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What Has Everybody Been Worried About?

A Closer Examination of the Angst Surrounding Emerging Markets

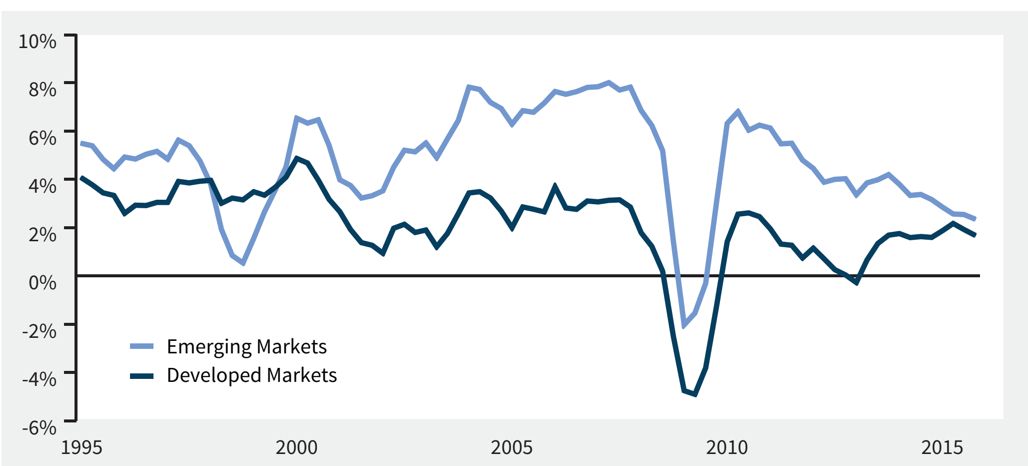
Despite recent signs of improvement, investor sentiment about emerging markets has been fundamentally depressed over the past year. Relative to their historical positioning, global institutional investors maintained a significant underweight to emerging market equities in 2015, and have also done so thus far in 2016, according to Bank of America Merrill Lynch. Driving the asset class's underperformance are a number of key concerns: disappointing economic growth in emerging market countries, the potential impact of U.S. interest-rate hikes and a stronger U.S. dollar (USD), fears of a hard landing and currency devaluation in China, and the collapse of the commodity complex, to name just a few. While these situations pose real threats to emerging markets (and to the world), we believe a closer examination of them can help alleviate some of the angst surrounding the asset class.

Disappointing Economic Growth in Emerging Market Countries

The once-strong economic growth engine in emerging markets seems to have run out of steam in recent years. Gross domestic product (GDP) growth in emerging markets has declined not only on an absolute basis, but more importantly, relative to developed markets (fig 1).

This is important because research shows relative GDP growth rates are a key factor in determining outperformance of emerging versus developed markets. We therefore expect greater differentiation in emerging market performance as a reflection of the dispersion in economic performance between manufacturing-led and commodity-led economies. The former have remained stable and the latter have collapsed, bearing the brunt of the slowdown in emerging markets relative to developed markets.

Fig. 1: Real GDP Growth, Emerging Versus Developed Markets



Source: William Blair, Emerging Advisors Group, as of December 2015. GDP is real, year-over-year, and mid-weighted.

