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MARKET PULSE

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A Trifecta for EM Equity Outperformance?
A Dovish Fed, Steady Dollar and China Stimulus Could Fuel Emerging Markets

EM Equities Are Looking Interesting

Having been cautious on emerging market (EM) equities for most of 2018, QMA's Global Multi-Asset Solutions team has recently shifted to a more positive stance, tactically adding to our EM equity allocation (funded from multiple sources)[1]. We believe that the global macroeconomic backdrop for EM has improved, and there is a strengthening case for EM outperformance. In our 2019 Outlook and Review, we wrote that, *"Although we anticipate taking on more aggressive positioning in EM equities, there are a number of catalysts we will be looking for before we do. These include a pause in the rate hiking cycle, a peak in the US dollar and a de-escalation of trade tensions."*

The pre-conditions for the outperformance of EM equities do seem to be lining up. The US and China are making progress on a trade deal; regardless of whether the deal is substantive in addressing underlying structural issues or just a temporary cessation of hostility, it would likely benefit China and the rest of the EM world. In addition, the Fed has not only paused the rate-hiking cycle, but it has also emphasized its dovish and data-dependent stance, relieving the pressure on EM nations. A lower interest-rate trajectory in the US also translates into a reversal of the financial flows from the US and towards higher-yielding EM countries, weakening the US dollar (USD) and propping up EM currencies. In addition, China continues to stimulate its economy, and we expect the impact will become more evident as we move through 2019. All these positive macroeconomic developments are underpinned by attractive valuations of EM equities and a stabilization in GDP growth forecasts.

Given these positive developments, EM is up 12% from the market bottom at the end of October, of which 8%[2] has come since US Federal Reserve Chairman Powell's speech in January. Even as EM has rebounded, we believe there are still sufficient positive catalysts to support the rally.

However, several risks remain that could derail this positive narrative, including a last minute breakdown in the US and China trade talks, a further deceleration of global growth and earnings, and a resumption of the rate-hiking cycle in the US. Still, we believe that, on balance, a tactical tilt towards EM is compelling.

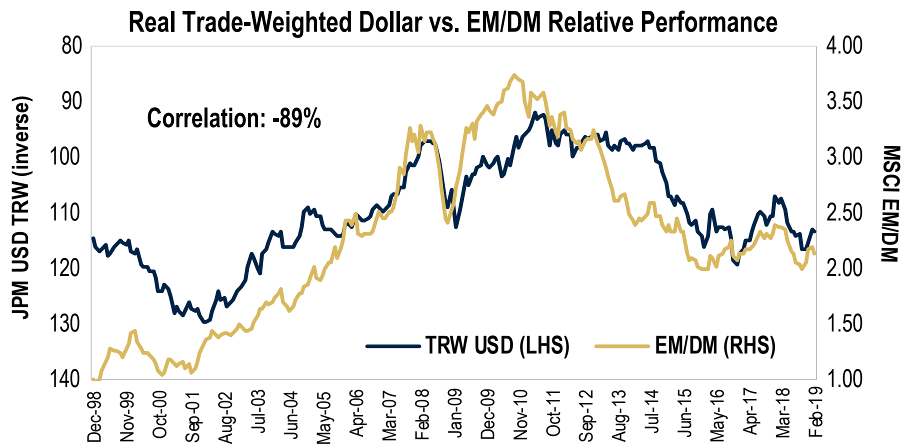
[1] Our bullish tactical view on EM equities is now aligned with our positive longer-term view in QMA's 2019 Capital Market Assumptions.
[2] Source: Bloomberg, MSCI EM Net Total Return Index (USD) from October 29, 2018 to March 11, 2019, and January 4, 2019 to March 11, 2019.

Last Year's Pressures: Higher Rates and a Strong Dollar

US Federal Reserve ("Fed") policy and the direction of the US dollar are key to the performance of EM economies and markets (Figure 1).

