SEAFARER

MARKET COMMENTARY

# Emerging Markets Briefing

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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 markets 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.
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> *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 suggests that investors adopt a minimum investment horizon of five years.
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> *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 (e.g., 10% to 30%) can be allocated to the emerging markets.

## With emerging markets having performed well in 2017, should U.S. investors be concerned regarding valuations in 2018?

It is important to preface this answer with a note that valuations do not tend to be a good predictor of short- or medium-term performance of an asset class. Expensive markets can continue to grow, and cheap asset classes can continue to languish. The observations below should not be construed as a prediction of short-term performance.

> *Growth accelerated in 2017:* estimated emerging markets earnings growth for 2017 is 23.5%, vastly exceeding estimates at the outset of the year.[1] This represents the first time in the past five years that final results appear to have surpassed initial estimates.
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> *The base for growth was narrow:* while growth accelerated sharply in 2017, it was concentrated in a narrow set of industries (primarily technology) and countries (primarily China). Unless growth broadens this year, the rapid acceleration in profits that characterized 2017 may not be sustained.
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> *Performance was narrow, too:* all major countries and all sectors within the emerging markets produced positive returns during 2017. However, the MSCI Emerging Markets Index's exceptional gain (up 37.75%) was dependent on a very small number of stocks; this in turn has heightened the index's concentration in certain securities and sectors (notably, technology).

### What is the effect of China's political changes and President Xi Jinping's "New Era" doctrine on U.S. investors' emerging markets exposure?

*China allocation is critical:* China has always been important for investors to consider and "right size" within the context of a diversified, long-term portfolio, but possibly never more so than now. Risk-tolerant investors should consider achieving exposure to a wide array of dedicated asset classes in China over the next decade; exposure via a diversified emerging market fund might not be enough.

*China is at a crossroads as a country:* Following Xi Jinping's apparent consolidation of power in 2017, the country's political, economic and financial risks are intensely concentrated and opaque to outside observers.

*China's international influence appears to be growing as never before:* Through the Belt and Road initiative, China appears to be determined to step into a leadership position in the global community that it has not previously held in modern history. New trade and infrastructure projects – in development on an unprecedented scale throughout Asia, Europe and Africa – demonstrate a desire to increase influence.

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[1] Source: J.P. Morgan, "Emerging Markets Strategy Dashboard," February 22, 2018.

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*Belt and Road Initiative is an international program to spur investment and trade links between China, central Asia, and Europe. The initiative was announced by China's President Xi Jinping in 2013. The official name for the initiative is the "Silk Road Economic Belt and the 21st Century Maritime Silk Road."*

*Decoupling is the divergence of asset class returns from their expected or normal pattern of correlation.*

*"New Era" Doctrine refers to President Xi Jinping's personal doctrine, known as "Socialism with Chinese Characteristics for a New Era," which was codified in the communist party's constitution at China's National People's Congress in 2017. As announced, Xi's New Era doctrine is only a vague vision, but is sweeping in scope. Its main objective is to cultivate influence and project power around the world, in order to install China as a global superpower alongside the U.S.*

*The MSCI Emerging Markets Total Return Index, Standard (Large+Mid Cap) Core, Gross (dividends reinvested), USD is a free float-adjusted market capitalization index designed to measure equity market performance of emerging markets. Index code: GDUEEGF. It is not possible to invest directly in this or any index.*