

Mitch on the Markets

What's Next for Emerging Markets: Crisis or Opportunity?



By Mitch Zacks
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Unless you have 100% of your portfolio invested in oil (which I would not recommend), it's been a pretty shaky start to the year for many asset classes and investment portfolios. Stocks, as measured by the S&P 500, underwent what now looks like a double-dip correction to start the year, and through mid-May are barely in positive territory.¹ Bond (U.S. Treasuries) prices have been under pressure all year, as yields on the 10-year and 30-year have both shot past 3%.² And, global stocks have been basically flat for the year.³

But the category I want to focus on this week is Emerging Markets (EM), whose recent sell-off has become a front-and-center topic in the financial news. Generally speaking, Emerging Markets have delivered solid relative performance compared to U.S. stocks over the last two years,⁴ but performance in year-to-date 2018 has many questioning whether the EM trade has seen its day.

Before I dive in, let me first say this: investing in Emerging Markets is not for everyone. Global diversification may be beneficial for many investors, and we advocate for it quite a bit here at Zacks Investment Management. But global diversification does not necessarily imply having a material allocation to Emerging Markets. EM as a category falls on the outlier of investing in foreign markets and is comprised of countries with volatile growth rates and largely nascent capital markets systems. A global investor with exposure to Britain has a much different risk profile than a person who invests in Brazil, where the economy and capital markets are far less sophisticated.

Whether you invest in Emerging Markets ultimately depends on your investment horizon, your appetite for risk, your income needs, and your growth objectives. In my view, unless you're in your 20's and desire a high-risk portfolio, you probably shouldn't have more than 15% to 20% in Emerging Markets. But at the end of the day, for most investors, I think the number should probably be much lower.

Emerging Markets: Brace for Impact or Seize the Opportunity?

The Bearish Outlook:

As of this writing, Emerging Markets (as measured by EEM) are down around -6% for the year.⁵ This marks a pretty wide diversion from the S&P 500 and global stocks (MSCI World), which are both slightly positive for the year in spite of higher levels of volatility.

I think there are a couple of distinct causes for selling pressure in Emerging Markets. One is the stronger dollar. As rhetoric surrounding trade wars has elevated and as the Federal Reserve sticks to its gradual path of rate increases, the dollar has fairly abruptly strengthened, which generally hurts Emerging Markets economies as financing and import costs rise.

The other issues impacting the EM trade could be global central banks leaning towards tightening as well, and the ever-present risk of a bubbling geopolitical event. In other words, the familiar headwinds that Emerging Markets face in pretty much any given cycle.

The Bullish Outlook

On the positive side, there are also a few reasons to be hopeful about where Emerging Markets could go from here. For one, the Emerging Markets tend to go the way of the global economy, and I

still believe that the theme of 'synchronized global growth' has lasting power in 2018. Global GDP growth expectations for 2018 remain positive and corporate earnings and global PMIs suggest nothing has fundamentally changed to the growth calculus.⁶ Emerging Markets also could see a bolster from higher commodity prices.

From an investment standpoint, the case is fairly compelling, too: the MSCI Emerging Index has recently been trading at a 30% discount to MSCI World Index (price/book ratio), which is the biggest discount since December 2016.⁷ Equity valuations in the Emerging Markets have also fallen to lower than 12 times forward earnings, with robust corporate earnings expected to top 20% over the next year.⁸

The bulls and bears can both make compelling cases in the EM space. So, which is it?

Bottom Line for Investors

For investors who already have Emerging Markets in portfolios, the recent downside volatility brings Emerging Markets to valuation levels that I think are probably too attractive to sell into. Just my opinion. For those who do not own Emerging Markets but are curious, I think long-term that EM offers real opportunity for growth, assuming you have the time horizon, risk tolerance, and the stomach for volatility needed to invest. But as I mentioned before, EM investing is not

for everyone.

I also think there is a wrong way and a right way to invest in EM, and much of it has to do with monitoring economic growth, corporate earning potential, the political situation, currency fluctuations and debt levels. In other words, it involves plenty of research and homework. If you do not have the resources and/or time to do it, I'd urge caution in going it alone. At Zacks Investment Management, we help our clients navigate this arena with investment management and research services that are all in-house.

About Mitch Zacks

Mitch is a Portfolio Manager at Zacks Investment Management. Mitch has been featured in various business media including the Chicago Tribune and CNBC. He wrote a weekly column for the Chicago Sun-Times and has published two books on quantitative investment strategies. He has a B.A. in Economics from Yale University and an M.B.A in Analytic Finance from the University of Chicago.

¹ Yahoo Finance, May 22, 2018, <https://tinyurl.com/y9clvg64>

² U.S. Department of Treasury, May 21, 2018, <https://www.treasury.gov/resource-center/data-chart-center/interest-rates/Pages/TextView.aspx?data=yieldYear&year=2018>

³ MSCI, March 31, 2018, <https://www.msci.com/end-of-day-data-search>

⁴ Yahoo Finance, May 22, 2018, <https://tinyurl.com/y9clvg64>

⁵ Yahoo Finance, May 22, 2018, <https://tinyurl.com/y9clvg64>

⁶ BlackRock Institutional Trust Company, May 10, 2018 <https://www.blackrockblog.com/2018/05/10/emerging-markets/>

⁷ BlackRock Institutional Trust Company, May 10, 2018 <https://www.blackrockblog.com/2018/05/10/emerging-markets/>

⁸ BlackRock Institutional Trust Company, May 10,

2018

<https://www.blackrockblog.com/2018/05/10/emerging-markets/>

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