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Emerging Markets: Down, Not Out

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After a spectacular year in 2017, emerging market equities have badly trailed their developed market counterparts in 2018. As of this writing (August 14, 2018), the S&P 500 has gained 6.8%, the MSCI EAFE Developed International Index is down 3.8%, and the MSCI Emerging Market Equity Index has declined 9.9% (all in US dollars). It has certainly been a rough ride.

We have been long-term believers in the superior growth characteristics of emerging market economies, in particular those in Southeast Asia. Our emerging market portfolios are tilted toward the enormous growth potential of the middle class consumer in China, India, and other developing Asian economies. JP Morgan estimates that China's middle class (defined as $3,600 to $36,000 in annual per capita income) will grow from 30% of the population in 2017 to 72% by 2030. In India, the middle class is expected to grow from 12% in 2017 to 79% in 2030. Given the large populations in these countries, that is a lot of new consumers.

We recognize, however, that these investments carry more risk than domestic stocks, and are subject to large price moves as a result of investor fund flows, currency swings, geopolitical unrest, and concerns about the sustainability of the China growth story.

Emerging market stocks are under pressure because of the possibility of a protracted trade war with the US. China exports approximately $500 billion in goods to the US, making their economy (and others in the region who export to China and/or the US) highly vulnerable to a trade war that would impose higher costs on US imports.

In addition, the strong US economy has driven up the US dollar by almost 5% this year. A strong dollar reduces the return on overseas investments denominated in other currencies, and increases pressure on foreign borrowers that have outstanding debts payable in dollars. Although Turkey has been getting most of the press (for reasons that extend beyond the strength of the US dollar), other emerging market countries are also bearing significant foreign-currency debt burdens. Turkey's foreign currency-denominated debt, at more than 60% of GDP, is the largest among emerging market countries, but others (such as Hungary and Argentina) are not far behind.

The stunning 40% decline in the Turkish lira just this month has become the latest *crisis du jour* in emerging markets. Ballentine clients have negligible direct exposure to Turkey (the country represents less than 1% of the MSCI Emerging Markets Index, which is owned by many of our clients), but there is concern that the selloff could broaden to other countries with large debts denominated in dollar or euros. Turkey's problems, brought on by excessive borrowing to fuel their growth, are more severe than other emerging market countries, but investors are unloading other currencies from countries with significant external debt. While small in relative terms, a default on

Turkish debt could ripple through to many of the big European banks that are significant lenders to Turkish borrowers. Memories of the Greek debt crisis are still fresh in investor's minds. Unlike the Greek situation, however, Turkey is not a member of the European Union, so a crisis in Turkey does not directly affect the stability of the EU or require it to provide a costly bailout to Turkish lenders.

Although Asian economies underperformed relative to expectations in the early part of 2018, recent economic data has improved. Negative sentiment around emerging markets has driven valuations down to very attractive levels. According to Blackrock, the MSCI Emerging Market Index is trading at 13.5 times trailing earnings and 11.3 times forward earnings. The former represents a 26% discount to developed markets. Based on price-to-book (P/B) emerging market stocks look even cheaper, with a 30% discount to developed markets, the largest since the summer of 2016 and significantly below the post-crisis norm of around 17%. We anticipate continued downside pressures until some of these trade issues are resolved, and we remain confident in the long-term thesis and continue to recommend an overweight position in client portfolios.

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Bruce is a Partner and Director of Research at the firm. Bruce rejoined Ballentine Partners in June 2016 after more than 5 years as Chief Investment Officer of City National Rochdale, LLC, in Los Angeles. City National Rochdale, a wholly owned subsidiary of City National Bank, serves family clients across the United States with a staff of nearly 100 investment professionals. Before moving to Los Angeles, Bruce served as Chief Investment Officer of Ballentine in our Waltham office for three years. Prior to that, Bruce spent four years with Morgan Stanley Private Wealth Management in New York and eight years with Glenmede in Philadelphia as Chief Investment Officer and Portfolio Manager. In addition to working directly with a number of family clients, Bruce serves on Ballentine's Investment Management Committee, which is responsible for the oversight of all of the investment activities for the firm. Bruce received an MBA with a concentration in Applied Economics from George Washington University and a BS degree in Business Administration from Penn State University. Bruce holds the Chartered Financial Analyst (CFA) and the Certified Private Wealth Advisor (CPWA®) designations. He lives with his wife in Palm Beach Gardens, Florida.