Rally in Emerging Market Equities Peaking, or Just Beginning?

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Emerging market stocks should be a permanent part of portfolio allocation.

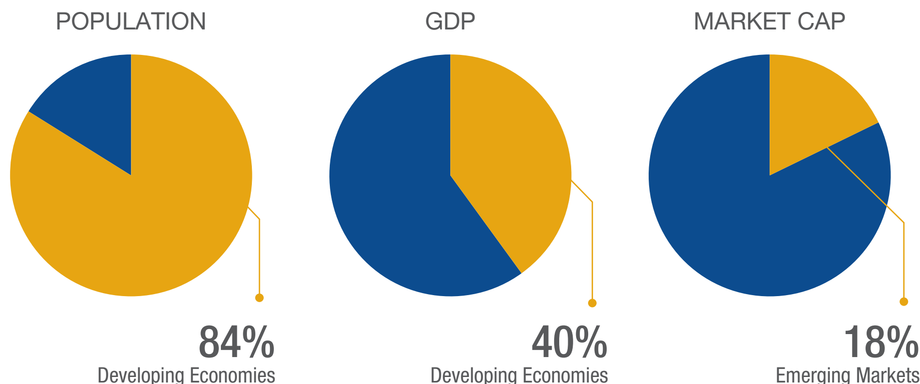
But for those wondering whether they've missed the opportunity to establish or build their exposure to the asset class, it appears the cycle tailwinds lifting developing country stocks have just begun.

Executive Summary

- Long-term returns from emerging market equities are higher than for the S&P 500 Index and other developed markets. Periods of strong emerging market performance have often offset weaker U.S. and developed market returns.
- Emerging markets' underperformance vs. the U.S. and developed markets from 2013–2015 reflected 1) falling earnings expectations related to commodities and currency headwinds, and 2) compressed valuations from concerns about political and macro risks.
- Emerging markets' strong returns since early 2016 reflect 1) stabilizing currencies and commodity prices, and 2) an alleviation of concerns about worst-case macro risks.
- In 2017 and beyond, moderate valuations and improving earnings growth, along with emerging markets' secular macro underpinnings, indicate the rally has plenty of room to run on fundamental factors.
- Leadership within emerging market equities has shifted to companies that exhibit good earnings growth prospects and free cash flow, along with low or manageable debt levels—key attributes at the heart of the stock-selection process for the Thornburg Developing World portfolio.

We have recently been hearing the same question quite frequently, "Did we miss the rally in emerging markets?" There are really two underlying but unasked questions here: Does it make sense to time allocations to emerging markets? Is it time to get out? Market timing is always a perilous exercise, and especially so in emerging markets. We think there are several compelling reasons to maintain a consistent allocation to emerging markets, and now is a great time to get involved for those that missed the turn last year.

Figure 1 | Distribution of Population, GDP, Market Capitalization



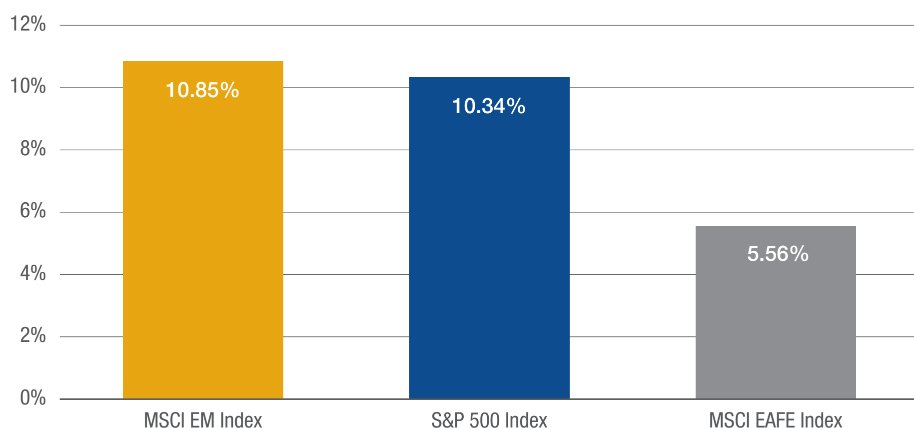
Source: World Bank, as of 12/31/15; International Monetary Fund (IMF), Bloomberg, as of 6/27/17.