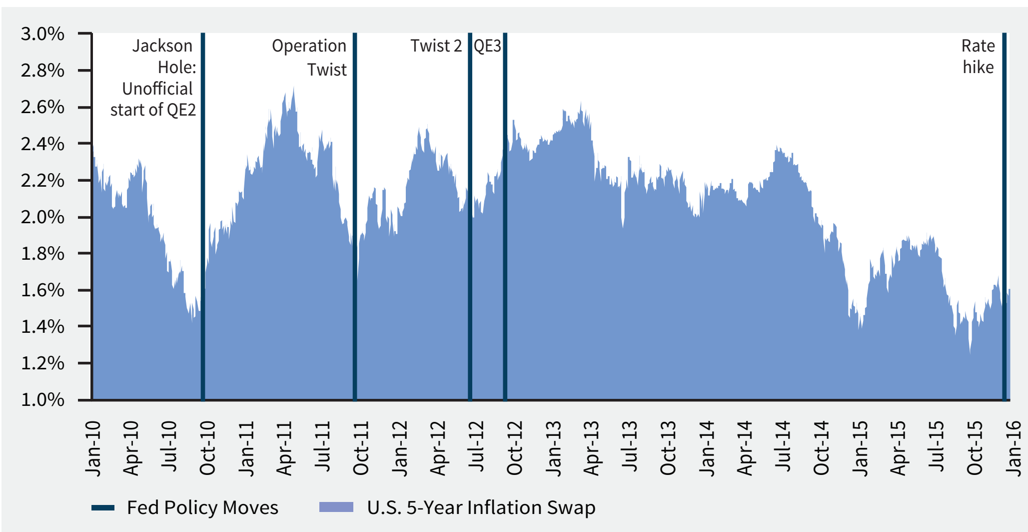
The Potential Impact of U.S. Interest-Rate Hikes and a Stronger USD

Concerns about the liftoff of U.S. interest rates by the Federal Reserve (Fed) and the evolution of the USD have weighed on performance in emerging markets over the past few years.

Despite investor concern, an analysis of historical Fed tightening cycles since 1969 shows that emerging markets have outperformed developed markets during most such cycles. The only exceptions occurred when tightening cycles were considered "violent"—that is, the rate increases came sooner than the market anticipated or were stronger than the market anticipated, or both.

We believe the current Fed rate-hike cycle is likely to be in the "benign" category. First, the Fed has painstakingly communicated a slow and gradual pace of rate hikes. Second, concerns about GDP growth in the United States and abroad, global deflationary pressures, and relatively tame wage growth in the United States will, in our view, limit the Fed's actions. In particular, inflation is currently well below the Fed's target of 2%, and inflation expectations are below levels at which the Fed has actually implemented easing policies (multiple rounds of quantitative easing, or QE) in the past (fig. 2).

Fig. 2: Inflation Expectations Are Below Past Easing Levels



Source: William Blair, Bloomberg, Evercore Research as of March 2016.

While the trajectory of Fed rate hikes is key to the performance of emerging market equities, the level of U.S. rates is also important as it directly impacts emerging debt markets, and through them, emerging market equities. Today, emerging debt markets are larger than ever before, and foreign funds have become significant players as large sums have flown into emerging markets as a result of a global search for yield following the collapse of interest rates in the wake of the global financial crisis. As a result, foreign outflows can have an outsized effect on emerging debt markets, affecting emerging market interest rates and currencies, as was the case during the summer 2013 "taper tantrum." Therefore, we believe it is important to monitor emerging market debt flows to assess potential risks to emerging market equities.

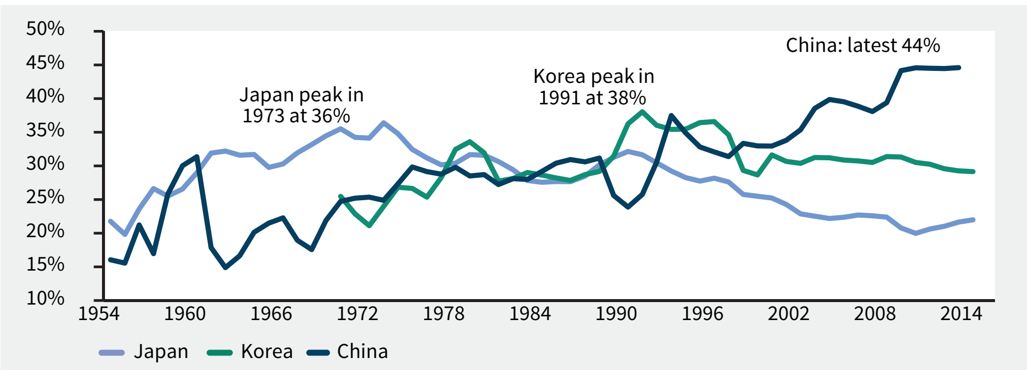
In regard to investor fears of further USD appreciation after Fed liftoff, history shows that in the majority of tightening cycles the USD has rallied into the first interest-rate hike then sold off in a classic "buy the rumor and sell the fact" type of investor behavior. We believe the bulk of the USD rally is behind us and the current trajectory of the USD since the Fed increased interest rates in December 2015 seems consistent with previous episodes.

