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WITH RECENT VOLATILITY, IS FORSTRONG STILL BULLISH ON EMERGING MARKETS?

Boiling Frogs and the Three Henchmen

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After a near two-year rally, EM stock returns have suffered in the first half of 2018. But consider that the volatility has been driven by a "made in America" trade war, leading to a sharp resurgence in the US dollar, rising interest rate expectations and damaged confidence for future global growth — a toxic mix for emerging markets.

To be sure, these are market trends driven by reactionary investor behavior. Changing EM fundamentals cannot be blamed. What is now clear is that the US is currently the mercurial radical egging global financial markets and economies.

Yet, the US's enthusiasm for trade brinksmanship will almost certainly be self-defeating, akin to the proverbial boiling frog. The damage to their own economy will be gradual ... unaware they are being boiled until it's too late.

INCREASING RISKS IN THE US

Why? At the risk of stating the obvious, much of American business operates globally. US companies have built up massive manufacturing bases overseas (iPhones anyone?). Host countries could easily retaliate and make the business environment much less hospitable. What's more, countries outside the US could shift their import demand. The tariffs that come into effect this week will undoubtedly impact EMs via their integration into China's supply chains. Over the long run, however, EMs will very likely see a redistributive effect whereby China shifts their import demand away from the US and toward other EMs.

Most importantly, Trump has taken a wrecking ball to the US-led post-war world order and America's longstanding alliances (including immediate neighbors, Canada and Mexico). By slapping tariffs on the US's closest allies, Trump is practically chasing them into China's arms. But there is a longer and more critical strategic reorientation at play: by withdrawing as the world's leading country, the US effectively allows for the emergence and even acceleration of new powers.

Chinese President Xi Jinping, who has worked steadily over the past four years to strengthen China's position in Asia, likely views Trump's retreat from globalization as his own triumph. Consider Obama's "pivot to Asia", with the Trans-Pacific Partnership being the centerpiece. It is now dead. That leaves Xi's "Belt-and-Road" strategy (his own version of "Make China Great Again") as the uncontested blueprint for future economic integration in Asia.

What about US markets? Here, the basic fundamentals of the US markets could not be less attractive. Its equity market is extremely expensive relative to the ROW; the US dollar is over-valued; its fiscal policy entirely inappropriate; and its tightening monetary policy prone to triggering high interest-rate sensitivity.

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EM FUNDAMENTALS SOLID

Given the extreme bluster and incivility of POTUS, it is remarkable how restrained the set-back has been in EM overall. Using the EEM ETF as a proxy, consider these comparatives. To date, since an intermediate top set at the beginning of 2018, EEM has declined 17%. In the second half of 2015, by contrast, EEM declined 36% (that more than twice the decline of EEM during the first half of 2018).

What was called the "taper tantrum" in 2015 was hardly the global rumpus spectacle of rabid populists that we see today. Therefore, seen relatively, the instabilities in EEM markets this year have been modest. That is a positive sign.

Most media attention has focused on the woes of Argentina and Turkey. But every year, some EM or frontier country will experience serious macroeconomic instability. Why superimpose the experience of a few idiosyncratic basket cases on an entire universe of more than 75 countries (many of which have solid fundamentals)?

The overall EM position is far more benign than a few outliers. Economies are much more shock-resistant than previous, owing to a whole host of improving macroeconomic factors. For example, in the mid-1990s inflation rates above 20% were not uncommon. Today's EM inflation is trending below 4%. The list of improving factors is lengthy: the emergence of domestic pension systems (which reduces reliance on foreign funding), improved trade balances, better fiscal positions and a number of other strong secular growth drivers.

What about valuations? Here, more good news exists. EM stocks trade at a hefty discount to their developed-market peers (based on price/forward earnings). EM debt presents good value, offering higher yields than the US high yield space with arguably less risk. And, EM currencies can only be described as a "deep value" play. Remarkably, EM nominal exchange rates are today roughly 40% lower than during the 2008 global financial crisis.

Where to next? History shows that EM outperformance cycles typically unfold over several years. The last 8 years of EM underperformance (for the period ending in 2016) were preceded by nearly nine years of outperformance. Furthermore, EMs already had a large slowdown between 2010 – 2016. Since then, currencies have weakened (boosting competitiveness) and policy has turned stimulative (lowering the cost of capital). These benefits always show up with a lag. Why should this time be different?

INVESTMENT IMPLICATIONS

Investors shouldn't be swayed by short-term market moves and must maintain longer-term perspective (a repeated point we make with clients). A quarter or two of underperformance or market downtrend neither offers a valid decision pivot point nor indication of long-term performance. Our 15-year track record proves that.

Emerging markets, as an asset class, are volatile by definition. During the last 7 years, there have been five other reversals of EEM (6 in total, nearly one per year) of greater magnitude than experienced year to date. In every case, there were subsequent recoveries … some carrying to new highs.

Any long-term commitment to emerging market equities will face blustery retracements and corrections. However, we believe that the higher long-term returns are worthwhile — especially so seen in the context of a balanced broadly-diversified portfolio.

The henchmen of recent EEM torture are these three macro pricing factors: 1. rising US interest rates; 2. rising oil prices; and 3. a strong US dollar. We think that several — or all —of these will soon bring some sinecure and relief. The US dollar may now be peaking, more certainly so against the euro. Secondly, intermediate-term U.S. interest rates have shown a moderating trend recently. And, what about the price of oil? It remains prone to a decline … but remains near recent highs. We therefore theorize that much of the EM waterboarding is over. EM outperformance should resume soon. We are only in the foothills of a longer-running period of outperformance.