Why Emerging Markets Should Remain a Consistent Allocation within a Portfolio

The high-level case for a long-term allocation is well understood. Developing economies represent about 84% of the global population and are expected to generate nearly half of global gross domestic product (GDP) by the end of the decade *(Figure 1)*. Despite the rapidly increasing importance of emerging markets in a global context, the companies in emerging markets represent less than 20% of global stock market capitalization. This will very likely grow over time.

Besides the compelling long-term investment opportunity, portfolio benefits are also to be had. Since inception in 1988, the MSCI Emerging Markets (EM) Index has delivered an 11% annualized total return, which is slightly higher than the S&P 500 Index's 10% annualized but more attractive than the MSCI EAFE Index's 6% gain *(Figure 2)*. In addition, emerging markets tend to perform in different periods than developed market equities, smoothing the volatility of overall equity returns in a portfolio. Not only is the long-term performance compelling, but consistent exposure to emerging markets can provide real portfolio diversification benefits *(Figure 3)*. After nearly five years of difficult performance, emerging markets positively inflected at the start of 2016. Since then, the MSCI EM Index is up more than 50% and many are wondering what's next. First, though, it's important to put the recent move into context by understanding why emerging market equities were weak in recent years.

Figure 2 | Attractive Opportunities Providing Attractive Long-Term Returns (Annualized Returns, 12/31/87–3/31/17)



Source: Bloomberg. *Past performance does not guarantee future results.*

Why Now Is the Right Time to Remain Involved

Recovering from the debt hangover

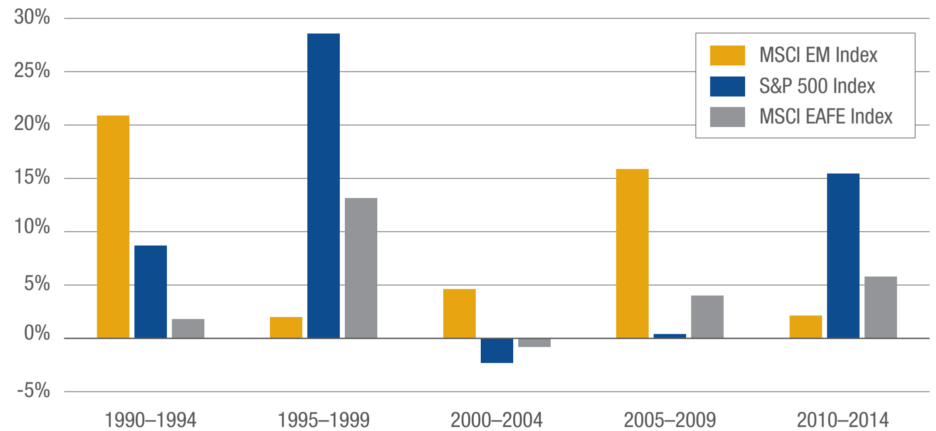
Following the 2009 financial crisis, emerging markets rebounded sharply on the back of strong domestic consumption trends and bold stimulus programs, particularly in China.

Expectations and valuations grew quickly, but were subsequently disappointed as the debt-fueled stimulus programs began to wear off. Most emerging markets were left with a debt overhang.

Add to this slow but improving economic growth in the U.S. with some scope for normalizing monetary policy and you had a recipe for negative emerging markets earnings revisions and weak overall earnings growth as the U.S. dollar strengthened. The dollar headwind was too much for most emerging market earnings translated into dollar terms, despite slowing but consistent underlying growth trends. Forward estimates for MSCI Emerging Markets Index forward 12 months earnings per share declined from $111 in July of 2011 to a low of $67 in early 2016.

