Emerging Market Equities

The Current Opportunity

SPRING 2017

SBH INTERNATIONAL EQUITY TEAM WHITE PAPER

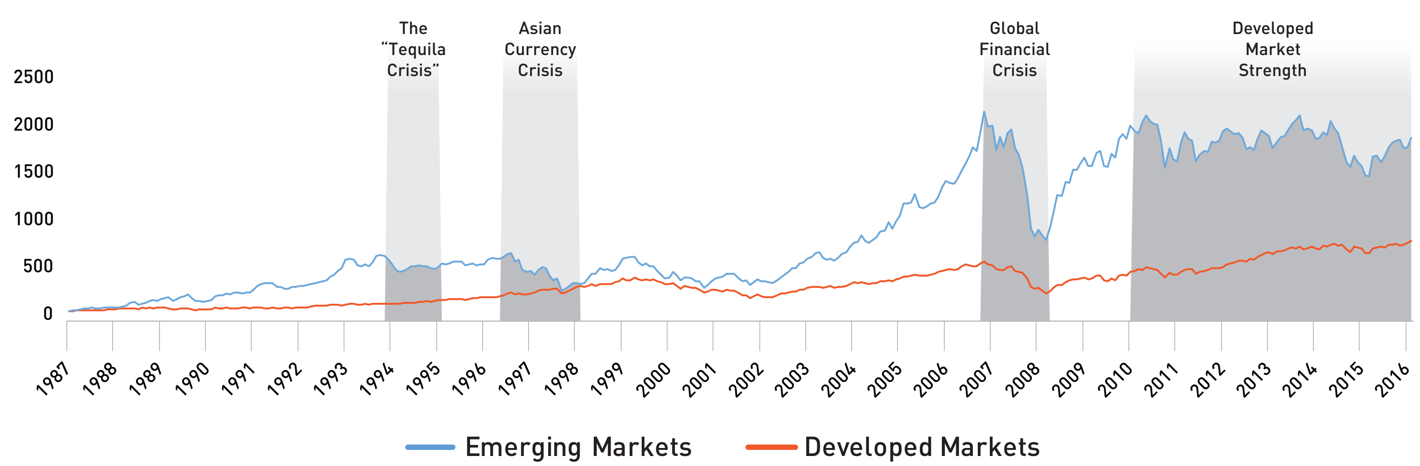
KEY POINTS

- Emerging market (EM) equities have offered significant return and diversification potential over time, despite some extended periods of volatility.
- The long-term positive attributes of emerging market countries remain intact, and there is support for a reacceleration of GDP growth that could bring their growth advantage versus developed markets back closer to historical levels.
- The trend of a strengthening U.S. dollar—which has hurt EM equity returns during the past few years—is unlikely to continue at its current pace. In fact, we believe that currency rates could become a tailwind for EM investors.
- EM equity valuations are attractive versus their developed market counterparts, and the "knee-jerk" response to the U.S. presidential election has only helped maintain this advantage after an otherwise strong 2016 for EM equities.
- The case for EM equities as part of a diversified portfolio remains unchanged. Given their attractive valuations and numerous signs of continued fundamental improvement, we believe now is a particularly compelling entry point for investors looking to increase or initiate allocations.

HISTORICAL PERSPECTIVE

For several decades, EM equities have attracted investors looking to diversify their equity exposure and access the strong return potential and expansive investment opportunities of these rapidly growing economies. EM equities have outperformed developed market equities over time, as shown in Exhibit 1, though not without shorter-term peaks and troughs along the way. The outsized returns from EM equities in the late 1980s and 1990s were punctuated by a number of crises, particularly the "Tequila Crisis" of 1994 and Asian Currency Crisis of 1997–98, resulting in extreme levels of undervaluation and investor pessimism around the turn of the 21st century. During most of the 2000s, EM equities again performed strongly, but were then hit (along with developed market equities) in 2007–08 by the Global Financial Crisis. EM countries, having learned hard lessons from past crises and having established healthier balance sheets, were able to lead global growth out of that period while the U.S. and Europe took longer to recover their losses.

