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Investment Perspectives – September 2018

After being the top performing asset class in 2017, emerging market equities have been the worst performer in 2018. Through September 17, EM equities are down 10.3% for the year in US dollar terms. Even worse, since they peaked in late January EM equities are down 18.4%. We think there are three fundamental drivers for this underperformance and we don't think any of them are long-term structural issues but instead are transitory.

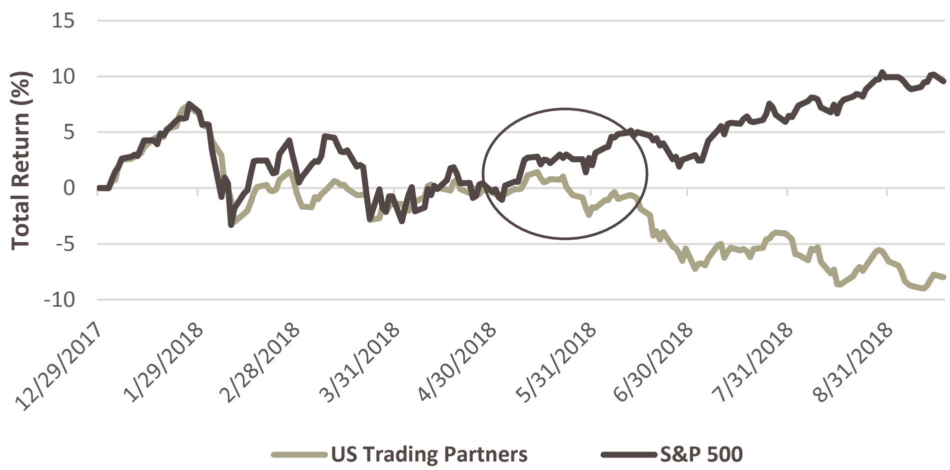
Issue #1: Trade
Since he was elected, President Trump has made it clear that he doesn't think the United States has been treated fairly by our trading partners. Earlier this year, he started taking action by imposing tariffs on imports.

This table shows the countries with the largest value of exports to the United States and how each market has performed so far in 2018. The main stock index in every one of these countries apart from Mexico is down in dollar terms in 2018.

Country	Value of Exports to USA	YTD Price Change (Loc)	YTD Price Change (USD)
China	$277 b	-19.82%	-24.14%
Mexico	$177 b	0.09%	4.75%
Canada	$143 b	-0.78%	-4.47%
Japan	$90 b	-4.89%	-4.42%
Germany	$81 b	-6.36%	-8.90%
United Kingdom	$59 b	-5.02%	-7.58%
India	$42 b	10.36%	-2.73%
Korea, South	$41 b	-6.67%	-11.12%
France	$35 b	0.68%	-2.05%
Italy	$34 b	-3.40%	-6.01%

Source: US Census Bureau; Bloomberg 2018

The chart below illustrates the returns for a composite of these countries' stock markets compared to US stock market returns for 2018:



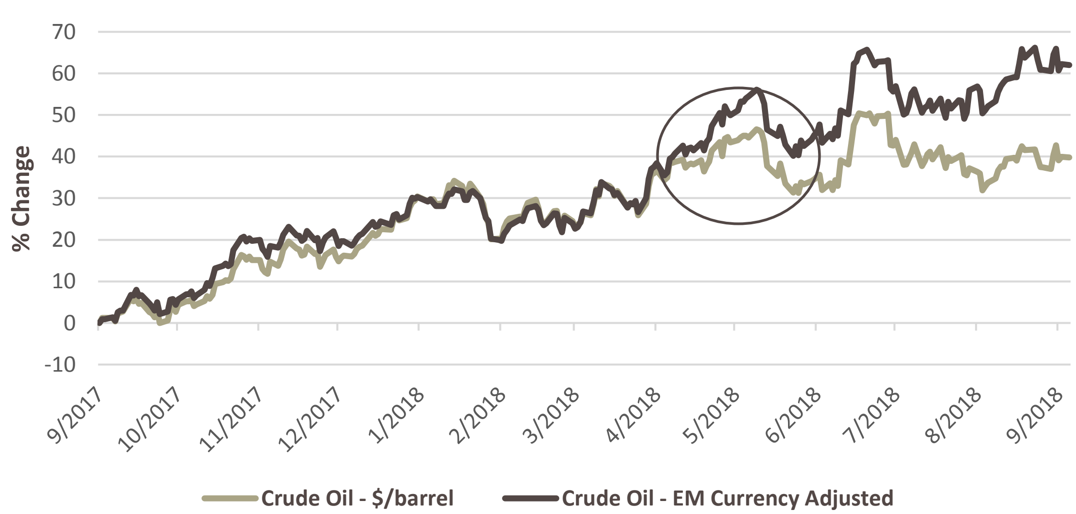
Source: Bloomberg 2018

You can see that starting in May a large divergence began and has continued since. Tariff disputes on steel & aluminum (March), Chinese imports (April) and cars (May) appear to have had an impact on the stock price performance of the US's largest trading partners with their equity markets underperforming the US by over 15% this year.