EM economies are extremely reliant on foreign inflows to finance their fiscal and current account deficits. Since the Global Financial Crisis, EM countries seduced by low rates have ramped up their levels of hard-currency denominated external debt to about 30% of GDP[3]. Higher US interest rates change the direction of capital flows away from the emerging markets, strengthening the USD and triggering depreciation of EM currencies around the globe. In 2018, US economic strength diverged from the rest of the world, prompting a consistent tightening of Fed policy. As a result, the US trade-weighted dollar rose around 5%, while EM currencies slumped some 10-15%.

Figure 1: EM and USD – Joined at the Hip



As of 2/28/2019.
Source: MSCI, J.P. Morgan.

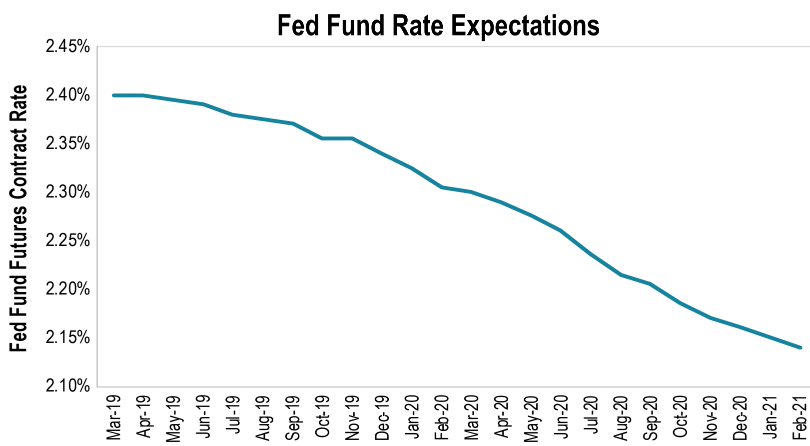
With their currencies depreciating and capital flows petering out, EM governments were struggling to finance their deficits as their debts are often in dollars, while taxes are denominated in depreciating local currency. The EM private sector was also squeezed by growing hard-currency denominated interest payments[4]. In order to relieve the pressure on their economies, EM central banks were forced to support their currencies by hiking rates, choking off growth and triggering a vicious cycle of depreciation and tightening. The currency and funding crises we saw in Argentina and Turkey in 2018 are an illustration of the effects of the US hiking cycle on weaker EM economies.

A Pause That Refreshes

After steadily raising rates for three years, and spooking markets with hawkish rhetoric in October of last year, the Fed raised interest rates one more time in December. It then surprised markets in January by hinting at a pause in the rate-hiking cycle, and emphasizing both patience and newfound flexibility on the shrinkage of its balance sheet. Given this dovish shift, fed fund futures are now pricing in no rate hikes this year, and a *CUT* in 2020 (Figure 2).

A dovish Fed offers support for EM currencies and halts appreciation of the USD. Indeed, this was the case back in 2016, and appears to be the case this year. The EM FX index has bottomed in September but after the speech by Powell at the beginning

Figure 2: Market Expects a "Patient" Fed



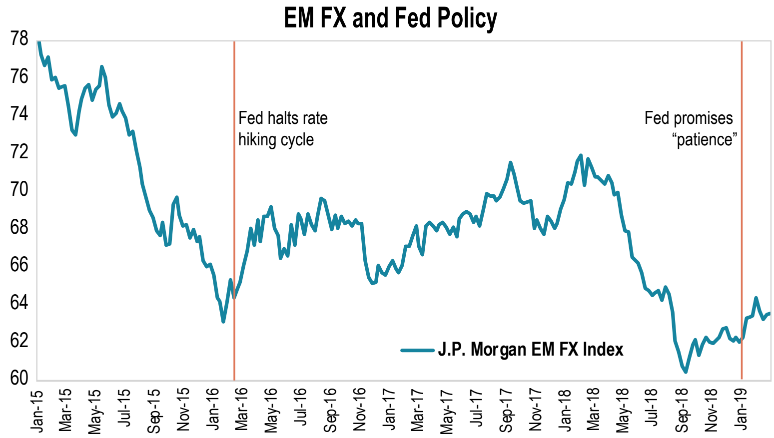
As of 2/28/2019.
Source: Bloomberg.