EXHIBIT 1: LONG-TERM RETURNS OF DEVELOPED AND EMERGING MARKET EQUITIES



Note: Developed Markets = MSCI World Index. Emerging Markets = MSCI Emerging Markets Index. Returns rebased to 100 at December 31, 1987. Index returns in U.S. dollars. Past performance is not indicative of future results.

Source: MSCI, FactSet, SBH

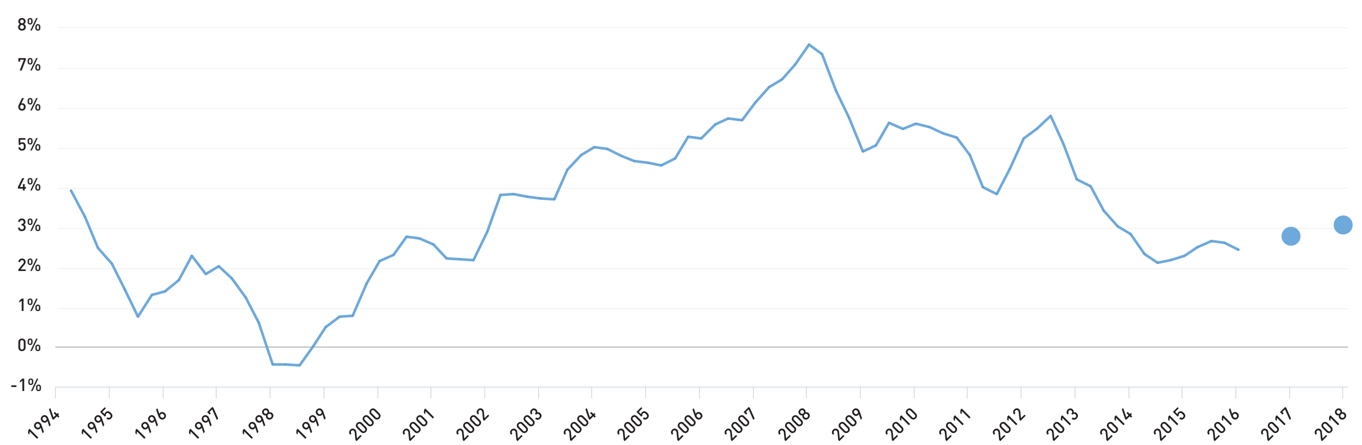
Yet since 2010, EM equities have displayed weakness for a variety of reasons—a slowdown in Chinese growth, plummeting commodity prices, a strengthening U.S. dollar (USD) and the U.S. Federal Reserve's (Fed) plans for an eventual unwinding of its accommodative monetary policies. In contrast, the U.S. and other developed market equities continued their post-crisis gains, which in tandem with EM weakness, led EM equities to lag for more than five years. However, that trend reversed in 2016, as EM equities posted double-digit returns. We now see multiple indicators that EM equities are poised to continue this resurgence.

A RETURN TO HIGHER GROWTH

Interest in emerging markets has historically been driven by a desire to invest in countries with attractive secular trends—favorable demographics, increased consumption by growing middle classes and higher growth rates. Despite the volatility in EM equities in recent years, these longer-term trends remain intact.

Although recent years have continued to see higher GDP growth in emerging markets than in developed markets, the spread between the two had shrunk significantly from the peak reached in 2008 (see Exhibit 2). This peak capped a period in the 2000s where EM growth accelerated significantly. But from the peak to 2015, the gap between the two cohorts declined as those trends reversed. EM growth was held back in part by lower demand for natural resources—a common export of many EM countries—which resulted from the global growth slowdown. Additionally, economic growth in many EM countries had been somewhat "front-loaded" by government policies that helped these economies power through the Global Financial Crisis.

EXHIBIT 2: EXCESS GDP GROWTH OF EMERGING MARKETS OVER DEVELOPED MARKETS



Note: Historical annual year-over-year % GDP growth from March 1995 to September 2016 smoothed on a trailing four-quarter basis. Forecast annual GDP data for full years 2016, 2017 and 2018.

