Diversifying in Emerging Markets

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As opposed to the 1990s and early 2000s, Emerging Markets (EM) can no longer be seen as a bloc. Individual countries must be evaluated based on their unique political and economic situations. A properly managed EM strategy requires attention to macro factors such as changes in monetary policy, elections and currency fluctuations.

Investors must use more discretion and analyze countries separately, assessing relative strengths and weaknesses. Emerging countries are at different stages of development and growth. For example, Taiwan--which joined EM in 1996--used to be the leading low-cost manufacturer, but it is now known as one of the foremost producers of semiconductors, LCD screens and other high-tech products. China, which joined at the same time, had picked up the low-cost manufacturing role, but with labor costs rising, that activity is shifting to other places like Mexico. Political factors are wildly divergent as well—the 23 current EM nations have varying degrees of private property rights, free markets, state-run industry, independent monetary policy and overall political stability. Thus, it is unsuitable to make any broad generalizations regarding the impact of macroeconomic factors across the grouping.

Tightening Monetary Policy

US Federal Reserve (Fed) policy actions that reflect a tightening monetary policy—including an end to its long-running quantitative easing (QE) program and an increase in short-term interest rates—have led to widespread fears regarding the impact on EM. The standard narrative is that monetary tightening can result in two unintended ill-effects: money supply decreases—overall, less capital would be available to invest in EM—and with US interest rates rising, investors may flee riskier EM assets for safer US fixed income instruments.

Quantitative Easing

In November 2014, the final round of the Fed's QE program took place, ending nearly six years of asset purchases that were intended to boost economic growth. While we believe it was ultimately a deleterious program that stifled growth and discouraged lending by flattening the yield curve, many others viewed QE as a buoy for EM. Fears of the unwinding and eventual end of QE sparked a sell-off in EM equities and currencies in the middle of 2013. The capital flight was most notable in countries with high budget and current account deficits, namely India, Indonesia and Turkey. Even though we viewed these fears as misguided in nature, the 2013 downturn highlighted the need to evaluate EM countries on a case-by-case basis rather than a category.

While certain countries like India certainly face internal structural issues that needed to be addressed for long-term economic health, investors largely missed the point that EM balance sheets as a whole have improved markedly.

In the past decade, many EM countries have amassed significantly higher foreign currency reserves (Exhibit 1) and improved debt profiles. However, as seen in Exhibit 2, it is still important to differentiate between countries here as well—a more nuanced analysis of foreign reserves by country shows that countries such as China, Thailand and even Russia are much more capable of withstanding possible foreign capital outflows than they were during the East Asian Crisis of 1997; in our view, the risk of such a wide-ranging crisis seems unlikely.

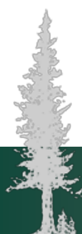

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Exhibit 1: EM Foreign Reserves as a % of GDP

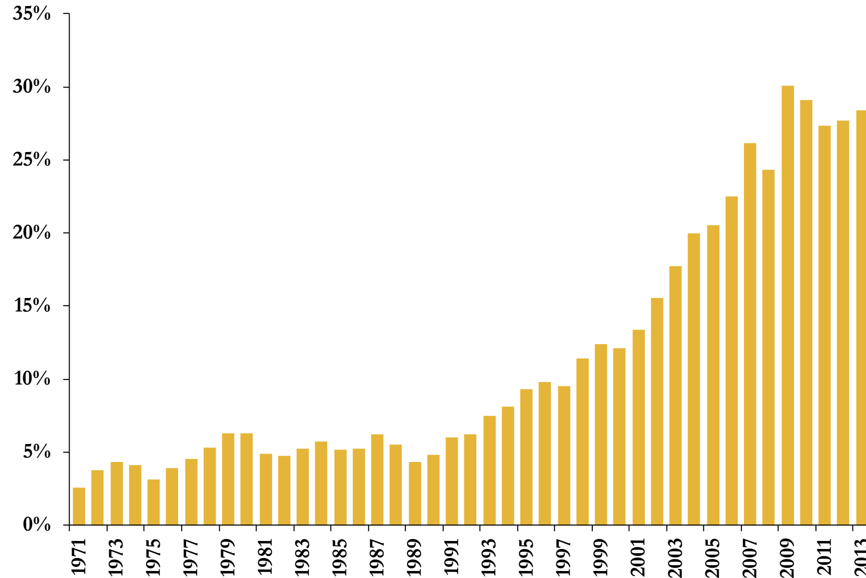
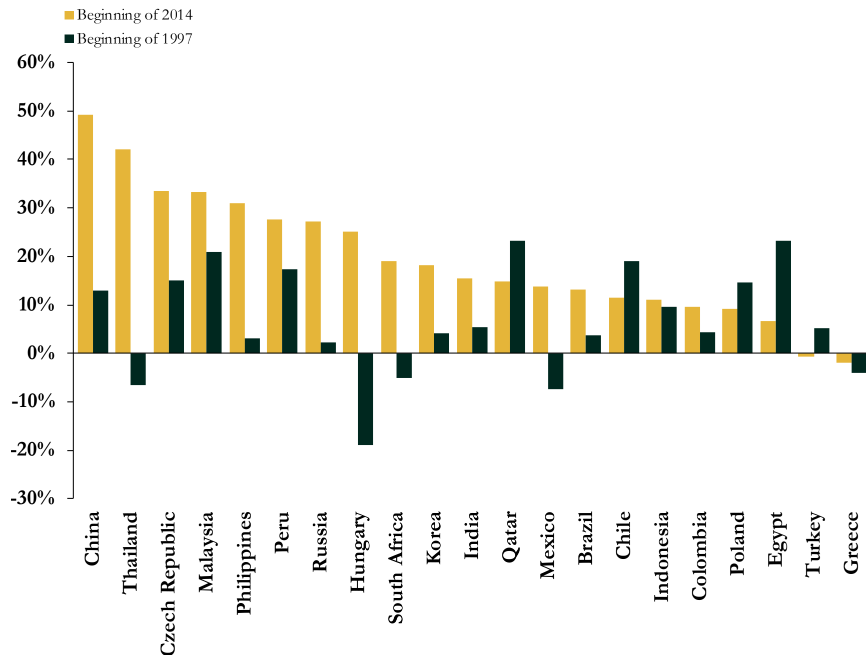


