FirstPoint Financial

WEEKLY MARKET THOUGHTS

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Emerging Markets Update – Are We There Yet?

The world's stock markets have been struggling with the political dislocation in Ukraine and the growth slowdown in China. We wrote recently on our concerns regarding the issue with Ukraine/Russia. Today's piece provides some insight into the growth issues in China.

Emerging markets, one of our favorite long-term asset classes, have, for the previous 12-18 months, also been among the worst-performing asset classes globally. Indeed, since the beginning of 2013 through last Friday, the world's emerging stock markets have registered a -13.4% retreat (as measured by the iShares Emerging Markets ETF) compared to the S&P 500 price return of +29.1% over the same period of time. That adds up to a whopping 42.5% spread between the two investment alternatives!

This chart depicts the return of the S&P 500 index (top line), the EAFE index (developed markets x-U.S. – middle line) and the iShares Emerging Markets ETF (bottom line) over the last year.

A combination of fundamental events during the last 14 months has helped the world's developed markets—United States, Europe and Japan— outperform their smaller, less mature companions. This level of disparity in the returns of the two asset classes is rare indeed. Which raises the question: Is it time to put capital to work in the emerging market space

Fundamental Worries - China

There are a number of reasons why the emerging markets have underperformed the world's larger, more mature markets. When viewing the emerging markets as a whole, it's important to recognize that China represents nearly 30% of the world's emerging economies, as measured by gross domestic product (GDP)—the sum of all goods and services produced by an economy. Consequently, understanding what's happening in the emerging markets space means first understanding what's happening in China.

China is experiencing a growth slowdown, much of it purposefully engineered by the leaders in Beijing. As we have written in the past, China's leaders have decided to shift their growth drivers from investments and exports to consumption (at the margin). Like all economic shifts, this one has created friction within their economic system. Economic resources have started to move from beneficiaries of the old economic model to the new. This reallocation of resources has created tension that has led to a slowing of GDP growth rates. It now appears China's GDP will grow less than 7% this year. While a 6% GDP growth rate sounds marvelous to most of the world, this is a country that became used to 8% - 11% GDP growth.

Additionally, China's financial system appears to need mending. Communist countries control lending at central levels. Officially, China has been subsidizing state-owned enterprises with low interest rates and capital. This has led the more efficient and well-run organizations in China to seek financing from the "Trust Banks"—highly levered organizations that have the capacity for default. The State is subsidizing inefficient, state-owned companies that have access to plentiful and cheap capital, while the more efficient, non-state-owned organizations are forced to pay higher rates and have less access to capital. In other words, it seems as though China's capital allocation process needs to be fixed.

China is also a major importer of raw materials – metals, oil, etc. With China's economic focus shifting from industrial manufacturing to consumption, the need for increased imports of raw materials is muted. The slowdown in overall economic growth is further dampening the need for raw materials. And because South America and certain parts of Southeast Asia are major suppliers of raw materials to China, they have been suffering recently.

Fundamental Worries – Social Upheaval

Egypt, Venezuela, Argentina, Turkey, Thailand, Ukraine, Brazil and South Africa all have some important things in common. They are all experiencing some type of social/political dislocation. All have currencies that have recently declined in value. Most of them also have poor leadership or have experienced a change in leadership alongside high unemployment and economic worries.

These worries seem to be intensifying recently with Russia's move into Ukraine. China's recent economic releases roiled many global equity markets, but particularly the emerging markets. This past week, the emerging markets (as measured by EEM) were down -2.83% in dollar terms, as compared to the S&P 500, which was down -1.97%. The underperformance continues.

