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Valuation: Bullish

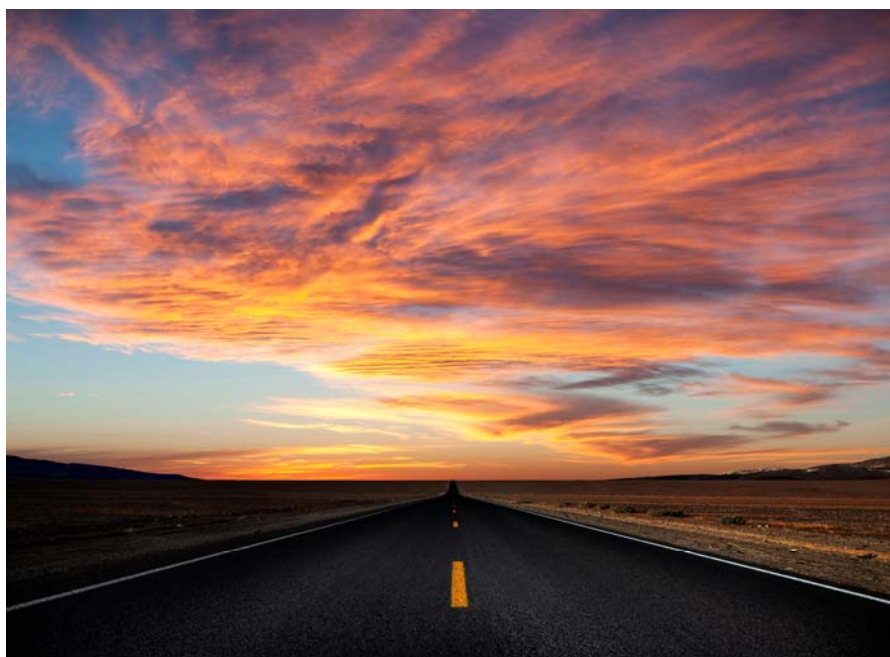


**vs MSCI World:
Bearish**



Timing model: Bearish

The way ahead for Emerging Markets



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All is not well in Emerging Market (EM) equities. Having underperformed stocks in mature markets since 2011, the MSCI Emerging Markets index has been especially hard hit in the recent shakeout in equities worldwide.

This is therefore a good moment to ask whether EM shares currently offer a tactical buying opportunity.

In this report, I explore:

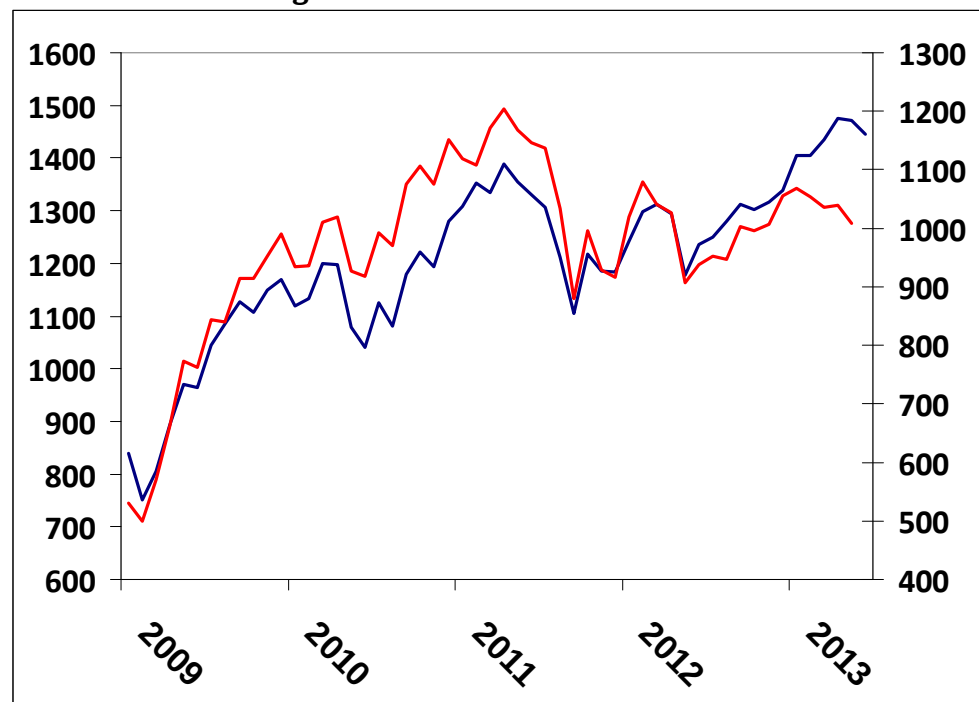
- The longer-term track record of EM stocks
- Some of the key performance drivers of EM stocks
- A timing model for beating the MSCI EM index