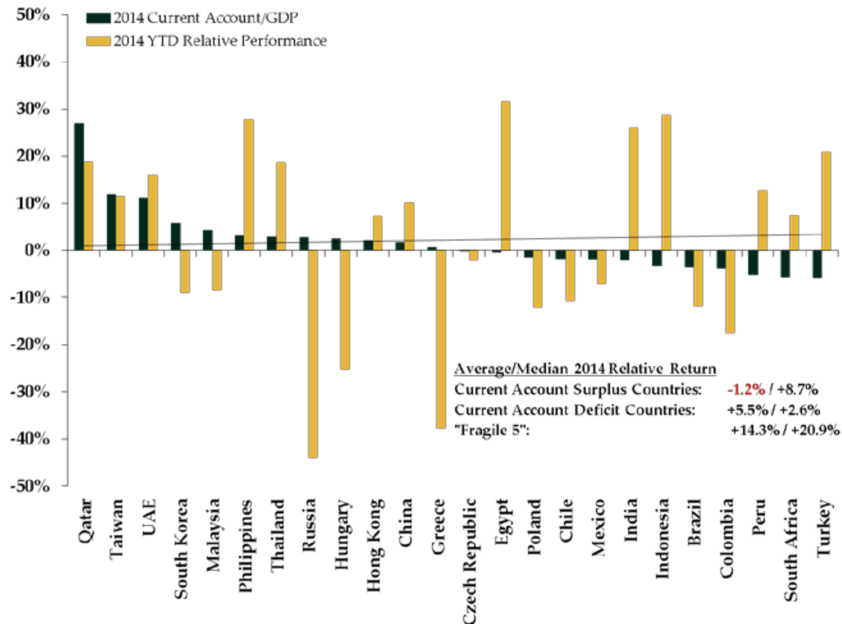
Exhibit 2: Net Foreign Assets Now and During the Eve of the East Asian Crisis



Source: UNCTAD, Imports and Exports; World Bank, GDP (current USD); Oxford Economics, Taiwan GDP (nominal USD)

As the fears associated with foreign outflows alleviated toward the end of 2013 and early 2014, most of these maligned countries' equities began to post positive returns. Surprisingly, on average, many countries with current account deficits such as India and Indonesia outperformed their peers that had surpluses (Exhibit 3).

Exhibit 3: EM Current Accounts vs. Equity Performance



Source: Factset, Eagle Investment Systems, LLC as of 12/31/2014

This further illustrates the point that EM countries need to be evaluated individually in order to identify opportunities and possible areas of weakness. A cursory glance at the constituents in the MSCI Emerging Markets index immediately exposes the differentiation between various EM countries (Exhibit 4).