Fundamental Worries – Profit Contraction

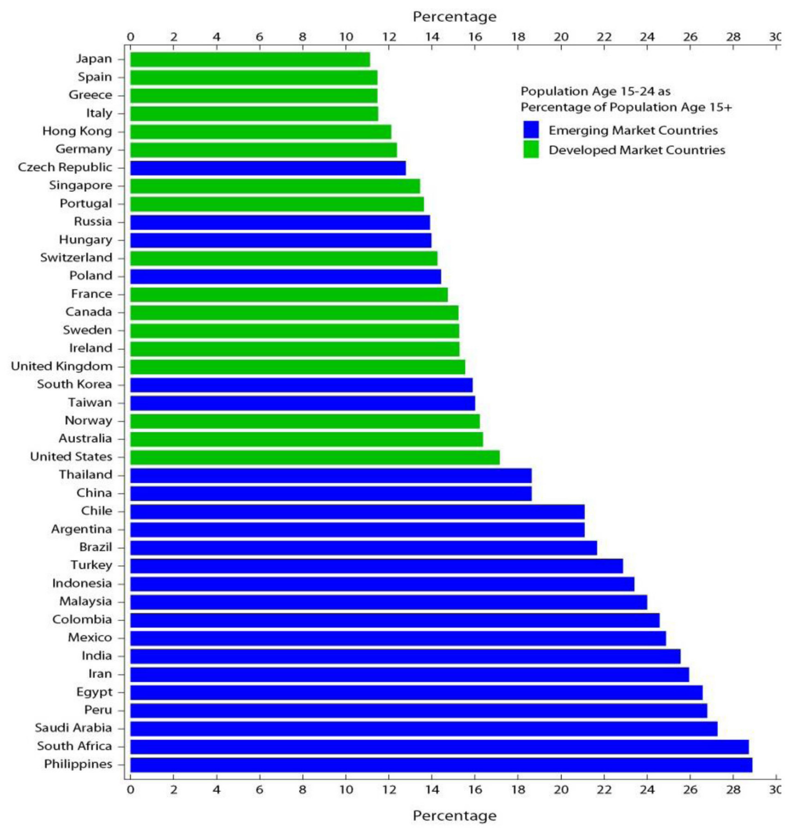
Reflecting social upheaval and the problems radiating from China, companies within the MSCI Emerging Markets Index have seen year-over-year earnings contract in six of the past seven quarters. Over this period of time, investors have been steadily pulling capital away from emerging ETFs. Moreover, net outflows have reached $24 billion over the last 12 months, and company earnings in the MSCI Emerging Markets Index have declined by -2.6%. Finally, the average OECD Leading Economic Indicator is now reading 99.5, suggesting further economic deterioration over the next six to 12 months (for those with a historical bent, this leading economic ratio is at the same level last seen in the first half of 2009).

Buy Your Straw Hats In January

We still believe in the emerging markets over the long-term. Why? Capital appreciation in stocks ultimately occurs with growth. Profit growth occurs due to a number of reasons, but economic growth is of paramount importance. Economic growth occurs for many reasons, but demographics (such as rising labor pool) are usually a critical factor over the long-term. We believe the emerging economies display this particular demographic trait, in spades.

The chart here shows the percent of a country's population between the ages of 15-24 years as a percent of that country's total population above the age of 15. In other words, this chart shows the size of the prospective labor pool relative to the size of the total current labor pool. As can be seen, the countries with the highest level of prospective labor pool growth are all emerging economies. More workers indicate higher economic growth. Higher economic growth indicates higher corporate profits. Pretty simple.

Youth Bulge by Country in 2013



From a valuation perspective, the emerging markets are starting to look downright cheap compared to their developed cousins. Relative to developed market valuation levels, emerging markets' Price-Earnings and Price-Cash Flow ratios are selling at the same levels last seen in late 2008 – at the depths of the last major bear market. From 1/1/2009 to 12/31/2011 – the three years following this low relative-valuation period—the EEM (iShares MSCI Emerging Market ETF) gained +99.1% in value while the S&P 500 generated a return of +45.3%.

This isn't to say that we expect the EEM to generate a return of +99% over the next two years – far from it. But for those long-term investors who are willing to overlook current economic/political/social dislocations, emerging market stocks look attractive as compared to their developed cousins.

Just For Fun

I thought it appropriate to close today's piece with a few quotes on a few of the emerging economies.

Latins are tenderly enthusiastic. In Brazil they throw flowers at you.
In Argentina they throw themselves.

Marlene Dietrich

China has to go along with world trends. That's democracy, liberty, individual freedom. China sooner or later has to go that way. It cannot go backward.

Dalai Lama

When I was growing up, my parents told me 'Finish your dinner. People in China and India are starving.' I tell my daughters, 'Finish your homework. People in India and China are starving for your job.'

Thomas Friedman

And finally…

China is a big country, inhabited by many Chinese.

Charles de Gaulle

We will be back next week.

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