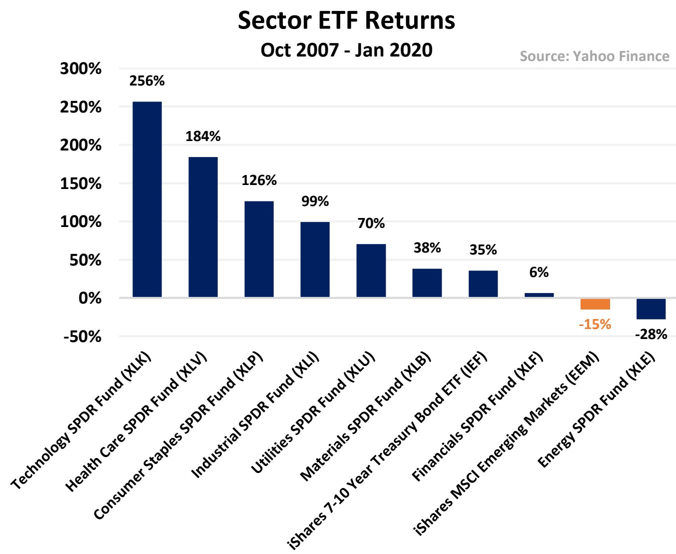
2020's Emerging Market Opportunity

Market Viewpoint: January 31, 2020

Summary: The weakening US Dollar will be a boon for Emerging Markets in 2020, a sector which has long underperformed the broader market, but is set for a stronger year ahead. While the outbreak of the Coronavirus has created complications for the first quarter, we believe the virus is more of a short-term factor and underlying fundamental trends in Emerging economies will power them to outperformance.

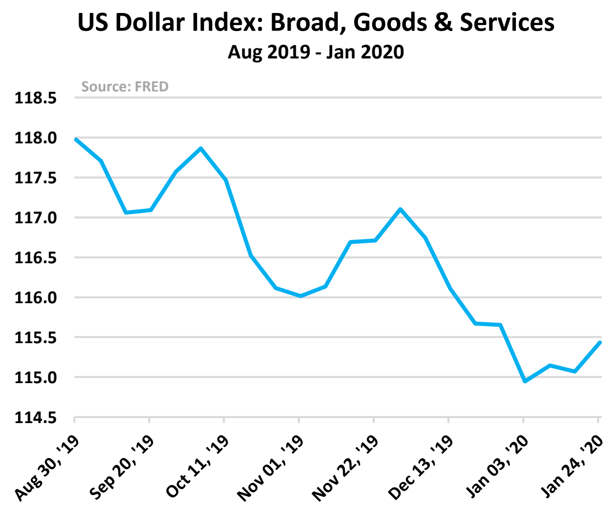


Since reaching an all-time peak prior to the financial crisis more than 12 years ago, emerging markets have consistently seen tepid long-term returns. In fact, energy is the only sector that has performed worse than EM since October 2007. Even Treasuries did better!

In the 5 years prior to December 2019, TCW Group estimates total returns for the S&P 500 outpaced nearly all EM securities. While the S&P 500 returned 53% over that period, EM high yield and sovereign debt pulled 36.5% and 30.0%, respectively. EM equity was as tepid as it gets, generating only a 5.6% return.

But that poor relative performance is about to change in the new year.

Notwithstanding uncertainty introduced by the rapid spread of the new Coronavirus, a combination of factors are likely to boost the performance of emerging markets in 2020. These include a weaker US dollar, improving global trade, and money inflows from bargain-hunting global investors who will be drawn more to EM in part because of low relative valuations compared to the lofty levels where US equities are currently trading.



Weaker Dollar = Easing Dollar-Denominated Debt Load

In December, the US dollar experienced its worst monthly performance in 2 years, sliding 2% on the month. Prior to its that decline, the Dollar had skyrocketed more than 11% between January 2018 and August 2019. Despite a modest rebound this month, due to a virus-induced flight to safety, the Trade Weighted US Dollar Index for Goods and Services has still declined by more than 2% versus a broad basket of currencies since then.

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Spread Between US & Euro Real Rates in Decline

Source: FRED	Jan-19	Jan-20
US Rate	2.4	1.6
Euro Rate	-0.3	-0.5
US CPI	1.5	2.3
Euro CPI	1.4	1.3
US Real Rate (US Rate – US CPI)	0.9	-0.7
Euro Real Rate (Euro Rate – Euro CPI)	-1.7	-1.8
US-Euro Real Rate Spread	**2.6**	**1.1**

Last August, MRP published our monthly viewpoint titled "The Booming Buck", detailing a number of reasons why the surging strength of the Greenback was unsustainable.