Exhibit 4: Emerging Markets Countries' Characteristics—Diverging

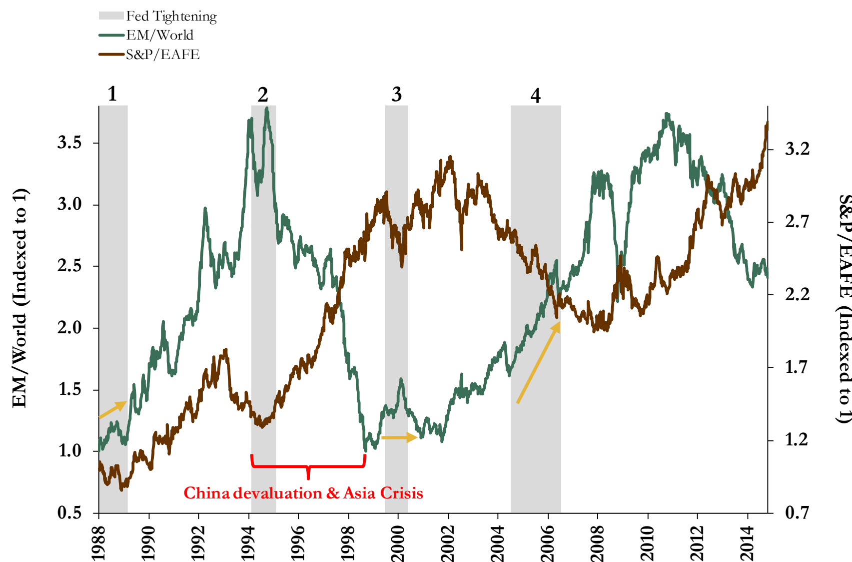
Country	Nominal 2013 GDP (USD Bil.)	Q1 2014 Real GDP Growth	Policy Rate	10-Year Yield	MSCI IMI Trailing 1-Yr Return	MSCI IMI Market Cap (USD Bil.)	Number of Stocks in MSCI IMI	Largest Sector	Weight of Largest Sector
China	$9,240	7.4%	6.0%	4.1%	15.7%	$865.77	500	Financials	33.6%
Brazil	$2,246	1.9%	11.0%	12.2%	11.9%	$481.81	156	Financials	30.3%
Russia	$2,097	0.9%	7.5%	8.2%	7.5%	$227.14	34	Energy	55.6%
India	$1,877	4.6%	8.0%	8.7%	31.1%	$322.01	215	Financials	21.3%
Korea	$1,305	3.9%	2.5%	3.2%	24.0%	$735.76	415	Technology	35.5%
Mexico	$1,261	1.8%	3.0%	5.7%	7.6%	$226.56	56	Staples	25.2%
Indonesia	$868	5.2%	7.5%	8.1%	-14.9%	$121.18	101	Financials	34.2%
Turkey	$820	4.3%	8.8%	8.8%	-4.0%	$80.28	84	Financials	47.2%
Poland	$518	3.4%	2.5%	3.4%	25.4%	$76.24	43	Financials	51.1%
Thailand	$387	-0.6%	2.0%	3.8%	-0.3%	$114.29	120	Financials	34.1%
United Arab Emirates	$384	N/A	1.0%	N/A	57.6%	$22.88	19	Financials	75.0%
Colombia	$378	6.4%	4.0%	6.5%	10.2%	$43.14	16	Financials	41.2%
Taiwan	$355	3.1%	1.9%	1.6%	20.4%	$627.92	478	Technology	55.4%
South Africa	$351	1.6%	5.5%	8.3%	20.8%	$353.04	111	Financials	27.3%
Malaysia	$312	6.2%	3.0%	4.0%	5.3%	$189.29	145	Financials	33.5%
Chile	$277	2.0%	4.0%	4.8%	-13.7%	$69.95	39	Utilities	25.5%
Philippines	$272	5.7%	3.5%	3.9%	6.5%	$47.28	41	Financials	40.9%
Egypt	$272	N/A	8.3%	15.4%	65.7%	$13.48	20	Financials	63.9%
Greece	$242	-0.9%	0.2%	5.9%	59.4%	$37.38	23	Financials	52.5%
Qatar	$202	6.3%	4.5%	N/A	25.1%	$20.38	21	Financials	60.0%
Peru	$202	5.0%	4.0%	5.3%	11.9%	$18.85	5	Financials	55.9%
Czech Republic	$198	2.9%	0.1%	1.7%	22.1%	$10.54	7	Utilities	46.2%
Hungary	$125	3.5%	2.3%	4.4%	-12.5%	$9.94	4	Financials	43.3%

Source: FactSet, Bloomberg, as of 07/09/2014. Policy rate is the interbank rate for each respective country. MSCI IMI is the MSCI Investible Market Index, a gauge designed to cover 99% of market capitalization.