Figure 3 | Emerging Market Exposure Enhances Diversification

(Annualized Returns for Different Periods)



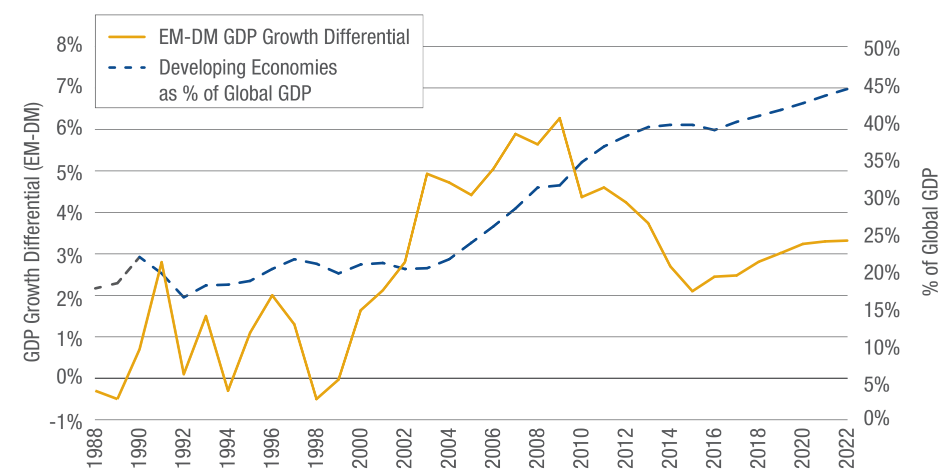
Source: Morningstar.

Not only is the long-term performance compelling, but consistent exposure to emerging markets can provide real portfolio diversification benefits.

Developed markets central banks help lower the risk premium

Then in January 2016, Federal Reserve Chairwoman Janet Yellen signaled a more dovish shift in U.S. monetary policy. Many investors saw the Fed's statement at the time that it would take "financial and international developments" into account as implicit support for risk assets such as vulnerable currencies, commodities, and emerging market equities and fixed income. Risk asset prices all went higher as risk premium fell globally.

Figure 4 | Emerging Markets GDP Growth Outpacing Developed Market Growth (1988–2022)



Source: IMF.

Later in 2016, after several years of deflationary pressures had subdued nominal revenue and earnings growth, the rally in risk-asset prices seemed to be flowing through to the real economy. Perhaps the first important indicator was Chinese PPI, which turned positive in September 2016 for the first time since February 2012. More recently we have seen a broadening in the recovery of emerging market economic growth. After growing on average 4.4% faster than developed markets from the year 2000 to 2012, ***(Figure 4)*** emerging market growth slowed and

> Despite the improvement in underlying earnings quality and the nascent recovery, the forward P/E multiple for the MSCI EM Index isn't stretched.

was just 2.1% faster in 2015. While this is well above the 0.7% premium to developed market growth demonstrated between 1988 and 2000, it was still substantially slower on a relative basis than most of the prior decade. According to International Monetary Fund forecasts, the spread to developed market growth is set to improve over the next few years, which should be correlated with emerging market earnings improvement, if past experience is any guide.

Potential for earnings recovery…and beyond

With expectations for dollar stabilization and accelerating emerging market growth in absolute and relative terms, the outlook for an earnings recovery seems solid. MSCI EM Index earnings forecasts project $79 in 2017 and $88 in 2018 *(Figure 5)*. Both estimates are still noticeably below the recent peak in expected earnings of $111 per share from the middle of 2011. It's worth noting that the composition of earnings from the prior peak has substantially changed and has improved in terms of quality. In the middle of 2011, energy and materials made up just under 30% of the index compared to 13.8% today *(Figure 6)*. During the same period, the information technology segment has grown from 12% of the index to 26% today. The transition in the top five index weights since 2011 reflects the change in the overall index. Gazprom, Petrobras, and Vale have been replaced by Tencent, Alibaba, and Naspers. The leadership within emerging markets has become companies with more of a domestic orientation and less driven by global trade and commodity prices.

Despite the improvement in underlying earnings quality and the nascent recovery, the forward P/E multiple for the MSCI EM Index isn't stretched. The 2018 earnings multiple of 11.4x (as of June 28, 2017) sits just above the 10-year average of 11.2x. This is hardly stretched relative to the history of the index or global equities in general. After five strong years of U.S. equity performance, the MSCI EM Index remains at a large discount to the S&P 500 even after the recent recovery (the S&P 500 is valued at 18.7x currently) *(Figure 8)*. That discount has continued to increase even during the recent emerging markets rally. As you can see, for a variety of reasons, the MSCI EM Index has room to run.

