April 2021

"In economics, things take longer to happen than you think they will, and then they happen faster than you thought they could." - Roger Dornbusch

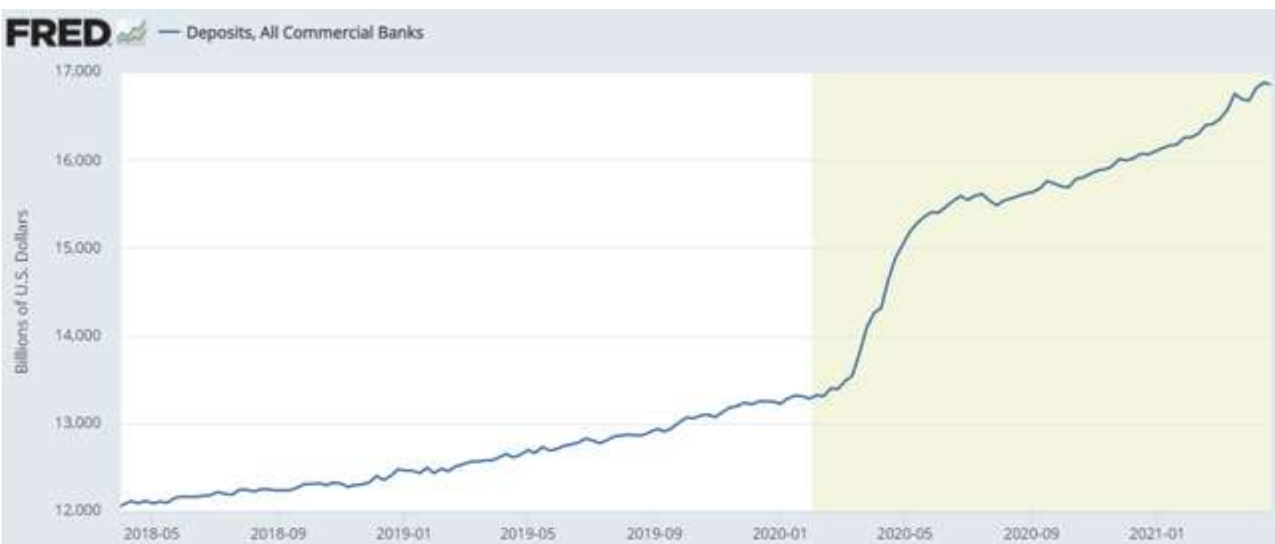
The bullish case, heavily edited, from High Dividend Opportunities:

Market Outlook May 2, 2021

... This is the most positive economic environment that I've ever seen with more than 6% GDP growth forecasts for 2021, ultralow interest rates, record order backlogs, and robust consumer spending. We have a record earnings season for the markets in general .... We expect many more to come!

I cannot stress enough that the main driver for these extraordinary times is the excess liquidity in the markets. We have historically seen great economic data that has not always translated into higher stock markets. **Liquidity is key and it is the ultimate driver for equities.** Not only did we have a massive amount of cash sitting on the sidelines until both the elections and the COVID situation were resolved, but in the meantime, the government has been injecting Trillions into the Economy. If you think about it, **just the last $1.9 trillion in stimulus plans is equivalent to 38% of one quarter's US GDP** (roughly $5 trillion). This is huge! This is in effect free money (or free liquidity) that is benefiting directly or indirectly most Americans in the short and medium-term. So we should not wonder why house prices are at all-time highs, and the stock markets are breaking their records almost on a weekly basis. If we dig more into the details:

- US Bank Deposits are up by 32% since pre-COVID. Stimulus checks and lack of spending opportunities were major contributors. We have about $4 trillion in additional bank deposits.



Source: [fred.stlouisfed]()

- Money market funds are also up significantly since pre-COVID levels. We have more than $1 trillion additional money market funds.

- Households' Net Worth at a Record $130.2 Trillion: The net worth of U.S. households finished 2020 at the highest level on record, as soaring prices for stocks and real estate are the major contributors.

While we have evidence that some of the "bubble of cash" sitting on the sidelines" is starting to find its way to the equity markets ... there are still trillions in excess liquidity earning near-zero interest rates. Part of this will also find its way to the equity markets providing additional upside. Even better news, we have at least $1 trillion in infrastructure spending that will hit this year and will give the economy and stock market investors another gift. The future looks very bright as far as liquidity is concerned.

So far, the government spending to get us out of the COVID recession is nearly four times the amount spent in response to the 2008 financial crisis.

The bottom line is that we are in the midst of a raging bull market that is likely to last another two years. It is supported by strong fundamental backdrops including a booming economy, consumer confidence, cheap money, and an abundance of liquidity.

Federal Reserve Statement ...

Last Wednesday, the Federal Reserve upgraded its views of the U.S. economy while keeping interest rates near zero. It added that COVID remains a risk to the economic outlook. Chair Powell said that the recovery has been faster than expected but "it remains uneven and far from complete" and the economy "is a long way from our goals." It was not yet time to discuss scaling back asset purchases and "it will take some time before we see substantial further progress."

This provided investors a clear signal that it will be a very long time (we are not as sanguine) until short-term interest rates will be hiked ....

Sell in May and go away? ...