Rising Interest Rates

Another instrument used in tightening monetary policy is interest rate hikes. The prevailing wisdom is that as the Fed increases interest rates, EM will be adversely affected as diminishing borrowing leads to diminishing foreign investment into EM infrastructure and corporations. In addition, an increase in US rates may lead to investors moving their money to US Treasuries and away from riskier EM debt. However, there is no actual evidence that suggests an increase in US interest rates leads to EM underperformance. In fact, as seen in Exhibit 5, during periods where the Fed has tightened money supply, EM has performed in-line with or even outperformed its developed peers.

Exhibit 5: Rising US Rates Doesn't Lead to EM Underperformance



Source: FactSet, as of 10/31/2014, S&P 500, MSCI EAFE, MSCI EM and MSCI World Price Return from 01/01/1988 to 10/24/2014

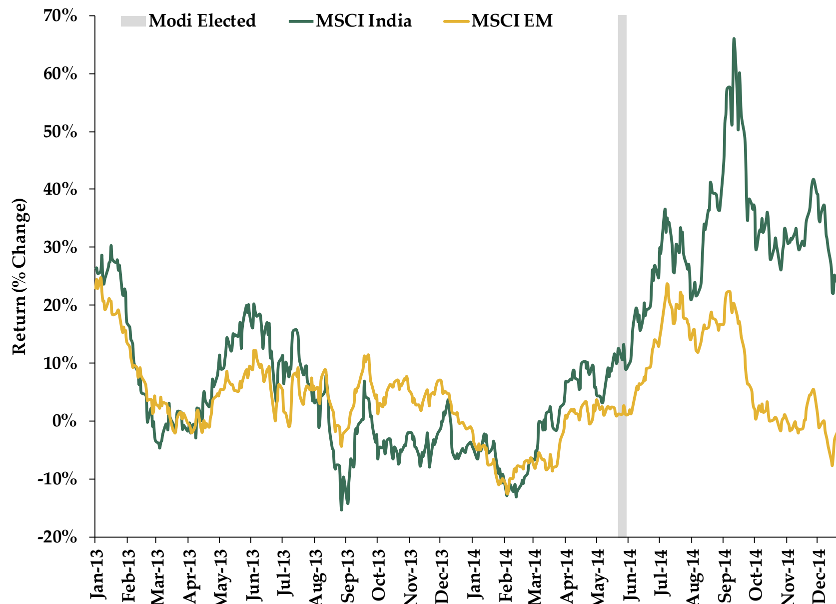
One of the primary factors that should not be overlooked is the motivation behind such interest rate hikes. Monetary tightening usually occurs in environments where there is strong economic growth. During such periods, the Fed will enact policy to dampen the money supply with the intended effect being lower inflation, as was the case in 2004, and a more sustainable (albeit lower) growth rate (as measured by GDP). While more favorable US economic activity does not necessarily portend greater equity returns for the US or EM, certain countries such as Mexico, with economic linkages to the US may stand to benefit from such growth. Again, as opposed to attempting to link interest rate fluctuations to the EM category as a whole, a more granular approach is more suitable in this case.

Elections

Evaluating EM on a country-specific basis can help investors navigate the outsized effects elections have on developing nations. Economically sensitive emerging countries face a greater risk of volatility when a change in political leadership is imminent. The 2014 elections in India and Brazil demonstrated this effect.

Since January 1, 2013 India performed closely in line with the MSCI EM until the onset of April elections when India began its upward divergence (Exhibit 6). The MSCI India was almost two times more volatile in 2014 than it was in 2013 because of elections. India benefited markedly from an election season driven and won by Narendra Modi, a politician known for his pro-business policies. His campaign boosted investor sentiment prior to his victory and continued to drive India's outperformance afterward as he increased household access to banking facilities, opened the railway industry to foreign investment and made other moves to improve the ease of doing business in the country.

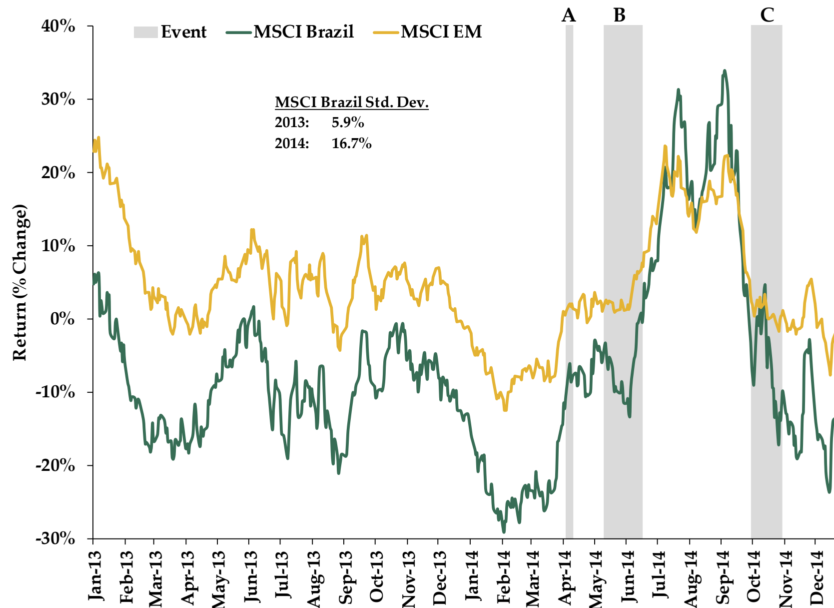
Exhibit 6: Pro Reform Election Boosts Investor Sentiment



