BLOG POST
Q&A Part 1
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Q: When will emerging markets pay off?

Brian Lockhart, CFP®: It has been a difficult period for emerging market equity and debt investors for the last 5 years. While emerging market stocks are mostly flat for 2019, there has been a lot of volatility. Going all the way back to 2014, emerging markets are down around 15% for the trailing 5-year period. Developed international markets have fared better but are still down 7% over that same period.

Emerging markets continue to have headwinds that caused Goldman Sachs to cut exposure earlier this year. The strength in the US dollar creates a liquidity issue for emerging market companies because their debt is often denominate in dollars, but their sales are in local currencies. When the dollar rises, their debt becomes more difficult to service.

There are also political concerns with many of the emerging market economies like South Africa and Latin America. Changes of political leadership in these countries can result in broad-based rioting that negatively impacts the local economies.

It has historically been safer to invest in emerging markets when the Federal Reserve is easing instead of tightening, so that may help them attract more capital. The valuations are also compelling today for emerging markets. The forward price-to-earnings ratio in emerging economies is below 12 compared to almost 18 in the US. I would prefer country specific exposure like India or Mexico rather than a broad basket.

Clint Pekrul, CFA: In the decade leading up to the Great Recession, emerging markets delivered very attractive returns. The MSCI Emerging Markets Index far surpassed the cumulative gain of the S&P 500 Index. If you believe in mean reversion across asset classes, you could argue that right now, emerging markets could be an attractive buy from a valuation standpoint. But there are headwinds. Higher interest rates in the U.S. make it more expensive for emerging markets to finance their debt and gain access to readily available capital. Likewise, a rising U.S. dollar can increase the credit risk of emerging market economies. Throw in the trade war, and it’s been a tough road for less developed countries. However, think back to 2017, when the macro narrative was globalized growth and GDP expansion. Emerging markets were up 37% compared to gains of 15% - 20% across developed markets. Plus, the U.S. dollar was falling, which is in stark contrast to what we are seeing today. My point is that macro conditions can change quickly, and you need to maintain exposure to emerging markets in your portfolio.