The tide turns against EMs

Mature markets have proved a better bet for the past couple of years

Emerging Market equities have had a tough time just lately. Since the start of 2013, the MSCI Emerging Markets Index – which covers equities from 21 developing countries – has dropped by 11.7%. This is in sharp contrast to the MSCI World Index, which tracks stocks from mature markets, and which is up by 7.9%.

EMs lose their edge



Datastream. MSCI World, MSCI Emerging Markets

EM underperformance isn't a new trend. The MSCI EM index is some 23% off its highs of May 2011, the World index having risen 4% since.

It's all a far cry from the booming returns that EMs delivered during the 2001-2011 period, where they racked up a thumping annualised total return of **20.7%** against a mere **6.7%** for DM stocks.

Uppermost in investors' minds right now is the Chinese credit crunch and markedly slowing economic growth there, as well as the outbreaks of social unrest in Brazil and Turkey.

At the same time, mature markets are looking much more attractively valued than they have done in a number of years.

Bye-bye boom-times

The Emerging Markets boom of the 2000s was not typical

The 20.7% annualised total return from EMs between September 2001 and April 2011 was pretty exceptional.

EMs over time

1973-2013	Total return, annualised (%)	Volatility (%)
Emerging Markets	11.4	26.5
Developed Markets	9.4	15.2

Datastream; returns in USD

A glance back over history reminds us that EMs have not always done so well, either in absolute or relative terms.

From its creation in 1988 to 2001, the MSCI EM index's annualised total return was a much more modest **8.9%**.

To get an idea of EM returns before 1988, I have built a capitalisation-weighted index using Asian (ex-Japan), Latin American and South African equity indices.

The annualised total return on this index between 1973 and 1987 was **9.9%**, while the MSCI World index generated **12.3%**.

So, while EM equities were the better bet for the 1973-2013 period as a whole, this was heavily influenced by their spectacular showing of 2001-2011.

Goldman Sachs' economics team lately argued that the returns of the last decade were attributed to an especially benign set of conditions that are unlikely to be repeated, including the taming of EM inflation, and the positive ripple effects from China's stunning expansion - *Not your older brother's emerging markets, Goldman Sachs' Global Economics Weekly, June 19, 2013.*

Mature markets like the US, UK and Japan post-2000 era in a secular bear market, starting from the heavily overvalued conditions around the millennium.

Today, mature markets are much more attractively valued than they have been in some time, with the prominent exception of the US.

EMs therefore look unlikely to offer the same sort of performance they did during the 2001-2011 period, in absolute or relative terms.

What drives EMs

The fundamental factors that power emerging stock returns

Between 1990 and 2013, just three factors explain 60% of the variation in the MSCI EM index's twelve-monthly performance:

- **Exchange rates:** moves in the trade-weighted US Dollar
- **The economic outlook:** changes in the OECD's leading indicator for the G7 nations
- **Valuation:** the relative price level of EM and DM shares

