Emerging Markets Outlook

June 2018

SUMMARY

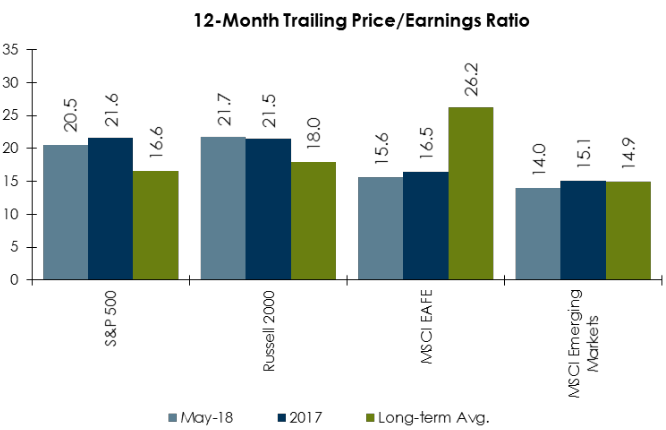
- **After delivering compelling performance in 2017 (up 37%), emerging market equities have struggled since late-January (down 12%), and 2018's year-to-date performance has fallen into negative territory (down 3%).**
- **Market concerns include: 1) rising US interest rates; 2) strong US dollar; 3) increasing oil prices; 4) growth concerns in Europe; 5) trade/tariff risks.**
- **Despite this potentially challenging macro backdrop, emerging market countries have diverse economies with disparate exposures to these sources of risk and, generally, offer more compelling valuations than their developed market counterparts.**
- **In a world of modest growth, emerging market assets continue to offer investors both diversification benefits as well as above average secular growth opportunities, and thus should retain an integral role in a globally diversified investment program.**

Emerging Markets – Diverse Exposures

Emerging markets were among the best performers in 2017 aided by a number of tailwinds including a declining US dollar (USD). As the USD trend has reversed in 2018 and other risks have materialized, emerging markets have struggled. However, the diversity of the countries and economies included in this cohort must be acknowledged and understood. For example, the market concern regarding a rising USD and its impact on debt burdens should affect primarily those countries with the greatest USD denominated debt such as Turkey and Argentina. In fact, emerging markets sovereign debt is now dominated by local currency issues at $12 Trillion compared to only $1 Trillion in USD denominated debt. At the corporate level, it is estimated that nearly 90% of total outstanding debt is owed in local currency terms. In another example, the rising price of oil is not universally negative for emerging markets as countries such as Russia, Mexico, and Brazil are oil exporters.

Valuation Comparisons

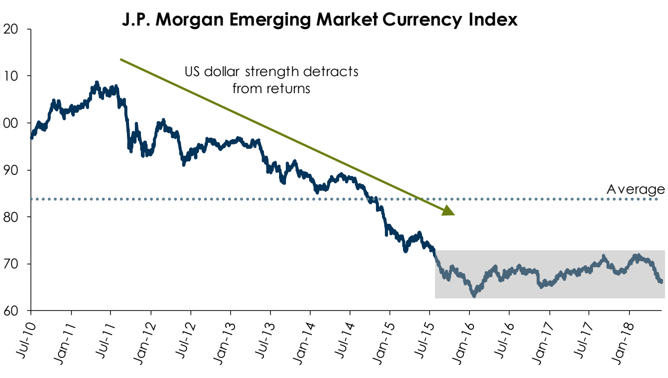
Although emerging markets generally face the economic headwinds noted above, investors need to evaluate the degree to which these factors have already been incorporated in current market pricing. The translation of activity in the real economy to individual companies and their resulting stock performance is ultimately what matters to investors. Also, the comparison of these valuations to competing asset classes provides an assessment of the relative opportunities across the globe.



Source: Bloomberg, ACG Research

Currency Impact

As an investor in emerging markets companies (via equities or local debt), one is investing in both the individual company as well as the currency for the country of domicile. Although over time the impact of currency may be relatively small, it can have significant influence on the short term performance of the asset class. Following a period of broad-based strength in 2017, emerging markets currencies have declined dramatically thus far in 2018. The graphic below, which illustrates the long-term performance of a basket of emerging market currencies, highlights recent volatility within the range that has developed subsequent to Chinese policy concerns roiling global markets in mid-2015. Since the beginning of the year, this basket has declined roughly 5%, indicating the year to date decline in emerging markets equities has primarily been attributable to currency.



Source: Bloomberg, ACG Research

Conclusion

As emerging markets continue to gain importance in the global marketplace, it is imperative that investors retain meaningful exposure to these countries and economies. For a globally diversified investment program, emerging markets offer significant diversification benefits and exposure to fast growing economies. Despite their secular attractiveness, emerging markets are prone to periods of cyclical pressure and must be considered a strategic allocation. It is during these periods of pressure, that active management can thrive. Painting this group of disparate countries with a broad brush inevitably leads to opportunities for those managers who are able to identify strong companies with solid leadership positioned to capitalize on the changing environment.

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