Weekly Market Flash

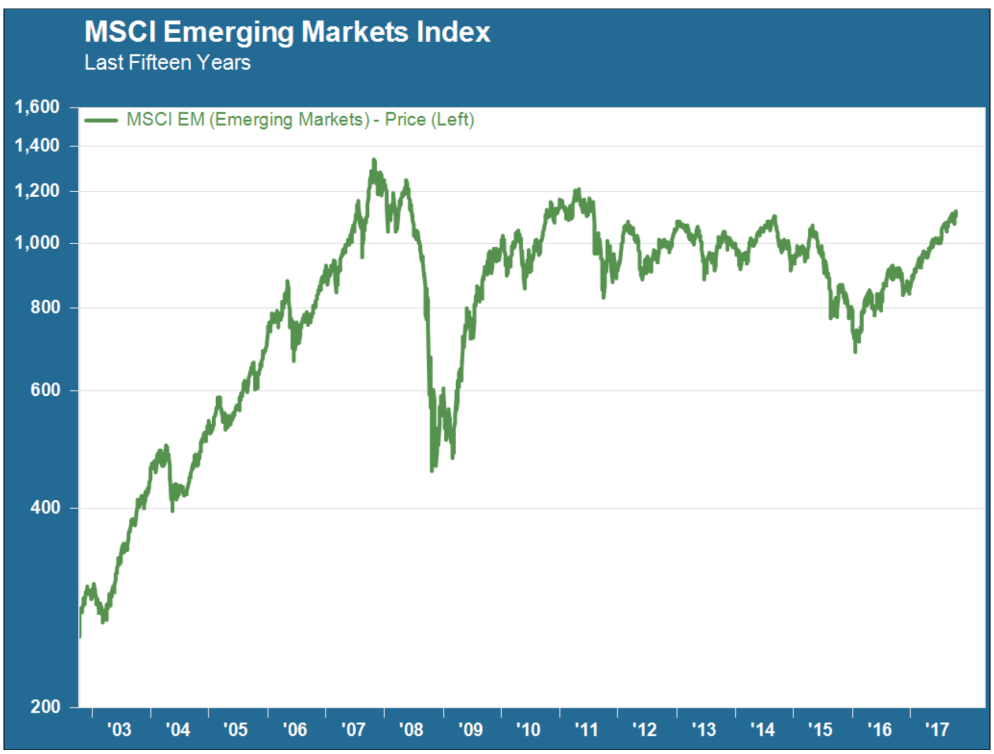
What's Next for Emerging Markets?

October 13, 2017

One of the odder stories in a year of general strangeness in the capital markets is emerging markets. Contrary to the vast majority of expectations in the wake of last November's presidential election, this asset class has been the darling of diversified portfolios in the year to date. The MSCI Emerging Markets index was up more than 28 percent YTD at the end of the third quarter – double the performance of the not shabby 14 percent logged by the S&P 500. Nor is the good news limited to equities; EM currencies have mostly risen against the dollar. Perhaps to underscore the weird irony of the situation the Mexican peso – the currency on the receiving end of all those nativist threats of security walls and trade wars and the like – has gained more than 15 percent against the dollar since January 1.

Reclaiming Lost Heights

In local currency terms, emerging markets equities reached all-time highs this year. In the dollar terms by which US-based investors measure their profits, though, EM stocks still have a bit of ground to make up from their peak during the great growth spurt of 2003-07. The chart below shows the MSCI EM Index (in dollar terms) for the past 15 years.



Source: MVF Research, FactSet

That 2003-07 run came courtesy of several factors unlikely to repeat themselves. These were the years of the great China boom: the country's record-breaking surge to become the world's second largest economy and largest producer / consumer of so many raw materials and finished goods happened in what seemed the blink of an eye. These years also witnessed what is likely to be the final phase of an extended commodities supercycle, which gave resource exporters like Russia and South Africa a few extra points of GDP growth to tack on. Emerging markets became synonymous with "growth" – often real GDP growth of the double digit variety.

Then it all came crashing down. The financial follies concocted in the quant labs of Wall Street and the City took down emerging and developed asset markets alike. The slow pace of growth in the ensuing global recovery has not been kind to many of those former growth market *Wunderkinder*. Brazil and Russia experienced deep recessions, South Africa and Turkey faced increasingly onerous repayment burdens on their outstanding dollar-denominated borrowings, and China has grappled with the complexities of managing stable currency and credit markets while still trying to hit their growth targets. Given all the challenges, perhaps the most surprising thing about that chart shown above is that this asset class didn't fare worse than it did during those sideways years of 2010-16.

What Flavor Crisis This Decade?

So where do they go from here – and are investors wise or foolish to follow? One of the important things an investor should always keep in mind about emerging markets is their dynamism – in the sense that the composition of these economies changes more fluidly from year to year than their developed world counterparts. Their installed base of productive resources, their monetary policies and the consumption habits of their citizens are all vastly different today from what they were fifteen or twenty years ago.

That is important because it was precisely twenty years ago that emerging markets fell into one of their periodic traps that turn investors' stomachs. A crisis in the baht, Thailand's national currency, went viral and wreaked havoc on currencies and central bank balance sheets from Seoul to Jakarta and beyond. A year later Russia defaulted on its sovereign debt obligations, swallowing up local punters and rich world hedge funds alike. There is a "crisis a decade" school of thought among long-term EM observers, going back to the Latin American debt crises of the 1970s and 1980s to Asia and Russia in the 1990s, Argentina in the 2000s and on and on.

The practical effect of these crises is well-documented: never contained as a local affair, the pain spreads as investors treat their emerging market exposures as one asset class. Never mind if Argentina and Malaysia have almost nothing in common: they rise together and fall together in the capricious ebbs and flows of portfolio capital. For this reason, the asset class as a whole has been a long term loser. Since the beginning of 1990, the average annual return of the MSCI EM index has been about 1 percent lower than that of the S&P 500 – but the risk, measured by standard deviation, has been a full 8 percent higher. "No gain, lots of pain" sums up this portfolio contribution.

Traps Old and New

It would be unwise to project the failures of 1997-98 onto possible negative scenarios for the near future. EM central banks have become much more robust in terms of foreign exchange reserve defenses, and their vulnerability to developed market currencies is mitigated by a growing portion of local currency credit instruments to fund their domestic investment initiatives. Many emerging markets today look…well, less "emerging" and more mature than they did even a decade ago.

But with maturity comes a new set of challenges, and potentially new kinds of traps. Resource exporters like Russia and South Africa will remain vulnerable to a potential weak secular cycle in commodities. Countries whose primary source of competitive advantage is cheap labor are at risk in a world where AI threatens to upend traditional employment patterns in industry after industry. Technology is widening the gap between the handful of companies able to leverage leading-edge technology in their business models and the legions of stragglers struggling to keep up. These are all traps that could trip up countries and regions in that delicate transition from widespread poverty to wealth. And all of this is to say nothing of the lurking threat of protectionism and nationalist nativism from disgruntled voters and their political avatars in the US or the EU.

The developed world is not growing quickly, and this pattern is likelier than not set to continue. If the combined heft of emerging markets can unlock a formula for higher sustainable growth then these markets are worth keeping in strategic asset allocations – and one would expect the risk-return composition to be more favorable than it has been in the past. But these are still significant ifs. We believe investing in emerging markets will call for more nuance going forward, starting with the practice of not treating this widely diverse collection of markets as one asset class.

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