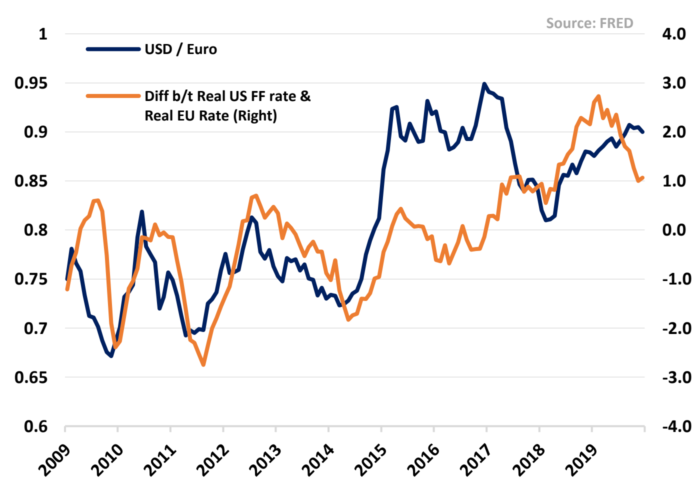
In the following month, we doubled down on that call, noting that an uptick in inflation and lower short-term rates would depress US real rates, setting the stage for a weaker Dollar through the end of the year.

As MRP has highlighted before, the most obvious determinant of where the money goes is short-term interest rates and their differences from other currency regimes. Other things equal, it makes more sense to keep cash in a currency that has a higher rate of interest.

Still, there is another key consideration: inflation-adjusted or "real rates". To calculate, simply subtract inflation from the central bank rate. However enticing a short-term yield may be, it doesn't buy much if the purchasing power of the currency diminishes by more than the interest earned; or it can buy even more if purchasing power improves. When overnight bank rates are adjusted for inflation, the swing in real rates is sometimes even more pronounced. International money flows usually chase "real" yield, however small the differentials may sometimes be.

The power of real rates is very pronounced when comparing the difference in US real rates to real rates for the Eurozone. When this difference tightens, as it has recently, following Fed easing and a jump in inflation, it has historically correlated with a weakening of the Dollar and a stronger Euro.

Real Rate Difference vs USD/EUR
Jan 2009 - Dec 2019

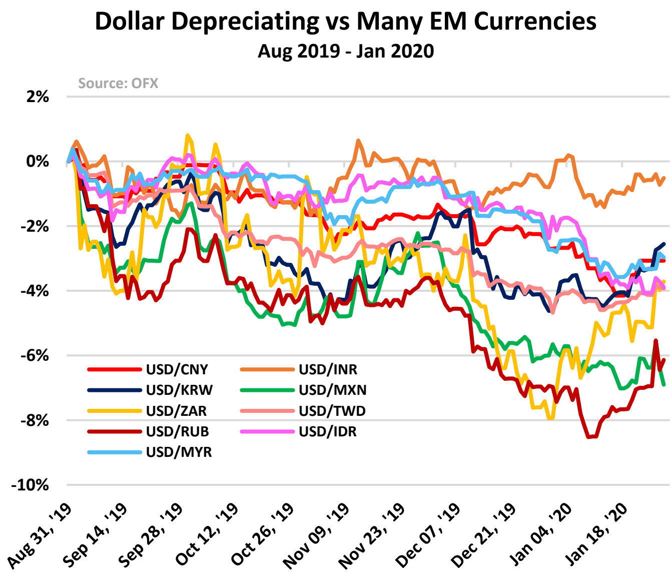


US monetary policy now appears to be on hold but inflation continues to ticks up steadily, reaching a 14-month high last month, therefore continuing to depress real rates.

EM policymakers have also begun to hit the brakes on rate cuts, ending a prolonged and ubiquitous period of aggressive easing that has marked the longest easing cycle for emerging markets since 2013. The number of EM central banks cutting interest rates has now fallen by more than half since August when interest rate moves by central banks across a group of 37 developing economies showed a net of 14 cuts. According to Reuters, that figure has fallen every month since, reaching a net of just 6 cuts in December.

Additionally, inflation is beginning to soften across a number of emerging economies, setting the stage for stronger real rates and a tightening spread versus the Dollar.

The Greenback has already depreciated versus a number of major EM currencies in the past few months. Since the end of August, the Dollar has lost about 3% of its value versus the Chinese Yuan and 0.5% against the Indian Rupee, the currencies of the two largest emerging economies.