Source: FactSet, MSCI India and MSCI EM trailing one-year percent change price return from 01/02/2013 to 12/30/2014

In contrast to India's sustained outperformance, the lead up to and eventual reelection of Dilma Rousseff reflected the ups and downs of investor's hopes as the MSCI Brazil was nearly three times more volatile in 2014 than the year before. Rousseff's first presidential term was marked by poor economic management and a recession—when she lost support in the polls (Exhibit 7 – Event A) and her reformist opponent, Aecio Neves, gained (Event B), Brazilian equities ascended. This rise led Brazil to outperform the MSCI EM for the first time in over two years. However, Ms. Rousseff maintained a steady lead over her opponents, gained in the polls again as election day came closer and ultimately won (Event C). Dampened expectations sunk Brazil back below the EM index.

Exhibit 7: Rousseff Reelection Sours Investor Sentiment



Source: FactSet, MSCI Brazil and MSCI EM trailing one-year percent change price return from 01/02/2013 to 12/30/2014

These two elections exemplify the divergence amongst developing nations and the outsized effects political drivers can have on them.

Currency Fluctuations

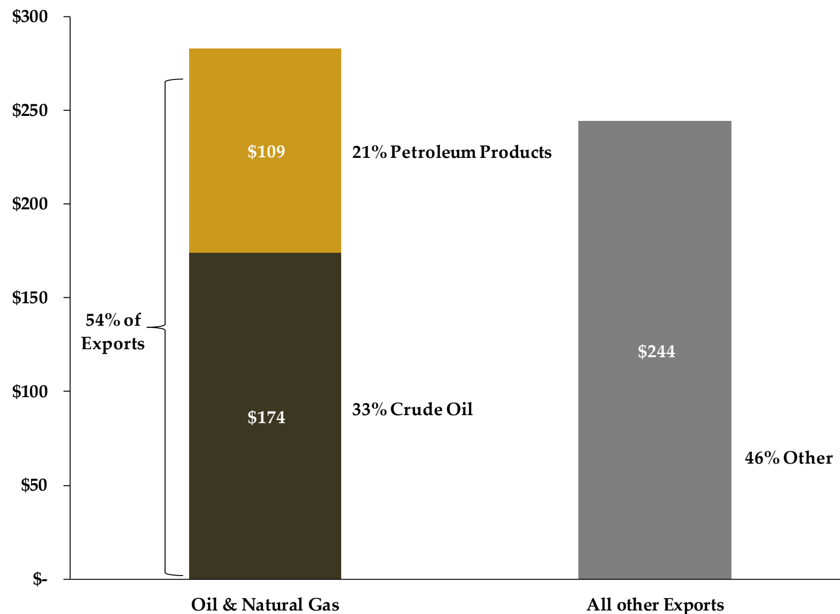
Commonly, when currencies are volatile—in either direction—the media propagate anecdotes regarding "contagion" effects on industries, currencies or countries they view as highly correlated. The recent downfall of the Russian Ruble reignited these treaded fears. However, it is vital to evaluate the historic and present circumstances of the currency's home country before making assumptions.

A Weakening Russian Ruble

While Russia likely faces mounting challenges in the near future, its current situation does not mirror the events of the 1998 Asian financial crisis when a series of currency devaluations led to the collapse of the ruble and a Russian default. At 2014's start, one dollar would buy approximately 33 rubles. That exchange rate remained consistent until late June—not coincidentally at Brent Crude's high for the year. Russia's economy is largely dependent on its oil exports which constitute 54% of total exports (Exhibit 8) and 13% of GDP (shown later in Exhibit 12). As oil prices began falling in late June, the ruble started weakening (Exhibit 9). Falling oil prices aren't good for an oil-dependent economy.

