MV Capital Management Midweek Market Commentary

What's Up with Emerging Markets?

April 5, 2013

Investors as of late have been heartily cheering the rally in US equities that (at least until today's bad reaction to the latest job numbers) has propelled the Dow Jones Industrial Average and the S&P 500 into all-time record high territory. Now, it often happens that when the animal spirits are let loose to run rampant in the land of blue chip US equities other riskier asset classes – like small caps and emerging markets – do even better. Often, but not always. Given that the S&P 500 has settled above its 200 day moving average for 304 of the last 314 trading days, you might think this would be a terrific environment for a traditionally riskier play like emerging markets. Not this time.

Emerging equities markets seem to be inhabiting some other spacetime realm entirely. The MSCI Emerging Markets index is down by more than 3% for the year to date. That's right – it's in absolute negative territory, and on a relative basis that's more than 13% worse than the performance of the S&P 500 over the same time period. What are we to make of this?

One school of thought leads to still-troubled Europe. Emerging economies have more at stake in selling their goods and services to Europe's households and businesses. This is less about the Eurozone financial crisis and more about good old fashioned supply and demand. Those GDP growth rates that have been so impressive in recent years among emerging markets are predicated on robust export markets. But demand in Europe – for many EM companies the most important export market – remains soft.

In a broader sense, though, it may be more about winners and losers in the global economy. The "winners" plausibly could be emerging markets households and US businesses. Average household income levels in the emerging world continue to grow briskly, and with that growth naturally comes increased consumer demand. But who supplies that demand? When you look at the financial reports of large US companies you get a glimpse of the answer: a very significant portion of the earnings growth that has been so impressive of late comes from…yes, sales in emerging markets.

So even if economic prospects for the growth engines are still strong, the main beneficiaries may not be the companies that make up their stock indexes. If GE and Cisco Systems and Procter & Gamble are enjoying explosive earnings from their sales in China, India and Brazil, that doesn't add direct value to the Shanghai Composite or the Bombay Sensex or the Bovespa. It adds direct value to the S&P 500 and the Russell 1000. And for the moment that value gap – in equity market terms – is in the double digits.

And what of the S&P 500? As of this writing the intraday level for the index is down by a bit less than one percent, in the aftermath of a slew of below-expectations job data. Well, the index had gained more than 10% for the year to date, and when that happens some kind of correction is usually to be expected. Whether it turns into anything more than a brief pullback remains to be seen, but at this point the data signals are not flashing emergency red. Patience and discipline are the watchwords.

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