More appreciation can be expected in the Yuan, specifically, due to declining trade tensions between China and the US. Their recently-signed Phase-1 Deal to avoid further tariffs also removed China from the US's "currency manipulator" designation while including language that discourages competitive devaluation. China is expected to honor that end of the bargain and encourage a firmer Yuan in months to come.

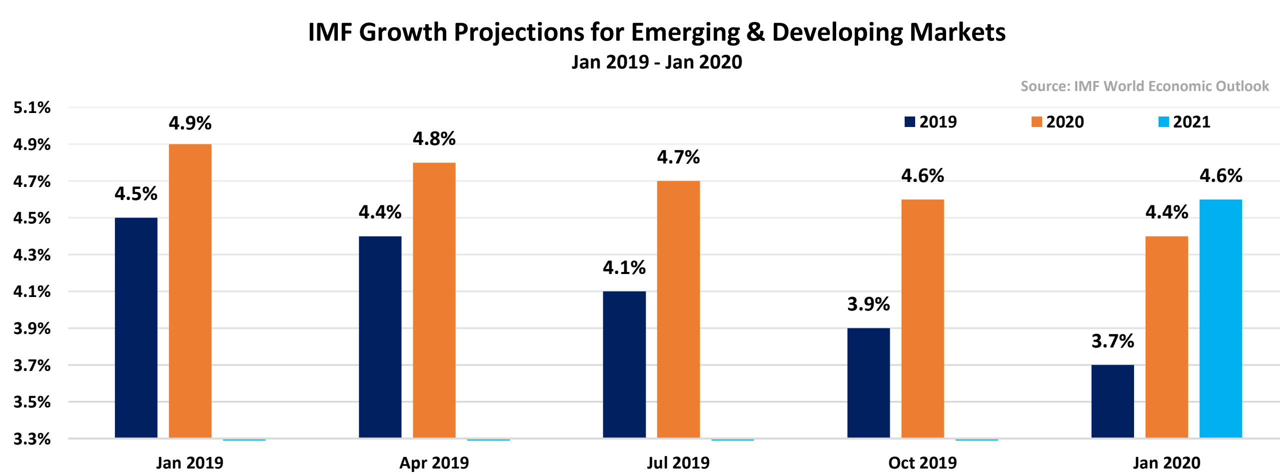
Even more drastic Dollar depreciations can be seen versus the Russian Rouble, Mexican Peso, South African Rand, and others.

There are many ways that a depreciating Dollar benefits emerging markets but these days easing of their Dollar-denominated debt burdens has become a major one. In the same way that US corporate earnings can be boosted when the Dollar depreciates vs foreign currencies, Dollar-denominated debt declines in value. This is very significant when one considers that about two-thirds of external debt of emerging market economies are now denominated in USD. The Institute of International Finance pegged total EM debt denominated in USD at a record $3.7 trillion through Q2 2019, more than 80% of total FX debt for emerging economies.

The downturn we saw in emerging markets through much of 2018 and 2019, a time when the Fed was raising rates, pushing up the value of the US Dollar, now has the potential to reverse and actually be a boon to Emerging Markets. As the Financial Times notes, EM economic cycles often follow US Fed action: "Over the past quarter of a century, emerging market crises most often struck following Fed tightening cycles, when the US yield curve was flatter than normal. Conversely, such crises rarely occurred following periods of easy US monetary policy characterised by a steeper than normal US yield curve".