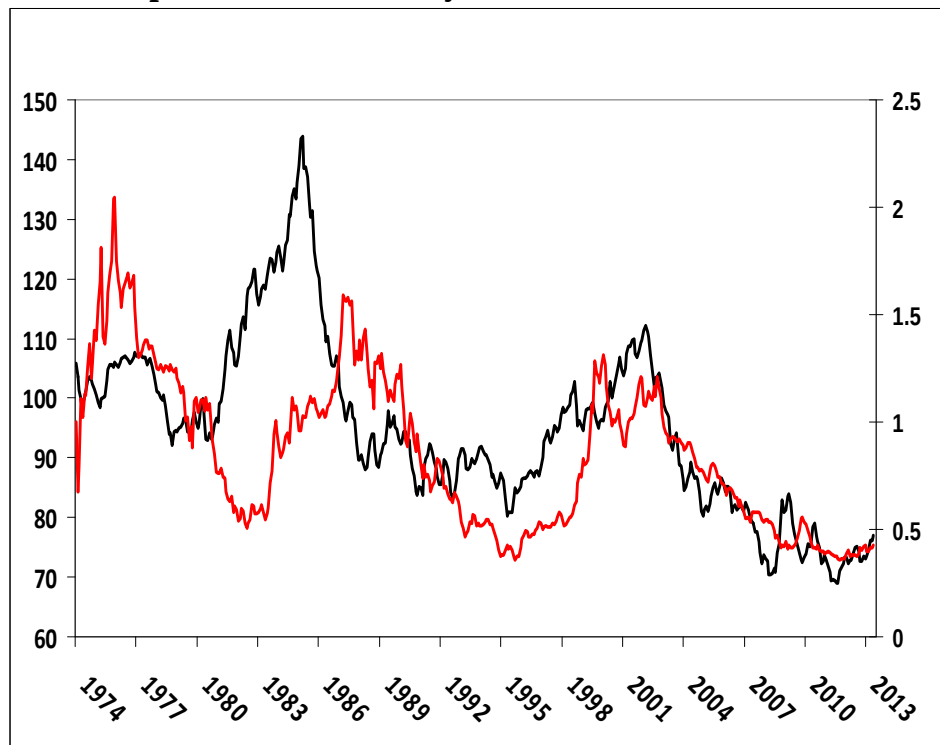
Having a view on these factors is therefore very useful when weighing up the outlook for EM equities.

The greenback's comeback

A stronger dollar isn't helpful for EMs going by past performance

Periods of strength in the US dollar index (black line) have tended to see mature stocks beat emerging markets (red line), as this chart highlights.

Dollar up, EMs lose the day



Datastream. US dollar index; MSCI World v Emerging Markets.

This relationship has become closer over time.

Historically, a strengthening dollar has caused problems in emerging market economies, since as many emerging countries borrowed heavily in US dollars rather than in their own currencies.

US dollar appreciation therefore raised the cost of paying interest and repaying such loans, triggering such crises as that in Mexico in 1994.

There is an increasingly popular view that the US dollar has now entered a significant new bull market.

EM currencies have become dearer over the last decade or so against the US dollar, in terms of their purchasing power parity (PPP) valuations.

At the end of 2002, around when EM stock markets began their mighty outperformance, the Chinese Yuan, Brazilian Real and Indonesian Rupiah were noticeably cheaper in PPP terms than they were today.

EM \$ exchange rates v as % of PPP fair value

vs USD	31/5/2013	Average	2002
Chinese Yuan	68.3	48.3	39.3
Brazilian Real	88.3	67.2	31.3
Indonesian Rupiah	70.6	49.8	36.1
Mexican Peso	60.0	58.4	63.2
Turkish Lira	57.5	47.1	37.2
S. Korean Won	73.3	73.2	64.8

Bloomberg

In the near-term, I do envisage the US dollar index strengthening more, especially against the Euro.

While further dollar gains would likely see EMs lose more ground to DM stocks, this does not mean they would necessarily struggle in absolute terms.

The US Dollar & Emerging Market performance

US Dollar	Start	End	EM v DM annualised (%)	EM annualised (%)
Bear	Jan-77	Oct-78	14.4	28.0
Bull	Oct-78	Mar-85	-3.6	8.9
Bear	Mar-85	Apr-95	8.3	24.7
Bull	Apr-95	Feb-02	-9.1	-2.4
Bear	Feb-02	Aug-11	10.7	17.0

Datastream

EM stocks registered respectable gains during the dollar bull market of the early 1980s.

In the coming months, I do expect the dollar to continue to strengthen further, which could further boost the appeal of mature markets over emerging markets.

In due course, I expect the effect to fade and for the US to revert to QE as its recovery sputters once more.