Issue #2: Oil (priced in US dollars)

Oil is a globally produced and traded commodity but it only trades in one currency, the US dollar. As the US dollar strengthens compared to emerging market currencies then the cost of imported oil goes up. In 2018, the price of a barrel of oil has gone from $60.37 to $68.91 (up 14%). The economic impact of this increase in oil has been amplified in emerging market countries due to the strengthening of the US dollar vs. emerging market currencies.

The chart below shows the price of a barrel of oil in US dollars and in emerging market currencies. Starting in April of this year a large divergence began to develop as EM currencies weakened while oil prices kept rising. Adjusted to the EM currency index, oil is up 31% year to date. This is straining oil importing countries at the same time as they are seeing reduced demand for their exports due to the tariffs discussed above.



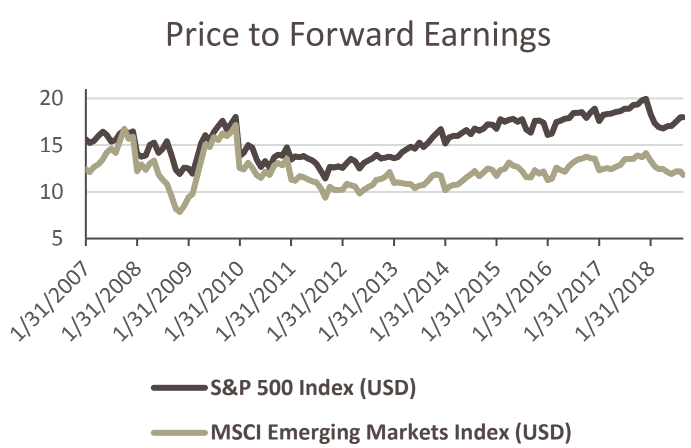
Source: Bloomberg 2018

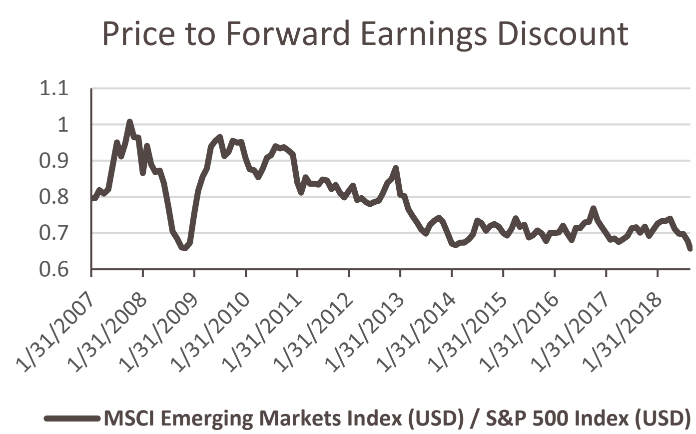
Issue #3: Increase in US real rates

The Federal Reserve has been hiking US interest rates for the past 2 years, causing 1-month US Treasury Bill yields to rise from 0% three years ago to 2% currently. As a result, real yields (taking out inflation) have risen steadily. Increasing US real yields can cause funding stress on emerging market countries that have borrowed large amounts of money in US dollars. Additionally, as US risk-free rates rise it may reduce the demand for risky investments like emerging market equities.

In Summary

We believe that each of these issues has contributed to the underperformance of EM equities in 2018. The result is a large valuation gap between US and emerging markets. The graphs below show that on a forward P/E multiple emerging market stocks are trading at a discount to the S&P 500 of nearly 35% - the deepest since November of 2008.





Source: Bloomberg 2018

We also believe that these issues are all transitory and unlikely to be permanent headwinds to investors. To the extent that taxing trade slows global growth, real yields and the price of oil would both face downward pressure. If instead trade disputes are resolved and tariffs reduced, it would be seen as a strong positive for emerging markets. In either case, emerging markets appear to be priced for a very pessimistic outcome relative to the US.

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