to grow, much more rapidly than their developed cousins. Why? Demographics, plain and simple.

People, People

Economic growth, as measured by increases in Gross Domestic Product (GDP), can occur for three reasons. Inflation (bad growth), productivity (good growth) and the size of a nation’s work force. Notice in the chart below, the developed nation’s workforce (as a percentage of total population) is starting to systemically shrink, leading to downward pressure in overall GDP growth rates.



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Notice the emerging economies’ work force is staying somewhat static until the year 2025. This is a very powerful long-term story where growth in the emerging economies, which has been higher than in the world’s developed economies for some time, will probably continue to remain relatively high.

Bottom Line

We have attempted to demonstrate that returns in the world’s emerging stock markets have tended to have a strong correlation with underlying relative currency movements and commodity prices. As the value of the dollar declines and commodity prices rise, historically emerging stock markets have outperformed their developed market cousins. When the value of the dollar has risen and commodity prices have declined – well, you get the picture.

These factors (currency and commodity prices) move rapidly. From a base-line standpoint, economic growth and profit growth drive equity markets over the long-term. Here, the story is very strong in favor of the emerging market space. The emerging markets have been underperforming

the developed space, on balance for more than 3 years.

Straw hats, anyone?

We will be back next week.



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