Source: Bloomberg

Now these trends have started to reverse as growth in many EM countries reaccelerates. Exhibit 2 shows that GDP growth rates in emerging markets are expected to increase faster than those in developed markets in the coming years. This same improvement in growth rates is also being reflected in the bottom-up earnings estimates of individual companies. After lagging their developed market counterparts from 2010 to 2015, annualized earnings growth for EM companies is expected to be 12.7% over the next three years, as compared to annualized earnings growth of 10.8% for developed market companies[1]. We believe these improvements in fundamentals should also improve investors' perceptions of, and interest in, emerging markets.

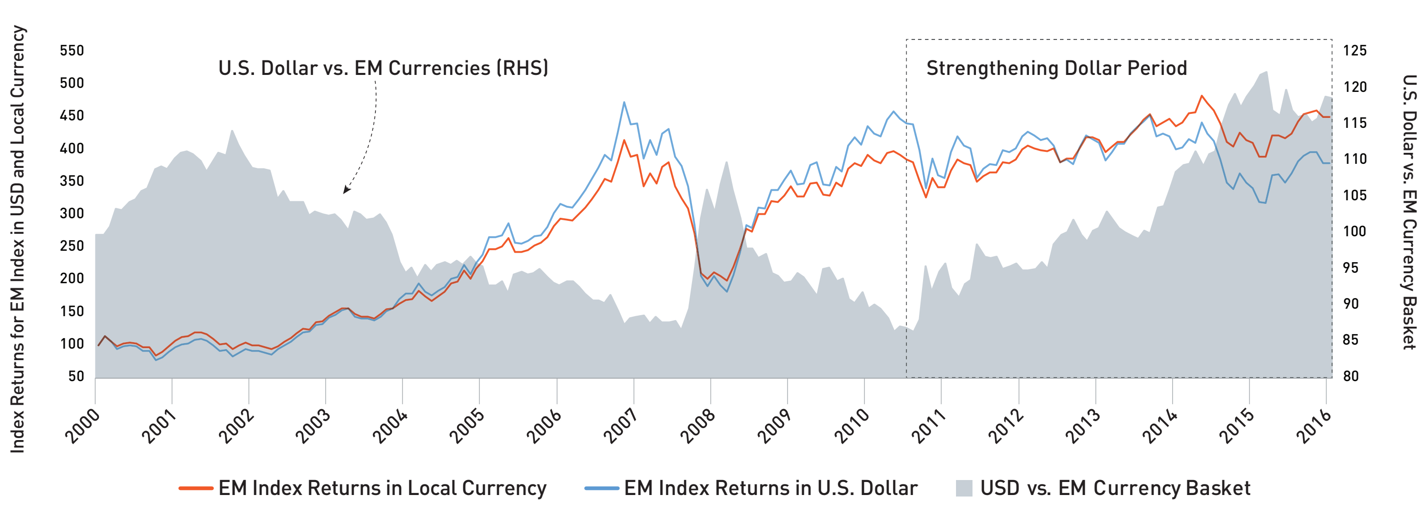
[1]Reflects annualized year-over-year growth rates for MSCI Emerging Markets Index and MSCI World Index, based on FactSet aggregate forecast data for 2016–2019.

THE EFFECTS OF RECENT DOLLAR STRENGTH

The strengthening of the U.S. dollar since 2011 has exerted a significant influence on EM equity returns for U.S.-based investors. As shown in Exhibit 3, during this period the U.S. dollar (USD) has strengthened considerably versus a basket of EM currencies, most dramatically in 2014–15. This currency move has held back EM equity returns in U.S. dollar terms as compared to returns in local currencies—since December 2011, the MSCI Emerging Markets Index returned 31.6% in local currencies (orange line), though only 6.5% in USD terms (blue line).