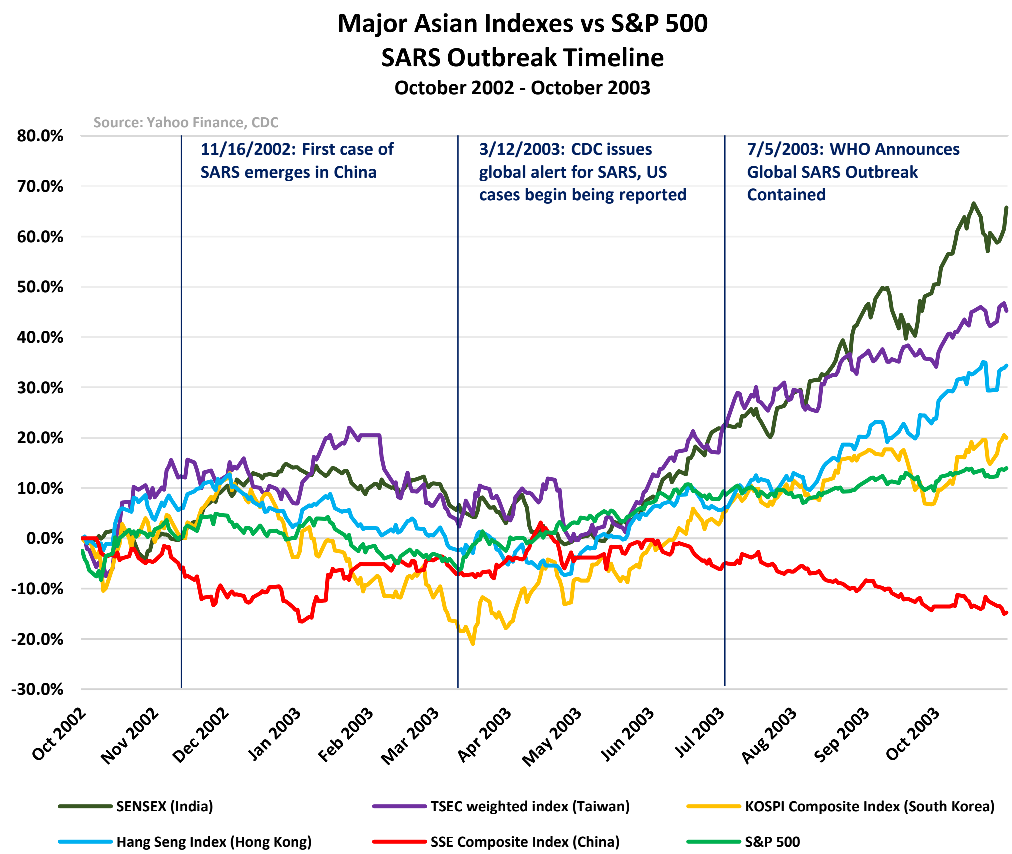
EM Growth Pick-Up, Coronavirus Complications

The IMF has consistently downgraded their growth expectations for EM and developing markets for over a year now. While GDP growth for 2019 is excpected to be as low as 3.7%, the fund still sees that figure as the trough. Not only is growth expected to rebound to to 4.4% this year, but their first projection for 2021 shows even more acceleration to come.



Those projections, however, have recently been thrown into question by the outbreak of 2019-nCoV (colloquially known as Coronavirus). The virus has now infected at least 10,000 worldwide, with more than 98% of cases being reported in the Chinese mainland, where the epidemic originated from. All 200+ resulting deaths have occurred in Chinese patients, but 24 countries, as well as Hong Kong and Macao, have now confirmed that the disease has breached their borders. China's growing quarantine zone now encompasses the equivalent of 50 million people.

Though this disease is certainly the most concering medical disruption to the global economy since SARS ravaged China back in 2002-2003, that occurrence and many others provide some optimistic precedent. Notably, markets across Asia and North America bottomed months before the SARS outbreak was officially contained. Coronavirus has spread faster than SARS, but it is believed to be much less deadly. SARS killed about 10% of the people it infected, while about 3% of the people confirmed to be infected with this new coronavirus have died.



Many of those who have died are elderly or have other illnesses such as diabetes. Business Insider notes that the median age of those who have died from the Wuhan coronavirus is around 75. This is not very different than the common flu, known as influenza, which is also mostly fatal to senior citizens.

Removing the elderly and those whose health was already compromised leaves us with a fatality rate that could approach the average annual fatality rate for the common flu – 0.13% – falling even further once peak flu season passes in March. Viruses are most contagious in the winter months when cold air and less humidity weakens human immune systems and helps contagions pass through the air more easily. Coronavirus' late arrival will severely handicap the time the virus will have to spread. To put things into perspective, the CDC estimates that more than 15 million people in the US have already gotten sick with flu this season.

Cold weather and the long shadow of the Lunar New Year holiday typically lead to very low levels of Chinese industrial activity in January and February as it is, before picking up to full speed between March and June. Per the Washington Post, in the five years through 2018, daily pig iron production in March was about 7.4%

higher on average than it was in January. Cement output ramps up even more rapidly, as warming weather makes it possible to mix concrete on building sites again: While January and February figures are often too weak to be reported by China's statistical agency, May output over the same period averaged about 23% above the levels just two months earlier.

Similar to its response to the 2003 SARS outbreak and 2008 financial crisis, Beijing is likely to take action to address consumption shortfalls resulting fro Coronavirus. As on those occasions, fixed-asset investment (particularly by state-owned companies) is likely to surge to fuel fresh industrial activity, and credit is likely to be loosened up by state banks.

