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.

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.

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.

The MSCI Emerging Markets Index has fallen -15.59% year to date.[1] What has caused the correction, and what does it mean for the state of emerging markets?

Two prevailing narratives: The U.S. financial media has largely attributed this year's decline in emerging markets to two factors: increasingly bitter U.S.-China trade relations and continued interest rate increases by the U.S. Federal Reserve. While these two factors are weighing on markets, Seafarer does not view them as the primary causes of the correction.

We believe the primary causes of the correction are weak earnings growth and inflation: First, earnings growth year to date is weaker than expected. At the beginning of the year many emerging market stocks had very high valuations, predicated on steep earnings growth forecasts. As the earnings trajectories for these companies have come in below expectations, valuations have corrected. To be clear, earnings in the emerging markets this year are not weak – they are decent – but they are falling short of expectations. Second, in many emerging markets, inflation is cropping up, forcing central banks to increase interest rates at a time when earnings growth is not as strong as expected. Dampened earnings expectations and interest rate hikes have created a challenging environment for emerging market stock prices and have been the primary causes of the correction year to date.

Tariffs could hurt the Chinese economy in the short-term: U.S. trade tariffs have not impacted corporate performance in China yet. However, tariffs may weigh heavily on economic and financial performance over the next year, or as long as they remain in place. The short-term effect on China's economy may be more acute than most strategists are estimating.

However, don't underestimate China's ability to restructure and bounce back: Over the medium-term, China can rapidly restructure its trade account to counter the negative impact of U.S. tariffs. Though China currently has a large export surplus with the U.S., it can soak up exports in its own sizeable domestic market, and re-direct the remainder to other developing countries. Thus, in the medium- to long-term, China's capacity to adapt could propel its economy into a stronger position.

In summary: Overall, the outlook for emerging markets is not as bad as it may seem. Shares are not overly expensive; earnings growth is likely to be positive; and while inflation is cropping up, significantly tighter credit conditions do not appear imminent.

[1] Source: *Bloomberg*, October 11, 2018.

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

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