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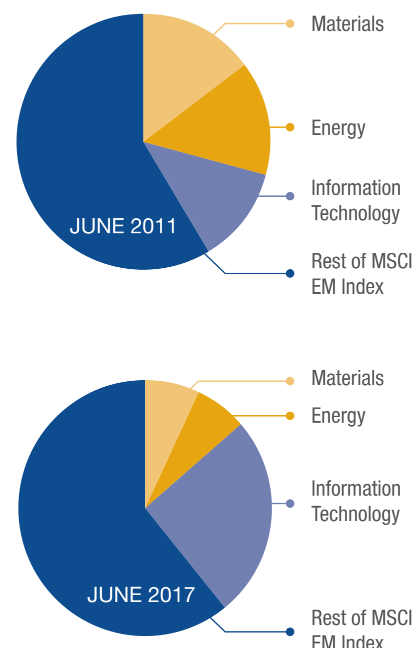
Figure 5 | MSCI EM EPS Has Room to Grow

	FEB. 2016	2017	2018
(Prior Peak $111)	$67	$79	$88
% Change to Peak	+64%	+41%	+25%
Implied P/E		12.8x	11.4x

Source: Bloomberg, as of 6/28/17.

Figure 6 | Change in MSCI EM Index Leadership since 2011



Source: MSCI, Bloomberg.

Figure 7 | MSCI EM Index Leadership Has Changed

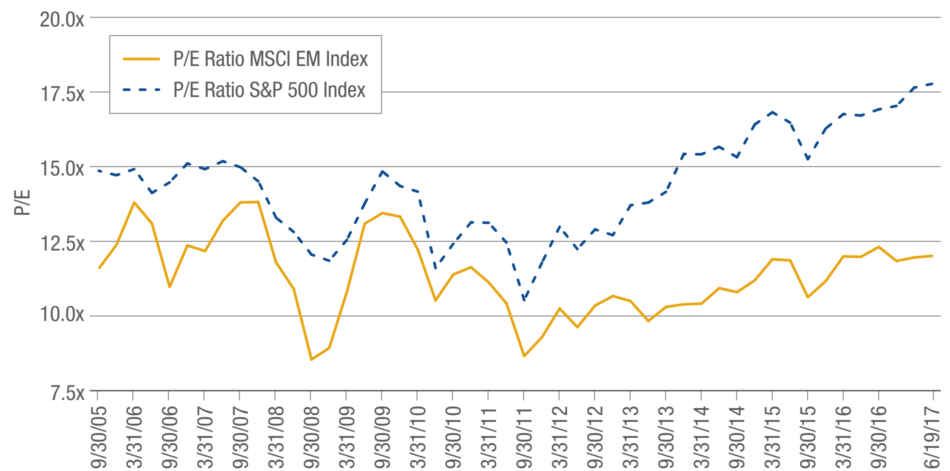
TOP 5 INDEX HOLDINGS IN 2011	TOP 5 INDEX HOLDINGS TODAY
Samsung	Tencent
Gazprom	Samsung
Petrobras	TSMC
TSMC	Alibaba
Vale	Naspers

Source: MSCI, Bloomberg.

Why Thornburg Developing World Strategy? The Power of Geometric Returns

The positive factors supporting the investment case for emerging market equities both in the short term (earnings recovery at a reasonable multiple) and the long term (accelerating relative growth) look as bright as ever. However, the traditional risks of currency volatility and steep draw downs still remain. Emerging markets typically see a draw down of at least 10% every year and quite often as large as 15% to 20% *(Figure 9)*. Those types of pullbacks can happen even during a very strong performance period, such as over the last 18 months.

