Emerging Markets Briefing

SECOND QUARTER 2017

Seafarer addresses key questions about emerging markets investing and how U.S. investors can integrate the asset class into long-term portfolios.

What role can emerging markets play in U.S. investors' asset allocations?

The emerging market asset class can serve two useful roles in a long-term investor's portfolio:

> *Emerging markets offer a prospective source of diversified growth within a long-term investor's portfolio.* During much of the last 15 years, the concept of "decoupling" was in vogue for the emerging market asset class, but was overstated and misapplied. However, Seafarer believes that two recent structural changes – reduced reliance on exports and independent monetary policy – might finally allow the markets to "decouple" from the developed world. "Decoupling" is now relevant, for the first time.

> *A high-quality, income-producing portfolio of emerging market securities (dividend-paying stocks and bonds) can act as a useful source of diversification (or hedge) against the U.S. dollar.* Seafarer believes that long-term investors should seek exposure to productive assets with meaningful growth potential, and that are capable of generating income in currencies other than the U.S. dollar.

How should long-term investors integrate the emerging markets asset class into their portfolios?

The emerging markets are likely to remain volatile for the foreseeable future. Risk appetite must dominate any consideration of the asset class. Seafarer believes that investors should consider two key factors:

> *Long-term time horizons are essential.* Given the volatility of the asset class, due especially to heightened currency risk, Seafarer recommends that investors adopt a minimum investment horizon of five years.

> *Investors should manage U.S. dollar versus non-U.S. dollar exposures in their portfolios.* Rather than initially allocating capital among traditional "asset classes" (e.g., domestic stocks, foreign stocks, bonds, real estate), Seafarer believes investors should measure the portion of their assets that are principally denominated in U.S. dollars versus those assets that are not. After matching U.S. dollar assets against U.S. dollar liabilities, a portion of the surplus capital (10% to 30%) can be allocated to the emerging markets.

With the negative headlines about trade and rising interest rates in the U.S., why have the emerging markets been strong and the U.S. dollar weak at the beginning of 2017?

Seafarer believes the emerging markets have surpassed expectations in 2017 for three fundamental reasons:

> *Corporate earnings growth in the emerging markets has accelerated for the first time in five years.*[1]

> *At the outset of 2017, valuations for emerging market stocks, measured in aggregate, were at least one-fifth cheaper than U.S. stocks.*[1]

> *Since December 2015, and despite three interest rate increases by the U.S. Federal Reserve, the U.S. dollar has not strengthened against a representative basket of emerging market currencies.*[2]

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[1] Source: J.P. Morgan, "Emerging Markets Strategy Dashboard," January 2, 2017.
[2] Source: MSCI, based on the MSCI Emerging Markets Currency Index.

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The MSCI Emerging Markets Currency Index tracks the performance of emerging market currencies relative to the U.S. dollar. The Currency Index measures the total returns of the currencies of countries in the corresponding MSCI equity index (i.e. MSCI Emerging Markets Index). Index code: MXEF0CX0. It is not possible to invest directly in this or any index.