Our Views on the Emerging Markets

Over the past few years, investors have not been rewarded for leaving the confines of the developed world in favor of the faster-growing emerging markets. In fact, since 2010, the emerging markets have underperformed developed markets by more than 30 percent and our long-standing overweight to the asset class has been a drag on our equity performance over that time period. Despite their recent struggles, however, we believe the emerging markets remain an attractive investment as they are trading at historically cheap valuations with a great deal of poor sentiment already reflected in today's prices. In this month's MAInsights on the emerging markets, we will cover the reasons for their recent weakness and layout our positive long-term case for the asset class.

In general, we believe the underperformance of the emerging markets can be traced to the following trends:

- **A shift in the Chinese growth model.** For over a decade, China has been the growth driver of the global economy, averaging over 10% annual real GDP growth between 2000 and 2010 and seeing its economy more than triple in size in just ten years. But after recovering strongly from the U.S. financial crisis thanks to a government-sponsored stimulus effort, the growth rate of the economy has slowed in recent years as the country attempts to shift away from investment-driven growth to a more sustainable consumption-driven model. While the long-term implications of this shift are positive for China and the global economy, the short-term implications have been negative, particularly for those commodity-producing economies that benefitted from the massive infrastructure build out in China over the past decade.
- **Deleveraging in the developed world.** The prolonged deleveraging process in the U.S. and Europe, the two largest export markets for China and other emerging economies, has undoubtedly constrained worldwide growth. Once thought to have decoupled from the developed world, it seems that the emerging markets are still very much connected and even levered to the health of the developed markets. With U.S. real GDP growth slowing to a 1.5-2.0% channel and Europe stagnating, it is no surprise that the sellers into these markets have been negatively impacted.

- **The recent decline of EM currencies versus the U.S. dollar.** With the U.S. Federal Reserve announcing the possibility of tapering QE starting this year, the markets have interpreted this as a shift in monetary policy that will redirect capital back to the U.S. dollar and away from higher-yielding emerging market currencies. This policy change has coincided with a steep decline in several emerging market currencies versus the U.S. dollar and has caused the performance of emerging market equities to be markedly worse in dollar terms than in local currency terms. In fact, through mid-September, the MSCI EM Index in local currency terms is up 2.3% in 2013, while the U.S. dollar terms the index is actually down 2.7%. Thus, the impact of currency translation has been working against the U.S. investor in emerging markets so far this year.

Despite the more challenging environment for emerging markets, we believe their equity markets are attractive today for the following reasons:

- **Participation in a powerful secular growth story.** The emerging markets have been and will continue to be the primary driver of global growth for the next several decades. The International Monetary Fund estimates that the emerging markets produce close to 40% of global GDP today and by 2030 will produce nearly 60% of global GDP. If this growth materializes, as we expect, an enormous amount of wealth will be created in those markets, and their relatively young populations will drive the next wave of consumer demand. All of this growth should result in increasing corporate earnings and improved market structures, making it easier and safer to invest in these regions of the world. In fact, Goldman Sachs expects that the emerging markets will account for over 55% of the world equity market cap by 2030, up from just 31% in 2010. We believe investors in the emerging markets stand to benefit from this powerful secular trend.
- **Low debt levels and financial flexibility.** Unlike much of the developed world, sovereign debt levels in the emerging markets have been well managed and declining (as a % of GDP) since the Asian financial crisis in the late 1900s. Credit ratings have been steadily improving and, in most cases, these countries now run their economies with current account surpluses and healthy reserves. Of course, there is always a short-term risk of capital outflows from these countries, but unlike the late 1990s, we believe the emerging markets now have the financial wherewithal to withstand it. For this reason, we believe

emerging markets deserve a premium valuation to where they have traded historically versus the developed world.

- **Historically cheap valuations.** At a P/E of 10x forward earnings, the emerging markets are trading at a 29% discount to the U.S. market (S&P 500 Index) and 23% discount to the world market (MSCI ACWI Index). Over the past 10 years, the Emerging Markets have traded at narrower discounts of 17% and 16% to the U.S. market and world market, respectively. We believe that these valuation gaps could narrow once the Chinese economy stabilizes and/or markets recognize that, regardless of tapering, U.S. monetary policy will remain very accommodative and supportive of risk-taking for the foreseeable future.

In client portfolios, our exposure to the emerging markets employs a mix of active managers and passive ETFs that provide a broad exposure across geographic regions, sectors, and market caps. We have a slight emphasis on Asian markets as well as "frontier" markets that are still early in their growth cycle and boast growing populations and rising standards of living. Where appropriate, we have also employed structured notes which offer some downside protection and significant upside participation in emerging markets over the next two to four years.

Skepticism over the outlook for emerging markets is very high, expectations are low, and it seems every economist on the street is now forecasting the developed markets to continue to outpace the emerging markets. While we do not claim to know how emerging markets will perform over the next six weeks or even the next six months, we do feel good about investing in an asset class that is out of favor, trading at historically cheap levels, with the most powerful secular growth story at its back.