Figure 8 | EM Remains at a Discount to the S&P 500 Index



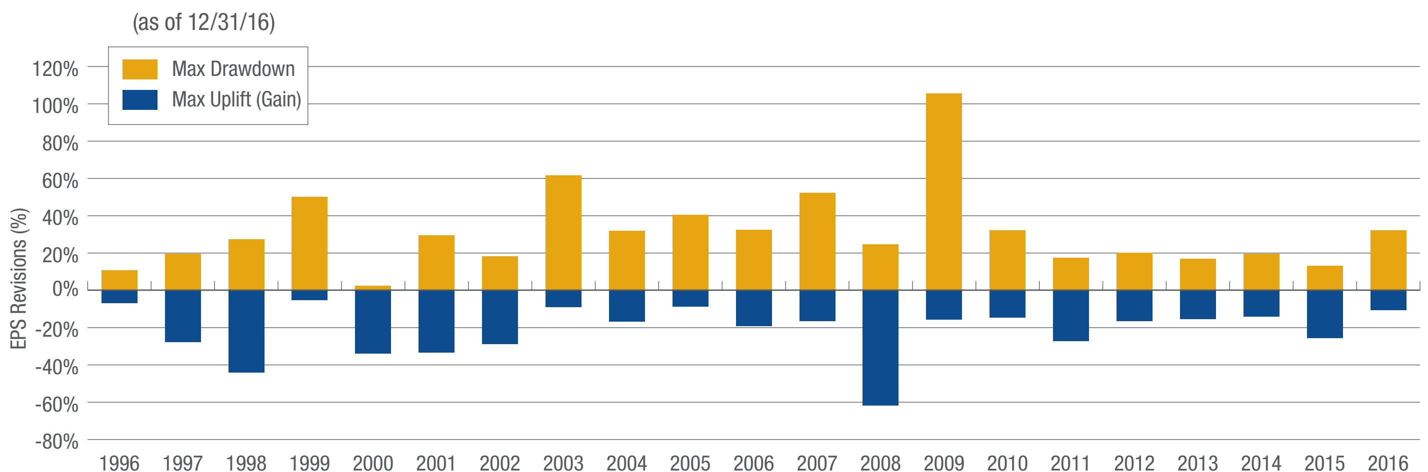
Source: Bloomberg. (Blended 12 Months)

With the recognition that pullbacks are frequent and often severe, we have designed an investment approach that attempts to protect on the downside by investing in companies exposed to the most interesting opportunities in emerging markets but that operate with low financial leverage and generate consistent free cash flow. It's our view that low financial leverage and free cash flow are strong indications of the strength of a business. Companies with these characteristics typically have above average returns and lower volatility of earnings. They often translate into stocks that outperform during weak market periods thanks to the strength of their business model and balance sheet.

However, early in a recovery cycle, the market usually prefers companies with low returns and margins coupled with high financial leverage. These companies often have compressed multiples following a period in which the market view had become very pessimistic. A slight shift in the market outlook toward a more positive stance can dramatically impact earnings expectations for these companies and that inflection often drives a rebound. During this period, market performance is primar-

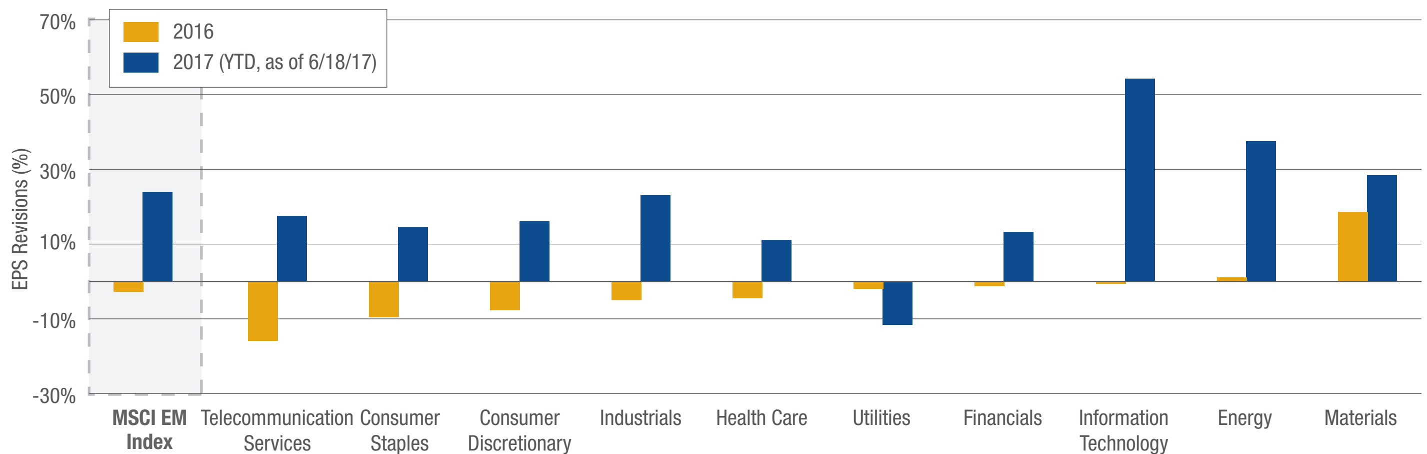
Figure 9 | The Importance of Downside Protection in Emerging Markets

(as of 12/31/16)



Source: Morningstar.