It's the economy, stupid

The economic outlook in the biggest economies sways EM fortunes

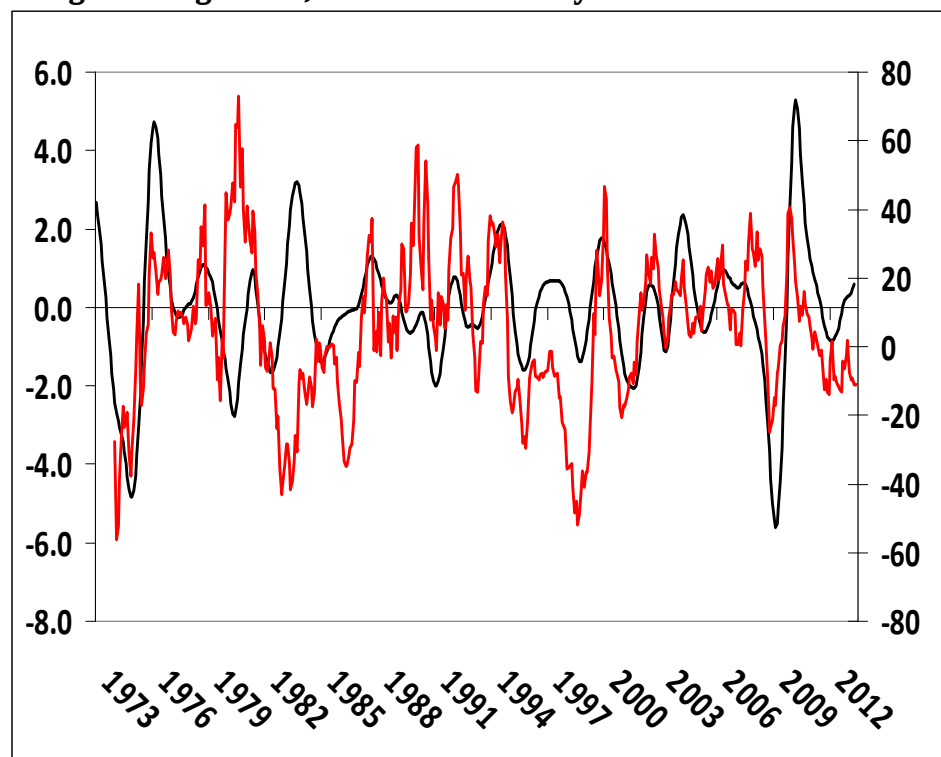
It is well known that strong GDP growth does not necessarily translate into strong stock-market returns in emerging or developed countries over time – the classic case stated in [Economic Growth and Equity Returns by Jay Ritter, 2005](#).

However, the near-term outlook – as measured by the economic leading indicators – has tended to influence the performance of Emerging Market shares against their developed counterparts.

EMs have tended to beat mature markets during times of anticipated economic improvement.

The MSCI EM index has tended to beat the MSCI World index when the OECD's leading indicator for the G7 countries is rising.

Brightening skies, EMs win the day



Datastream. OECD G7 leading indicator, 12m %; EMs v DMs, 12m %.

Buying into EMs as the leading indicator is at depressed levels below 100 or turning upwards from there can be an especially good idea, therefore.

The leading indicator's latest readings are consistent with EMs experiencing a flat relative performance against DMs of 0.8% over the coming twelve months.

Under the circumstances, then, I do not see the current outlook as especially helpful for EM equities.

The value of everything EM

The economic outlook in the biggest economies sways EM fortunes

In my research, valuation tends not to be an especially important driver of one-year equity market returns, i.e. for tactical asset allocation purposes.