China Fears: Hard Landing, Currency Devaluation and More

Fears of a hard landing in China as the country transitions from an investment-led economy to consumer-led economy have been a persistent drag on investor sentiment toward emerging markets. Successive policy missteps and a lack of transparency have undermined market confidence in the Chinese government's ability to successfully conduct this transition.

In our view, the transition to a more sustainable economic growth model is necessary. Over the past decade, China has experienced an investment boom, which has in turn fueled a commodity super-cycle. At almost 45%, investment as a percentage of GDP in China has reached levels never before witnessed during any modern country's development (fig. 3), and it seems poised to contract as the efficacy of additional borrowing on economic growth is decreasing. The concern is that China could follow the same path as other countries that experienced similar development models, such as Japan or Korea. In those countries, GDP growth collapsed in the 10 years after investment as a percentage of GDP peaked.

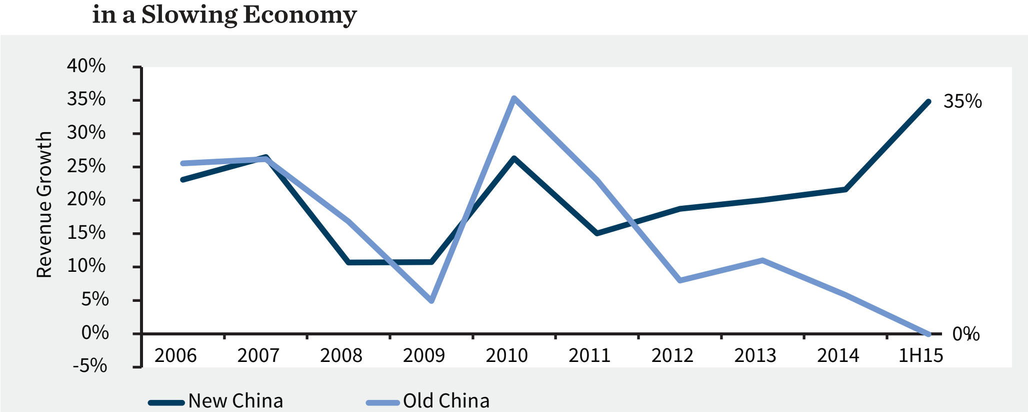
Fig. 3: Investment as a Percentage of GDP is at Historical Highs



Source: William Blair, Credit Suisse, Bloomberg as of December 2014.

However, the picture is not so dark, in our view. The largest parts of the economy (the service- and consumer-related sectors) are strong (fig. 4) while the weaker parts are showing signs of stabilization. In addition, the much-feared residential property market has been on a path to recovery for several months, responding well to stimulus measures taken late in 2014 and early 2015. So while there are indeed serious challenges associated with the economic transition, we believe it is important not to ignore the progress made, as well as the government's commitment to support the economy and the room it has to maneuver.