Figure 10 | EPS Revisions Broadening to Most Sectors



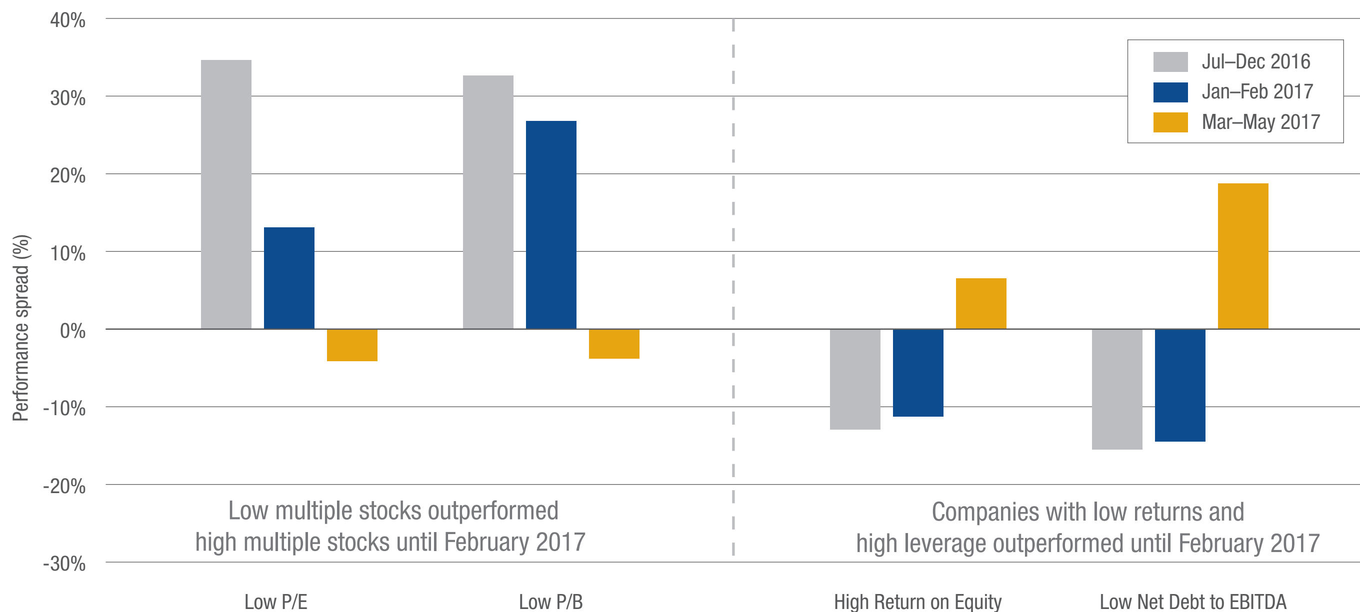
Source: Bloomberg.

ily driven by multiple expansion rather than true earnings improvement. We think most of 2016 was a reflection of this phase. As expected, earnings revisions were narrowly concentrated in a few sectors, often comprised of companies with low returns and high leverage, characteristics we generally avoid.

More recently, earning revisions have started to broaden and with them so has the market leadership ***(Figure 10)***. We think this means the market is entering the second leg of the recovery cycle. This phase is typically marked by a shift toward earnings growth as a primary market driver and market leadership that aligns with our stock selection criteria, as stronger companies are just as likely to lead the market during this period.