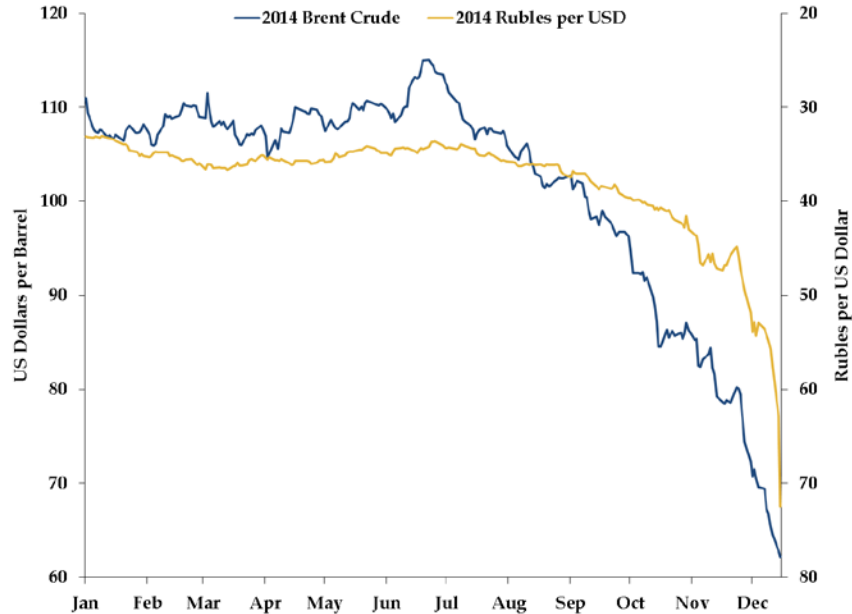
Exhibit 8: Russia Gross Export Sales, 2013

Billion U.S. Dollars



Source: U.S. Energy Information Administration, data as of 12/31/2013

Exhibit 9: Brent Crude Price and Russian Ruble in 2014

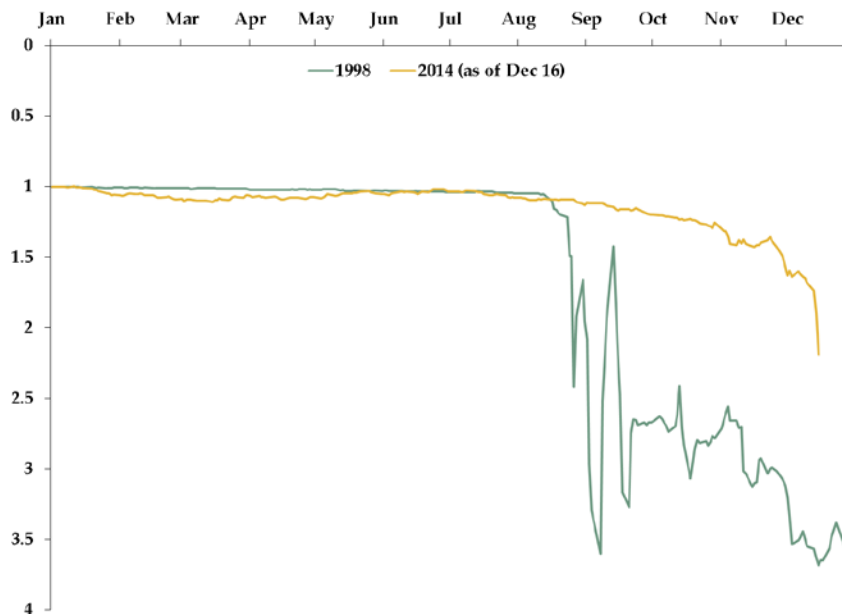


Source: Factset, exchange rate and Brent Crude closing price from 1/1/2014 to 12/16/2014

To stem the ruble's depreciation, the Central Bank of Russia (CBR) raised its key interest rate several times. Central banks seeking to shore up currencies often raise rates to attract yield-seeking speculators and keep foreign capital from fleeing. The CBR raised its key rate to 17% on December 15, 2014, a move designed to swing investor sentiment. Yet the ruble dropped again on the following day by a massive 15%; at this point, one dollar buys approximately 73 rubles—a 55% drop over the year. [i] Bankers report little demand for the currency, even with rates at 17%, and fears are intensifying surrounding the crisis' fallout. But while Russia's situation is far from stable, it also isn't a 1998 repeat.

Similar to 1998, the ruble's recent drop has been sharp (Exhibit 10). In 1998, Brent Crude's price fell 42% from late January to late December.[ii] In 2014, it dropped roughly 46% in around half the time.[iii] In both cases, falling oil harmed Russia's economy.