Much of the recent strengthening of the dollar has been in anticipation of the Fed's upcoming rate rises. These moves may now be largely priced in by the market. In fact, during prior periods of monetary tightening by the Fed in 1994–1995 and 2004–2005, the U.S. dollar actually declined over these time periods. If the dollar were simply to stay near its current level, it would not further drag on international returns for U.S.-based investors, and this strong dollar would likely help foreign firms' earnings since they could better compete as their exports become cheaper on a relative basis. If instead the dollar does weaken from here, those currency returns will accrue positively to holders of non-USD investments. Either of these scenarios could turn the recent currency headwind for EM equities into a tailwind.

EXHIBIT 3: THE EFFECT OF CURRENCIES ON EM EQUITY RETURNS



Note: MSCI Emerging Markets Index in Local Currency and USD rebased to 100 at December 31, 2000. Currency return represents the U.S. dollar versus the basket of EM currencies in the MSCI Emerging Markets Index rebased to 100 at December 31, 2000. Past performance is not indicative of future results.

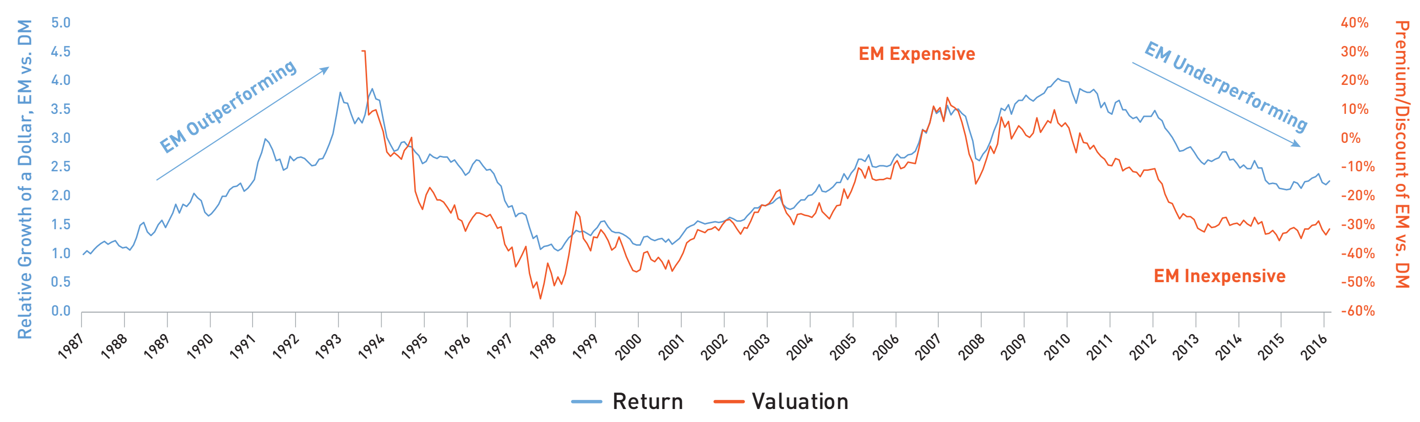
Source: Bloomberg, SBH

EM EQUITIES APPEAR ATTRACTIVELY PRICED

Even after strong performance since the start of 2016, EM equities are still priced at a significant discount compared to developed market equities, to a large degree set up by the disparate returns of the preceding five years. As shown in Exhibit 4, EM equities were trading at a steep discount compared with developed market equities in early 2016—a roughly 30% discount on a composite of valuation measures. EM equities made a nice start to closing that gap, posting a return of more than 16% through the third quarter of 2016[2]. However, the U.S. presidential election brought a sell-off in EM equities and a subsequent rise in U.S. and other developed market equities. This has again left EM equities well positioned versus developed market equities on a valuation basis, with EM equities still at a roughly 30% discount. Exhibit 4 also highlights how, in past cycles, relative valuations between emerging and developed markets have closely aligned with relative returns.

[2] As measured by the MSCI Emerging Markets Index.