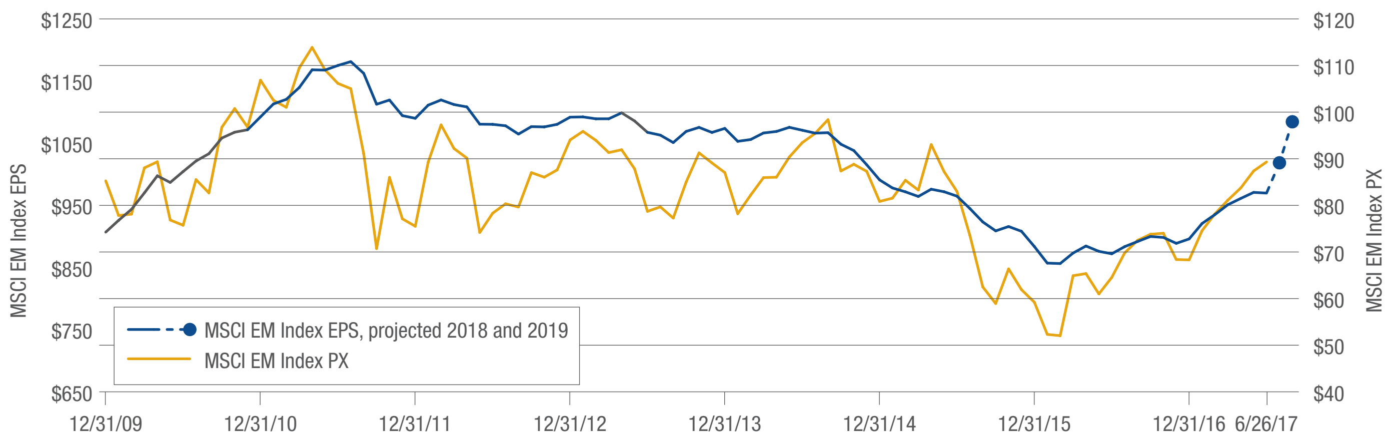
Often you can identify market transitions by looking at the style factors driving performance. In ***Figure 11***, we show the performance spread between the top and bottom quintile

Figure 11 | Low Quality Leads in 2016, Leadership Change in 2017



Source: Bloomberg, Thornburg Investment Management. *Past performance does not guarantee future results.*

Figure 12 | MSCI Emerging Market EPS Moving Back towards Prior Peak



Source: Morningstar, as of 6/26/17.

for several factors. In 2016, especially in the second half of the year, factors such as high debt, low valuations, and low returns drove the performance of the market. It was actually harmful to performance to hold companies like those we target, which have high returns and low debt and that typically carry a premium valuation. These same types of factors led over the first months of 2017. However, in the second quarter the market drivers have broadened to include other factors typically related to growth and quality, which tend to be better represented in our free cash flow, low financial leverage-focused process.

Conclusion

Going back to the two unasked questions. We think the rally still has more to go based on a re-acceleration in economic growth in emerging markets, earnings recovery potential, and low relative valuations. We also note that these emerging market cycles can last several years, and at this point we are just 18 months into the current recovery. But it's also our strong view that because of the compelling long-term returns and portfolio diversification benefits, emerging market equities should remain a consistent allocation. Yes, emerging markets are volatile and the large draw downs can be painful. This is why we try to construct portfolios focused on full-cycle returns and that provide some level of downside protection during turbulent periods, creating a higher base off which to compound over the recovery. ■

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The MSCI Emerging Markets Index is a free float-adjusted market capitalization index that is designed to measure equity market performance of emerging markets. The MSCI Emerging Markets Index consists of the following 23 emerging market country indexes: Brazil, Chile, China, Colombia, Czech Republic, Egypt, Greece, Hungary, India, Indonesia, Korea, Malaysia, Mexico, Peru, Philippines, Poland, Qatar, Russia, South Africa, Taiwan, Thailand, Turkey and United Arab Emirates.

The S&P 500 Index is an unmanaged broad measure of the U.S. stock market.

The performance of any index is not indicative of the performance of any particular investment. Unless otherwise noted, index returns reflect the reinvestment of income dividends and capital gains, if any, but do not reflect fees, brokerage commissions or other expenses of investing. Investors may not make direct investments into any index.

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Earnings per Share (EPS) – The total earnings divided by the number of shares outstanding.

Gross Domestic Product (GDP) – A country's income minus foreign investments: the total value of all goods and services produced within a country in a year, minus net income from investments in other countries.

Multiple – A valuation multiple reflects an investment's market value relative to some key metric. Price to earnings ratio (P/E) is a commonly used multiple. It's calculated by dividing a stock's price by the company's earnings per share.

P/E – Price/Earnings ratio (P/E ratio) is a valuation ratio of a company's current share price compared to its per-share earnings. P/E equals a company's market value per share divided by earnings per share. Forecasted P/E is not intended to be a forecast of the fund's future performance.

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