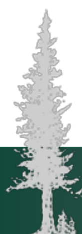
Exhibit 10: 1998 Ruble vs. 2014 Ruble (Indexed to 1)



Source: Factset, 2014 exchange rates from 1/2/2014 to 12/16/2014 and 1998 exchange rates from 1/2/1998 to 12/31/1998, indexed to 1

Yet, there are critical differences between the set of circumstances in 1998 and now. In the 1990s, many Emerging Markets economies (like Russia) pegged their currency to the dollar—hence the near flat line in Exhibit 10 before August 1998. While pegs seemed like a great idea in theory—protecting economies from exchange rate fluctuations—they are inherently unstable. The dollar was strong in the late 1990s, particularly against the Japanese yen—a major trading partner for Asian nations. Hence, the dollar pegs became difficult to maintain and led to the 1997-1998 "Asian Contagion," as one pegged nation after another came under pressure.

Russia was no exception. As the ruble began its precipitous drop, the CBR countered with rate hikes. In May 1998, the CBR hiked overnight rates from 30% to 150% in eight days. That is a far cry from the 6.5 percentage point hike in December 2014. It also burned through forex reserves in a futile attempt to bolster the ruble. But in August, Russia gave up and lifted the peg. The ruble collapsed, Russia defaulted and global markets corrected.

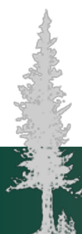


Today's Russia doesn't face all those issues. For one, most EM nations—Russia included—don't peg to the dollar. Its debt isn't as onerous either. Back then, Russia's $45 billion in debt service requirements due by year-end 1999 dwarfed its $17.8 billion in international reserves. In addition, the government was running a budget deficit of roughly 8% of GDP. Russia needed to tap markets then. It doesn't now. Today, most estimates put Russia's public and private foreign debt due by the end of 2015 at $132 billion—a figure covered by the country's $419 billion[iv] in international reserves (built largely as a result of the 1998 crisis). Given the country spent about $90 billion through November 2014 both servicing debt and defending the ruble,[v] the likelihood of a default is low—unless Russia chooses to do so of its own volition.

As for market impact, Russia's troubles contributed to a roughly 20% correction in US and global markets from July to October 1998. And it is possible Russian woes trigger more volatility in global markets today. Corrections are sentiment-driven, and they can happen for any reason or no reason. Yet just because one occurred in 1998, that doesn't mean a similar correction is in order. Additionally, as massive as the 1998 global correction was, it didn't stop the decades-long 1990s bull. Global markets finished the year up 24% and the bull didn't peak until March 24, 2000.

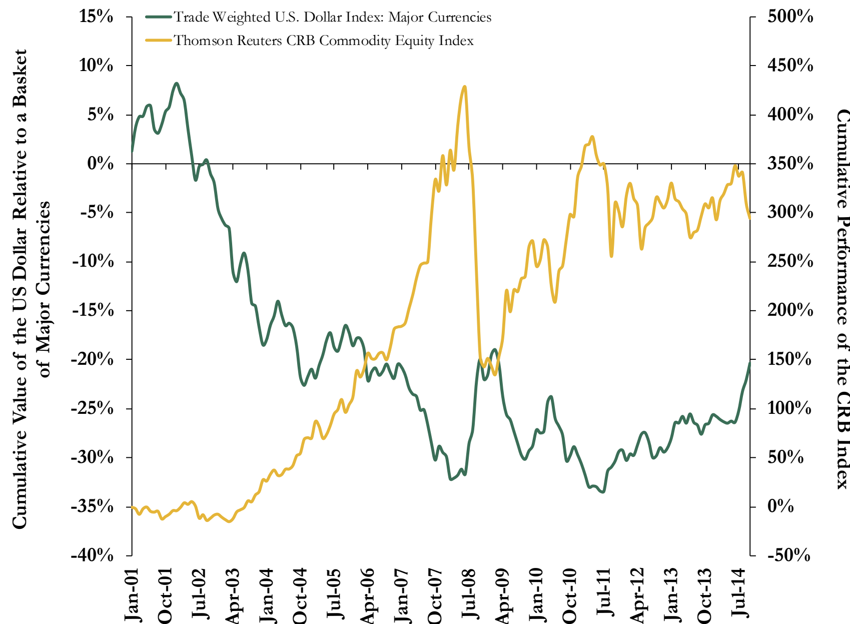
At less than 3% of global GDP, Russia's woes have minimal influence on the global economy and we don't see this as a stumbling block for the global bull. Now, there are some ancillary concerns regarding how Putin reacts to the pressure from a geopolitical perspective, but that is all speculation at this point. Geopolitical events must be massive and surprising to have a lasting, material impact on stocks. This is an example of a localized issue that is unlikely to cause much lasting trouble globally.