EXHIBIT 4: EMERGING MARKETS VS. DEVELOPED MARKETS: RELATIVE RETURNS AND RELATIVE VALUATION



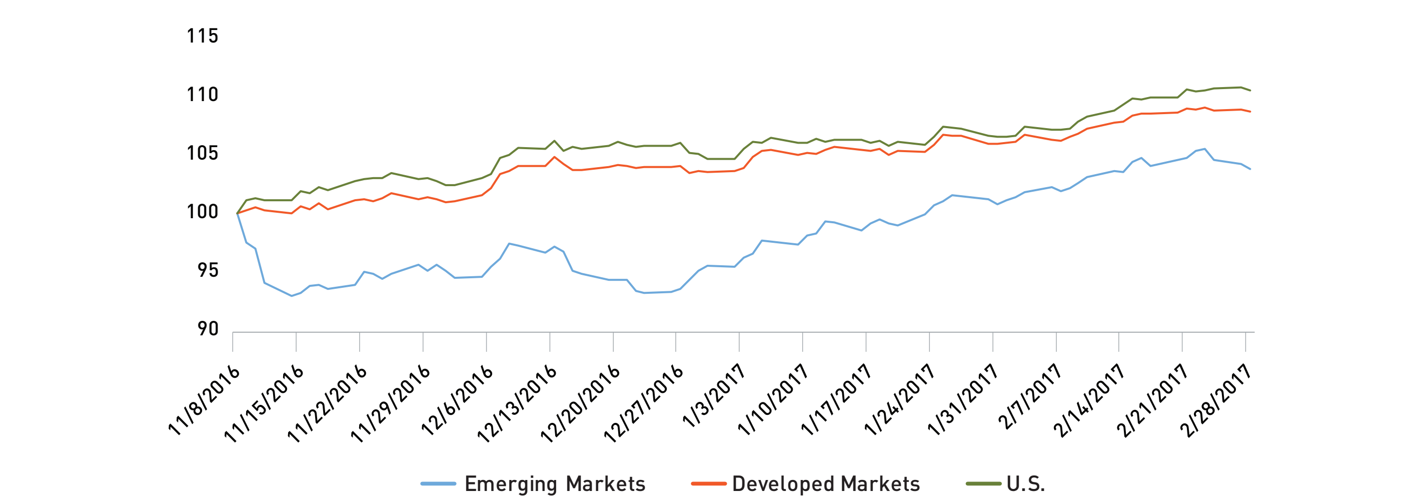
Note: Relative Valuation is the average of four measures of the premium/discount between the MSCI Emerging Markets Index and the MSCI World Index: Price/Earnings, Price/Book, Price/Cash Earnings and Price/Five-Year Smoothed Earnings. Past performance is not indicative of future results.

Source: MSCI, SBH

THE TRUMP EFFECT?

One unknown is, of course, the impact of U.S. President Donald Trump's policies, specifically those on trade. On the surface, Trump's unexpected victory might seem to derail the climb of EM equities that began in 2016. As shown in Exhibit 5, EM equities plunged following the U.S. presidential election, in contrast to developed market equities (and the U.S.), which rallied. We believe this "knee-jerk" reaction in favor of developed markets over emerging markets could be short lived as EM equities have begun closing the gap since the election, particularly in early 2017 (see Exhibit 5). There are multiple uncertainties from the Trump administration, including a potential for renegotiated trade agreements and antagonism between the U.S. and EM countries such as Mexico and China. Yet, despite the noise surrounding Trump's potential actions, we believe it will be in no one's interests to provoke an all-out trade war, thus allowing the positive fundamentals for EM equities to assert themselves.

EXHIBIT 5: POST-ELECTION EQUITY PERFORMANCE



Note: Returns rebased to 100 at November 8, 2016. Emerging Markets = MSCI Emerging Markets Index. Developed Markets = MSCI World Index. U.S. = S&P 500 Index. Index returns in U.S. dollars. Past performance is not indicative of future results.

Source: Bloomberg

LOOKING AHEAD

We believe the outlook for emerging market equities remains compelling. While short-term global uncertainty is likely to persist, we see no fundamental changes to the attractiveness of the asset class as a whole. As with any investment, there is, of course, the possibility of market losses and volatility. However, we believe that EM equities are in the best position in years to provide stronger returns than either U.S. or other developed market equities.

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