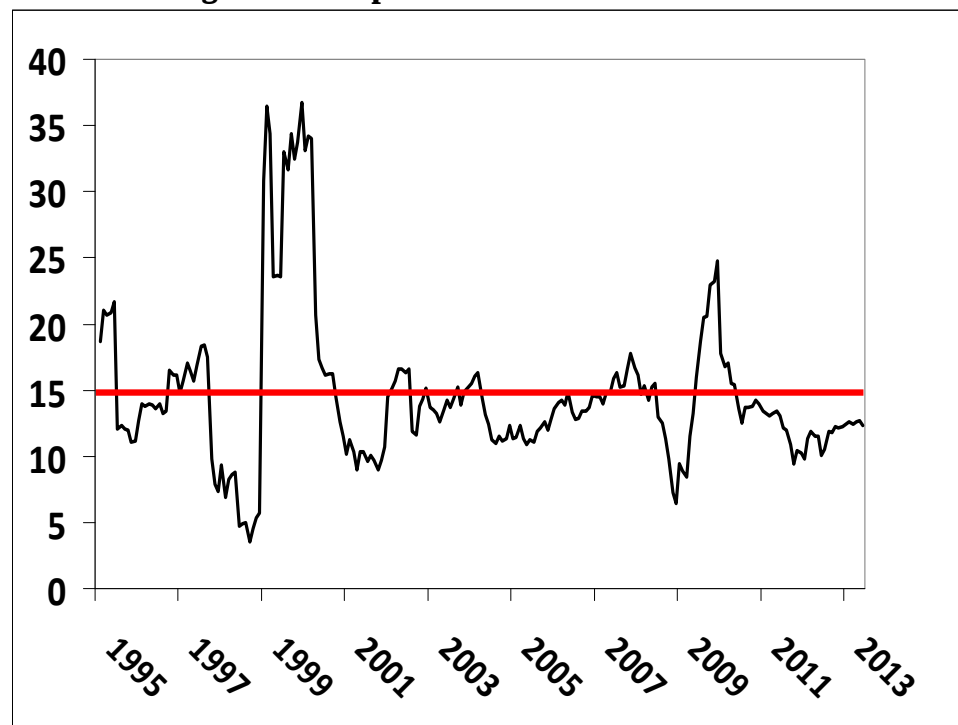
Most valuation tools, whether earnings, dividend or asset-based are most effective over horizons of two years and more.

Over time, the trailing price/earnings on the MSCI EM index explains – statistically speaking – less than 2% of its variation over the next twelve months, and the price/book ratio even less.

On a two-year view, though, trailing PE explains about 11% of subsequent annual returns and PB about 15%.

As of 1 July 2013, the trailing PE on the MSCI EM index was **11.4**, while the PB was **1.42**.

EM's trailing PE multiple



Bloomberg; MSCI PE/**average PE**

On a two-year view, such a PE rating is consistent with annualised return of 10.1%.

The chances of losing money over the next two years are roughly 16 per cent, meanwhile, based on past relationships.

Current valuations are modestly bullish for EMs therefore.