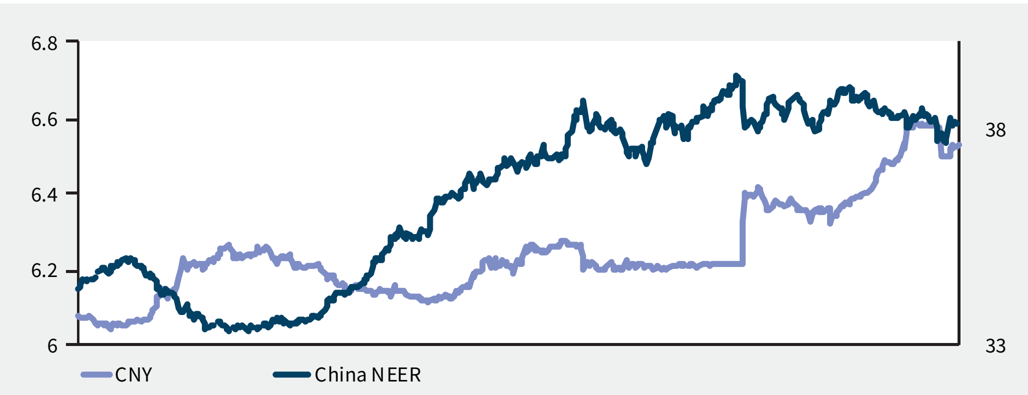
Fig. 4: "New" China Delivered High Top-Line Year-Over-Year Revenue Growth in a Slowing Economy



Source: William Blair, Goldman Sachs Global Investment Research as of June 2015. New China includes GICS Sectors Healthcare and Information Technology and GICS sub-industries Education, Publishing, Advertising, Movies & Entertainment, Travel & Leisure, Internet Retail, Environmental Services, and Renewable Electricity.

Furthermore, since the Chinese yuan's (CNY's) unexpected devaluation in August 2015, the currency has been the center of currency, equity, and bond market turmoil amid concerns about the potential for a large-scale competitive devaluation. Devaluation fears rocked the markets again in early 2016, but then abated somewhat amid increased clarity in policy communication from the People's Bank of China (PBOC). We believe investor expectations of further devaluation have been overly bearish as four factors do not seem to support a competitive devaluation argument: China's record 2015 trade surplus of $600 billion, the health of the Chinese consumer, the absence of unemployment, and China's relentless rising market share of global exports. Importantly, the CNY does not appear to be fundamentally overvalued, as shown by its closer parity with its nominal effective exchange rate, or NEER (fig. 5). Consequently, we do not believe there is an inherent pressure for a significant CNY depreciation.

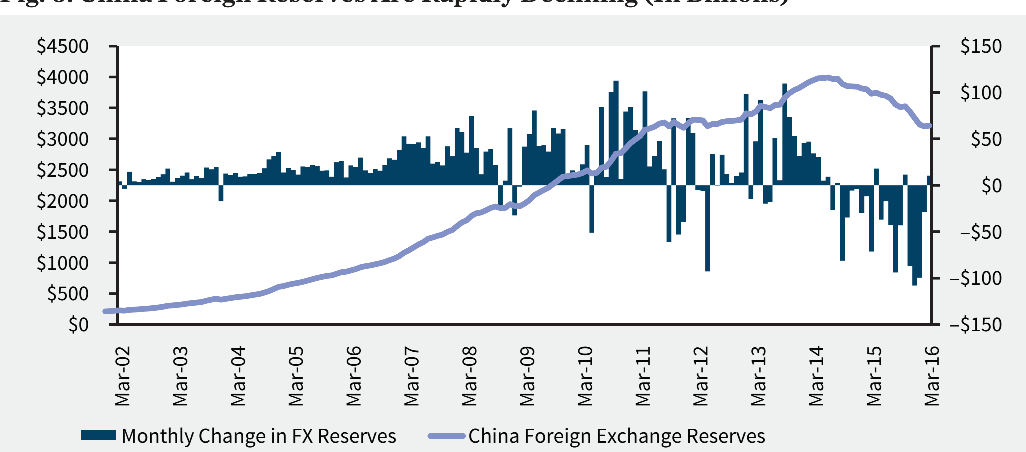
Fig. 5: The CNY Does Not Appear to Be Fundamentally Overvalued



Source: William Blair, Barclays Research as February 2016.