[3] Source: Bloomberg, IMF World Economic Outlook, April 2018.
[4] IMF Development Committee, Debt Vulnerabilities in Emerging and Low-Income Economies.

of January that signaled the start to a more "patient" Fed stance, it has increased by about 1.5%[5] (Figure 3). At the same time, USD has stabilized.

In addition to a pause in rate hiking, the US economy is cooling, and its growth differential with the rest of the world is narrowing as the boost from 2018's tax reform is waning. None of these developments bode well for the dollar, which may be nearing the end of its multi-year bull cycle. A stabilization and/or weakening in USD will likely benefit emerging markets.

Figure 3: Dovish Fed Offers Support for EM FX



As of 2/28/2019.
Source: J.P. Morgan.

China: Whatever It Takes?

The combination of China's deleveraging campaign and its trade dispute with the US has put additional downward pressure on China's economy. With the economy slowing, business confidence sagging and non-performing loans rising, China initiated a stimulus program in mid-2018 that started with monetary measures such as rate cuts. Following these monetary measures, fiscal policy and credit (i.e., Targeted Medium-term Lending Facility (TMLF)) easing have followed. Bottomline: we believe China will do whatever it takes to stimulate its economy, putting its deleveraging campaign on hold until there is a clear evidence that growth has stabilized or even accelerated.

So far, China's economy continues to slow with even official GDP data showing a mild deceleration in growth in Q4 to 6.4% year over year (y/y) from 6.5% y/y in Q3[6]. However, there are already some "green shoots." These include a large increase in overall social financing growth (which contains shadow lending), the Caixin/Markit combined PMI composite rising in February with the new orders component moving into expansion territory, and home price growth for Tier 2-4 cities accelerating from 5% y/y in mid-2018, to over 11% y/y in January.

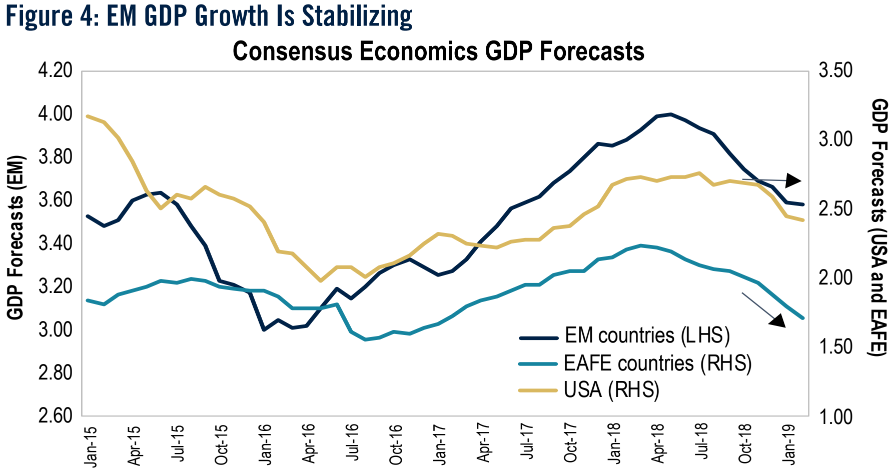
China is a major destination for many emerging market exports[7] (35% of China imports or $87B p.a. are from EM countries), so the trajectory of China's economy is tightly linked to the rest of EM world. Once China's economy stabilizes and/or accelerates, the multiplier impact on EM economies and EM corporate profits could be substantial.