During the SARS epidemic, The Wall Street Journal, quoting Goldman Sachs' chief Asia-Pacific equity strategist, Timothy Moe, notes that markets traded largely on the number of cases that were reported daily. Markets fell hardest when the pace of new cases accelerated, but ultimately bottomed once that rate started to slow. Other historical evidence from cases like the outbreak of Ebola in 2014 and the avian flu in 2009 or suggest there won't be much long-term impact on the global economy or headline stock indexes.

China is especially critical to emerging markets (constituting 35% of the iShares MSCI Emerging Markets ETF (EEM)). Though the Coronavirus will temporarily dent tourism and consumer spending, setting up a weaker Q1 than expected, MRP believes the easing of trade tensions, a rebound in exports, recent tax cuts worth more than 2 trillion yuan, and a ramp up in infrastructure spending will be the trends that define 2020 for the world's second largest economy.

Cheap Valuations & Many Investors Underweight

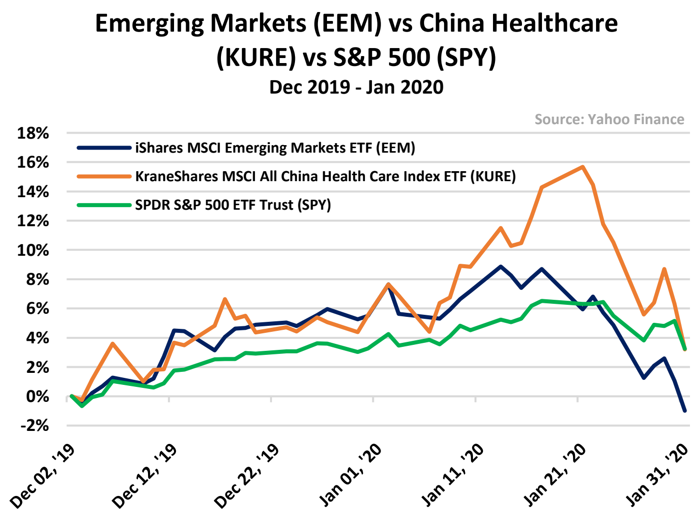
The poor long-term performance of EMs has created very attractive pricing for many indices and ETFs. The currenttrailing price to earnings ratio (P/E) for China's Shanghai Stock Exchange (SSE) currently clocks in at 14.42, while Russia's Moscow Exchange (MOEX) is even cheaper at 12.65. Meanwhile, the S&P's P/E has been climbing rapidly since last December, reaching a 2-year high this month. The ratio currently sits at 24.63.

The aforementioned emerging markets ETF (EEM) stands at just 12.79. P/Es of Major MSCI ETFs tracking Southeast Asia (ASEA), China (MCHI), Russia (ERUS), and India (INDA) each come in below the S&P 500. Accoridng to ETF.com, fund flows for the EEM, ASEA, MCHI, ERUS, and INDA have all seen net gains in January.

JP Morgan Chase has recently told Bloomberg that the firm is now overweight emerging markets, due to a the shift from momentum into value stocks that started last quarter. This comes on the back of the firm's creeation of a new division to boost private investment in emerging-market projects. CNBC reports that JPM is targetting more than $100 billion in annual financing from its investment bank to pursue the project.

Re-Affirming Long EM and Adding Long China Healthcare

When MRP originally added LONG Emerging Markets to our list of themes, the flavor of the week in risk was potential escalation of US conflict with Iran. By the time mid-February rolls around, barring any unexpected uptick in fatlities or US contagion, it's very likely that Coronavirus too will fall into the abyss of rapidly shifting news cycles – eliminating a large amount of the market volatility we've seen in the past week. China certainly will have some very tangible issues to deal with in the short-term, but when the fear subsides, we still believe that the overall outlook for emerging markets is strong in the coming year. We continue to track this theme with the iShares Emerging Markets ETF (EEM).



However, to make a play on the Coronavirus itself, we've also added [LONG China Healthcare] to our list of themes as a likely beneficiary of eventual treatments and other products related to the virus. Health officials across the country have been stocking up on protective gear, testing people, and preparing isolation beds at hospitals. That should translate to more business for healthcare equipment makers, diagnostic labs, and healthcare providers in general. Of the three best-known Chinese healthcare and biotech ETFs, KraneShares MSCI All China Health Care Index ETF (KURE) offers the greatest geographic exposure to mainland stocks.

Both ETFs have, unsurprisingly, taken a hit in the last 2 weeks from the initial global sell-off of almost every asset class. For now, though, it may be time to buy the dip.

Joe Mac

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