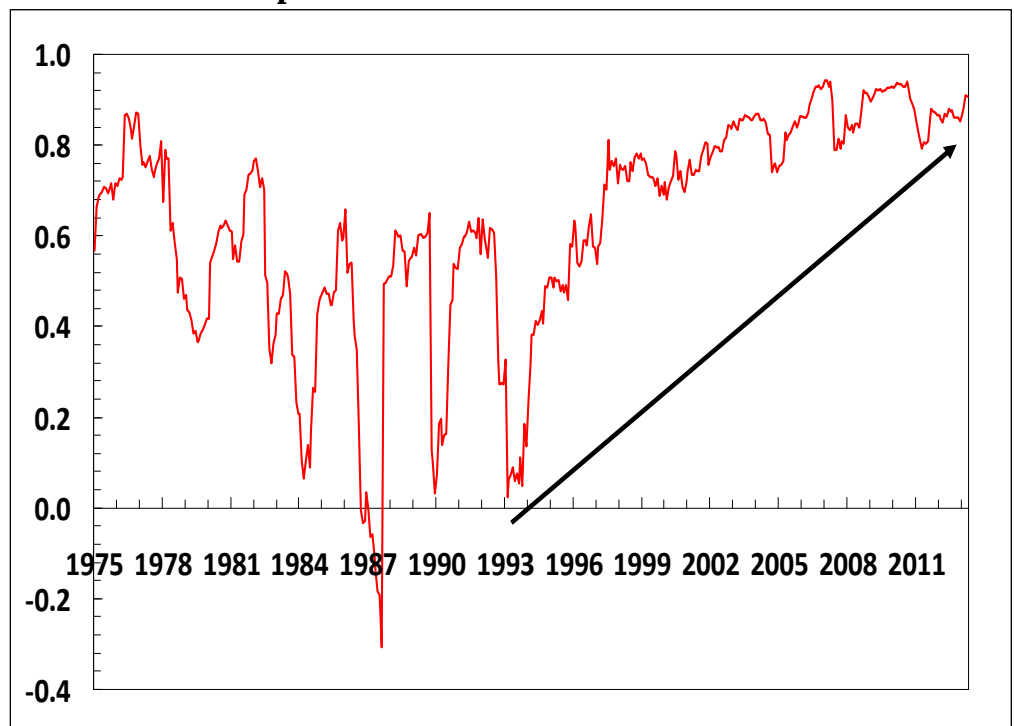
No longer a great diversifier

EMs used to offer a good way to lay off mature market equity risk

A key attraction of Emerging Markets over time has been the diversification benefits they offered.

The correlation between Emerging Market returns and Developed Market returns was moderate to weak for much of the 1970s to the mid-1990s.

Mature & developed markets: ever closer ties



Datastream, Bloomberg. **Correlation MSCI World-EMs**

Since then, however, the correlation has strengthened consistently and lately has been above 0.9.

The integration of capital markets and the ever freer flow of money across border is the most likely explanation for this.

One danger, therefore, is that EMs now suffer another era of underperformance while also offering fewer diversification benefits.

Timing EM equity investments

Our tactical timing model has outperformed this market

To determine good times to buy and sell the MSCI Emerging Markets index, we run a simple momentum-based model, which aims to catch the lion's share of bull-moves, while exiting the market during significant downtrends.

Its buy- and sell-signals are entirely objective, entering as early as possible during a new uptrend, but also when an uptrend reasserts itself, and then exiting as the market loses steam at very stretched levels and when the uptrend reverses.

The market-timing model in action



This approach has beaten simply buying and holding the MSCI Emerging Market over time, and with a good deal less volatility.

The annual price return between 1988 and 2013 was 14.2%, against 9.7% for buy-and-hold. Volatility, as measured by standard deviation, was just over two-thirds of that for buy-and-hold.

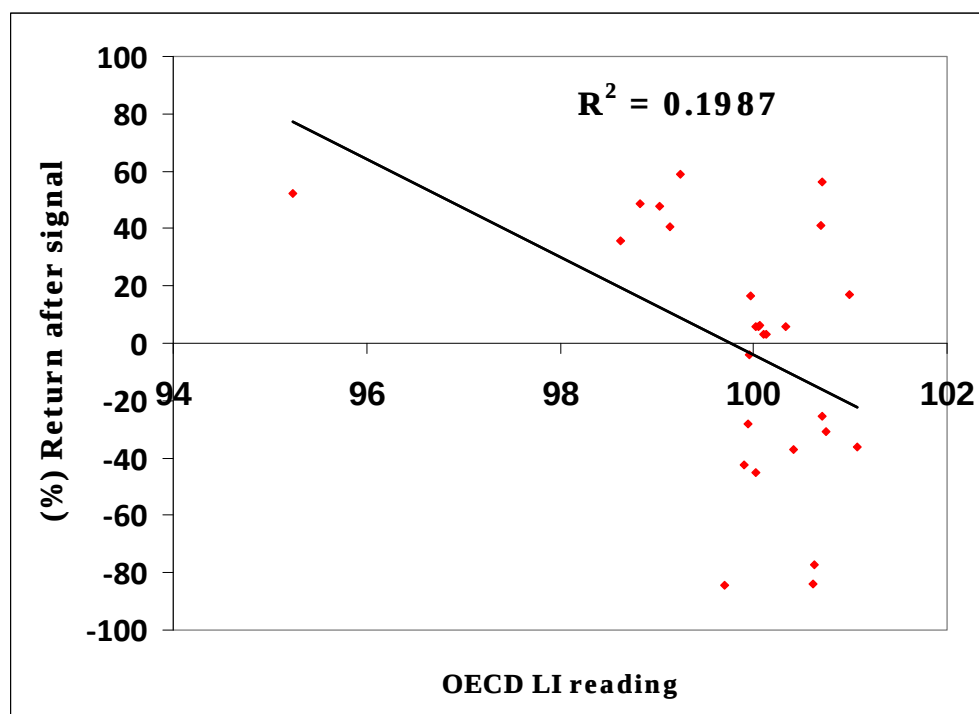
In reality, one could have improved on this by holding one's fund in an interest-bearing account during "out-of-the-market" phases.