Macroeconomic Forecasts Are Stabilizing

Another strong catalyst for outperformance of emerging markets has been a stabilization in macroeconomic forecasts (Figure 4), thanks to tailwinds from low commodity prices, especially oil, that benefit EM commodity-poor nations, such as India. Also, the OECD expects global growth to pick up in 2020 to 3.4% from 3.3% expected in 2019[8].

Furthermore, many idiosyncratic factors that weighed on markets last year, such as election uncertainty in Mexico and Brazil, are behind us, providing further optimism on the outlook for EM.

Figure 4: EM GDP Growth Is Stabilizing



As of 2/28/2019.
Source: Consensus Economics median GDP forecasts, market-cap weighted.

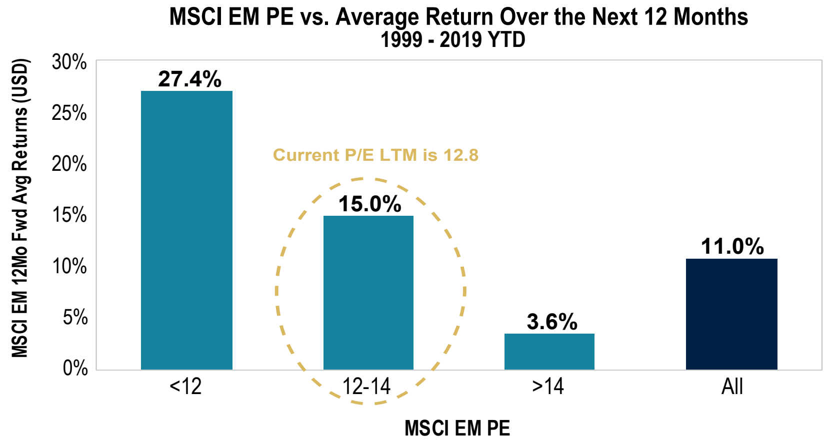
[5] Source: Bloomberg, J.P. Morgan Emerging Market CPI-Based Real Broad Effective Exchange Rate, January 4, 2019 to March 11, 2019.
[6] Source: Factset.
[7] Source: Factset, National Bureau of Statistics of China, March 9, 2019.
[8] Source: OECD, Interim Economic Outlook, March 6, 2019.

Valuations Are Attractive and Earnings Expectations Are Easy to Beat

EM equities are inexpensive, trading at a 12-month trailing PE of 12.8x[9], which is slightly below the 10-year average. Historically, at this starting level of valuations, EM equities have delivered an average return of 15% over the next 12 months (Figure 5). Not only are EM equities inexpensive relative to their own history, but also relative to developed markets, trading at a roughly 27% discount, which is slightly above its historical average discount.

Meanwhile, earnings expectations for EM have come down from a lofty 15% in the beginning of 2018 to 7%, and show signs of bottoming. Current expectations are also a lower hurdle for upside surprise.

Figure 5: EM Valuations Are Attractive



As of 2/28/2019.
Source: QMA, MSCI, FactSet.

With supportive valuations and sensible earnings expectations, EM is looking increasingly more attractive.

Conclusion

We are tactically overweighting EM across our multi-asset portfolios. The macroeconomic backdrop is now more supportive of EM, with the combination of the Fed pausing, a steady dollar and China's easing campaign. Moreover, valuations are supportive and fundamentals are stabilizing. However, risks remain, including a much deeper slowdown in global growth, a breakdown in trade talks, or the Fed pivoting to a more aggressive stance in response to more positive US growth or an inflation surprise. Yet, on balance, we believe that the risks are skewed to the upside and EM equities are an attractive value proposition, offering an ample risk premium.

[9] Source: Factset Estimates, March 5, 2019.

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*As of 12/31/2018.

NOTES TO DISCLOSURE

Sources: QMA, FactSet, Consensus Economics, Organisation for Economic Co-operation and Development (OECD), Bloomberg, International Monetary Fund, J.P. Morgan, MSCI, National Bureau of Statistics of China, U.S. Federal Reserve System, Federal Reserve Bank of New York.

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