Some fear Russia's problems may spill over to other countries sparking a "contagion." While similarly politically dysfunctional and commodity-reliant nations like Argentina and Venezuela face pressures, the impact is likely limited. For one, commodity-based reliant Emerging Market countries haven't led the global expansion—or bull market—the last three years. In fact, they have largely floundered. Further, consider other EMs: China, Taiwan and South Korea, for example, are heavy exporters of goods like electronics. They, along with other EMs like India and Turkey, are net importers of commodities—so lower Energy input costs would theoretically be a benefit. As we explain more in-depth in the subsequent section, there is a large difference between a few commodity-dependent countries with dominant commodity-oriented sectors experiencing complications and a wide-ranging EM-wide crisis.



More on Commodity Price Effects: A Strengthening US Dollar
Another common misconception among investors is that a strengthening US dollar spells trouble for EM countries. This assumption is based on the idea that a stronger dollar is tied to weaker commodity prices: in fact, there is a strong negative correlation between the US dollar's value versus major currencies and commodity prices (Exhibit 11).

Exhibit 11: Relative Strength of the US Dollar and its Effect on Commodity Prices

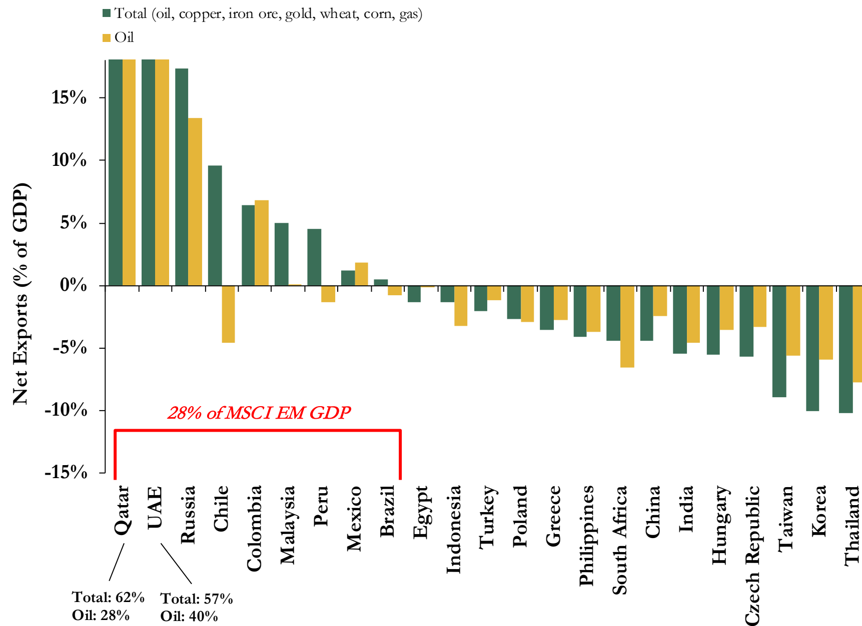


Source: FactSet, Thomson Reuters, as of 11/11/2014.

When the value of the US dollar weakens relative to major currencies, commodity prices usually rise, while they fall as the US dollar strengthens versus major currencies. Upon further examination, this is very logical. Commodities are priced in dollars, and as the currency strengthens, it will cost less in order to purchase the same basket of commodities. The opposite occurs when the dollar weakens. It costs more dollars to buy that basket of commodities and hence, commodities prices rise.

Theoretically, this should serve as a detriment to EM countries, as they are generally seen as net exporters of goods, such as commodities. Again, this is where differentiation is important. As earlier noted, while there are EM countries that are net exporters, they only comprise of 28% of total EM GDP (Exhibit 12).

Exhibit 12: Most of EM Benefits from Lower Commodity Prices



**UAE GDP uses 2012 level from World Bank*
Source: UNCTAD, Imports and Exports; World Bank, GDP (current USD); Oxford Economics, Taiwan GDP (nominal USD)

In reality, the majority of EM countries—comprising 72% of GDP—are importers and benefit from lower commodity prices. When commodity-related devaluations like Russia's occur, it is crucial to evaluate countries on a case by case basis to understand the degrees of individualized currency effects and invest accordingly.

Investing in EM, One Country at a Time

To invest successfully in EM, investors should employ the same practices that they would for the developed world: Assess each individual country to see how fundamentals compare to sentiment. Compare expectations versus the likely reality. Find where opportunities and risks are overlooked and where they are widely discussed. Exploiting such opportunities can help drive portfolio returns, even in environments that have traditionally been perceived as detrimental to EM as a whole.

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[i] FactSet, as of 12/16/2014.
[ii] Ibid. From 1/29/1998 – 12/21/1998.
[iii] Ibid. From 6/23/2014 - 12/16/2014.
[iv] Central Bank of Russia, as of 12/5/2014.
[v] Per the Central Bank of Russia, international reserves were approximately $510 billion as of 12/31/2013.

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