The full record of this tactical timing approach compared to buy-and-hold is shown in this table.

	System	B&H
Annual return	14.2	9.7
Standard deviation	14.9	21.7
Average trade return (%)	16.0	-
Average trade (weeks)	32.6	-
Winners/losers (#)	16/11	1/0
Reward/risk ratio (x)	4.5	-
Most consecutive losers	3.0	-
Average worst drawdown per trade (%)	-5.6	-
Time in the market (%)	66.3	100

Signals generated when the G7 OECD leading indicator reading is below 99.2 have tended to be more profitable, as the accompanying chart stresses.

Low readings lead to higher returns from signals



Out of 27 trades for the period, it generated 17 winners and 10 losers, with a stop-loss of 20% triggered on two occasions.

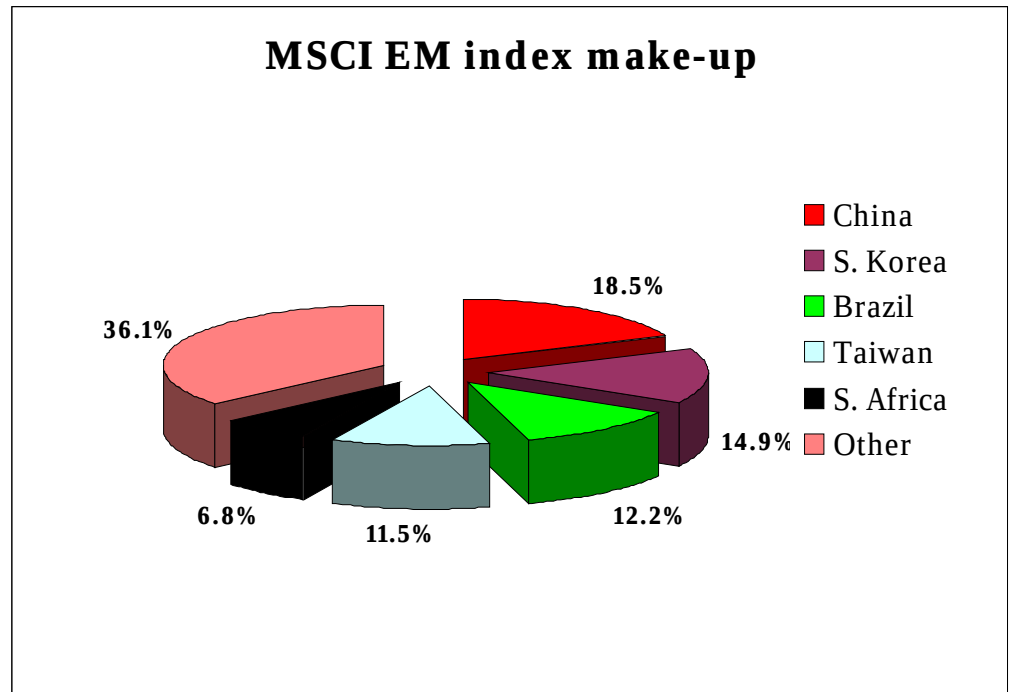
The last signal generated was a **SELL** on 7 June 2013.

Conclusions

Mature markets offer more attractive tactical buying opportunities for now

- The MSCI Emerging Markets index is unlikely to repeat its 2001-2011 success any time soon
- EMs no longer offer the same diversification benefits as they once did and we are not expecting this to change
- Further near-term strengthening of the US dollar is likely to weigh upon EM relative performance versus mature markets.
- Mature markets such as the US, Japan and Europe offer better opportunities in the months ahead
- EMs as a whole are reasonably cheap, rather than screamingly so.
- A selective approach to EMs is advisable under these conditions and we will be addressing certain individual emerging markets in the weeks ahead.
- Our tactical switching model – which has outperformed the MSCI EM index over time – recently gave a SELL signal, so our tactical position is neutral for now.

Appendix



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In comparing the investments described in this publication, you should bear in mind that the nature of such investments and of the returns, risks and charges differ from one investment to another. Smaller companies with a short track record by their nature