Expectations of continued currency depreciation have also been a drag on foreign-exchange (FX) reserves. While current FX reserves still stand at very high levels, $3.2 trillion as of end of March 2016 (fig. 6), the acceleration in capital outflows has rung alarm bells about the pace of depletion of these reserves. However, we expect the pace of outflows to abate as the Chinese authorities are actively tightening rules to limit capital outflows and capital flight by Chinese corporations (which very rationally decide to pay down their USD-denominated debt in anticipation that further CNY weakness) should moderate over the next few months.

Fig. 6: China Foreign Reserves Are Rapidly Declining (In Billions)



Source: William Blair, Bloomberg, as March 2016.

Collapse of the Commodity Complex

The collapse in commodity prices over the past year is another concern driving underperformance and outflows in emerging markets.

Pressure on commodity prices has come from a combination of decelerating economic growth in China (the largest buyer of most commodities) and, more importantly, oversupply resulting from new mining projects, conceived and initiated at the highs of China's economic growth boom, which are coming online now. Oil prices are durably affected by a structural change in energy markets. As shale oil has disrupted the equilibrium in the oil market and the Organization of the Petroleum Exporting Countries (OPEC) can no longer control the price of oil by slashing production, producers are now focusing on defending their market share at the expense of pricing.

But does the end of the commodity boom spell doom for emerging markets? We do not think so.

First, it is interesting to observe that the impact of commodity sectors on emerging market equities has vastly diminished. The energy and materials sector weights in the MSCI Emerging Markets Index are now only 13%, down from 38% at the peak of the commodity boom and almost on par with the MSCI World Index.

Furthermore, if we differentiate the MSCI Emerging Markets Index by countries that are winners and losers as a result of weaker commodity prices, we find that countries that account for 70% of the index are net beneficiaries of falling commodity prices. So, despite the conventional wisdom that falling commodity prices are negative for emerging markets, the reality is that there are far more emerging markets that are beneficiaries of weaker commodity prices than those that are not.

Lastly, in our view, the general perception that emerging markets and commodities are highly correlated suffers from an anchoring bias. The correlation between commodity prices and emerging market equity prices significantly increased from 2005 to 2013, driven by an acceleration in Chinese demand for commodities amid China's investment boom, which benefited commodity-producing countries in emerging markets and drove a general optimism regarding the asset class. It was a sort of rising tide that lifts all boats, driving correlations higher.

What Could Help Emerging Markets?

Valuations are still attractive. In our view, broad macroeconomic fears are priced into emerging market equity valuations as they are trading well below one standard deviation relative to developed markets on both a price-to-earnings (P/E) and price-to-book (P/B) basis. They are also below levels seen at the depth of the global financial crisis.

With regard to corporate performance, a more significant decline in emerging market earnings revisions relative to those in developed markets has driven emerging markets to underperform developed markets for some time. However, recent data is showing encouraging improvement as the difference between emerging and developed market earnings revisions is closing.

Additional factors that could support emerging market performance relate to improvements in economic growth and policy communication in China (stabilization of macroeconomic data, further monetary and fiscal stimulus, and improved investor confidence in Chinese policymaking), a benign U.S. Fed tightening cycle coupled with continued weakness in the USD, and a stabilization of commodity prices supported by curtailment of production.

Many of these factors seem to be materializing in the past weeks, bolstering investor sentiment and underpinning the recent rebound in emerging market equities.

About the Author

Todd McClone is a portfolio manager for William Blair's EM strategies. Before joining William Blair in 2000, he was a senior research analyst specializing in international equity for Strong Capital Management. Previously, he was a corporate finance research analyst with Piper Jaffray. At Piper Jaffray, he worked with the corporate banking financials team on a variety of transactions including initial public offerings, mergers and acquisitions, and subordinated debt offerings; he also issued fairness opinions and conducted private company valuations. He received a B.B.A. and B.A. from the University of Wisconsin–Madison.

About William Blair

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Important Disclosures

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