Interestingly, JP Morgan analysts yesterday were advocating to do the exact opposite than to take profits in May. The advice was: "**Buy in May and Go Away**" referring to value stocks and cyclical stocks (or economically sensitive stocks such as BDCs, CLOs, mREITs, and Property REITs that we are holding in our portfolio). They believe that the strong uptrend for value and cyclical stocks is likely to accelerate into late spring and summer, buoyed by a continued rally in commodities and a resurgence in Treasury yields. Here is their quote:

We believe this move is likely to accelerate as we move into late spring and the summer amid the reopening of the economy, with the primary beneficiary being value and cyclical stocks... Importantly, we do not believe these developments are priced in, and believe the reopening and reflation trade will resume with a move that will be bigger than we saw early this year.... A continued rally in commodities and a resurgence of Treasury yields higher stand to be near term catalysts for value and cyclical stocks.

Not only do I agree with the JP Morgan analysts, but I am against trying to time the markets. (His last attempt, raising 10% cash, failed, as we shared at the time.) This is especially a bad strategy when we are in a very strong market such as the one we are seeing today. The odds are that you are likely to buy back at higher prices. Importantly, short-term market fluctuations do not matter for us. We are income investors and time is on our side.

Risks to the Bull Market

1. Higher capital gains taxes will have a short-term impact on the market, but will not derail it. Growth and momentum stocks will be the most impacted. Dividend-paying stocks will be the least impacted. In fact,

many dividend stocks such as those that do not pay "Qualified Dividends" (for example REITs, BDCs, MLPs, and many of our CEFs) should actually be "net winners" because they will not be impacted by these taxes.

2. Higher corporate taxes have historically not had a significant impact on the bull market as long as they remain competitive globally. ...

However, the biggest risk to equities today is a Federal Reserve policy error by hiking interest rates too soon or too late. (When has the Fed ever been not "too soon or too late"?)

1. Hiking short-term interest rates too soon, that could derail the economic recovery and could result in a severe market crash.
2. Hiking short-term interest rates too late would result in inflationary pressures that would be hard to control. First, this is not negative for the economy in general, and for the U.S. consumer in particular. (Not true!) It would prompt the Fed to start hiking too aggressively in a short period of time, creating imbalances in the markets. This would be bearish for most equities but would (could) be bullish for inflation resilient stocks and sectors.

This is a risk that I will be continuously watching and will keep our members informed. We will make adjustments to our portfolio accordingly to hedge against any such upcoming risks. (and when did that last work?) ...

Conclusion

It is one of the best days to be an investor in the markets. What is important is to stay on top of the big picture. Some investors may feel that this bull market is mature or are scared that they missed the big rally; yet, they are discounting the fact that we have monetary and fiscal policies of a young, emerging bull market, and an economy just coming out of a recession. This mountain of money that has been created is an unprecedented opportunity for financial assets and will keep this strong bull market running for the next two years at least. The key is to be invested in the right stocks and sectors. ...

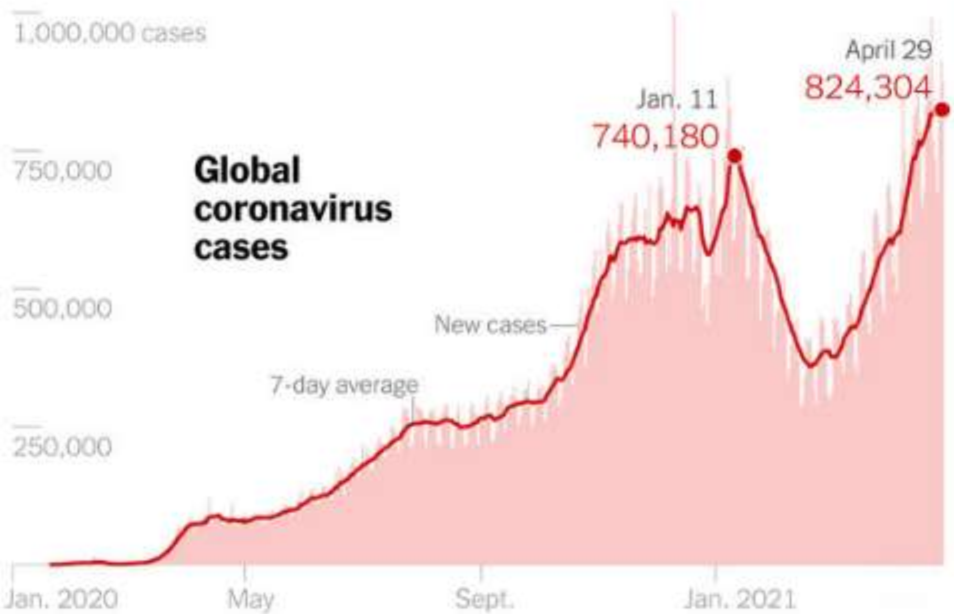
To us, Covid-19 remains a concern. While the 7-day average of new cases in the US is down to under 52,000, from over a peak of 255,000 in January, that is a number that is only good by comparison. According to a new CNN poll released Thursday, "26% of adults say they will not try to get a coronavirus vaccine". Europe is back in recession. The international picture, as reported by the NYT this morning:

Global coronavirus cases are surging, driven by India and South America.

The number of new daily cases has exceeded 800,000 for more than a week. The spike is largely driven by the outbreak in India, which now accounts for more than 40 percent of the world's new cases. ...

Vaccines in India are running short, hospitals are swamped and cremation grounds are burning thousands of bodies every day. ...

Much of South America is also faring poorly. Uruguay, Paraguay, Brazil, Peru, Argentina and Colombia all rank among the 20 nations with the highest number of Covid deaths per capita.

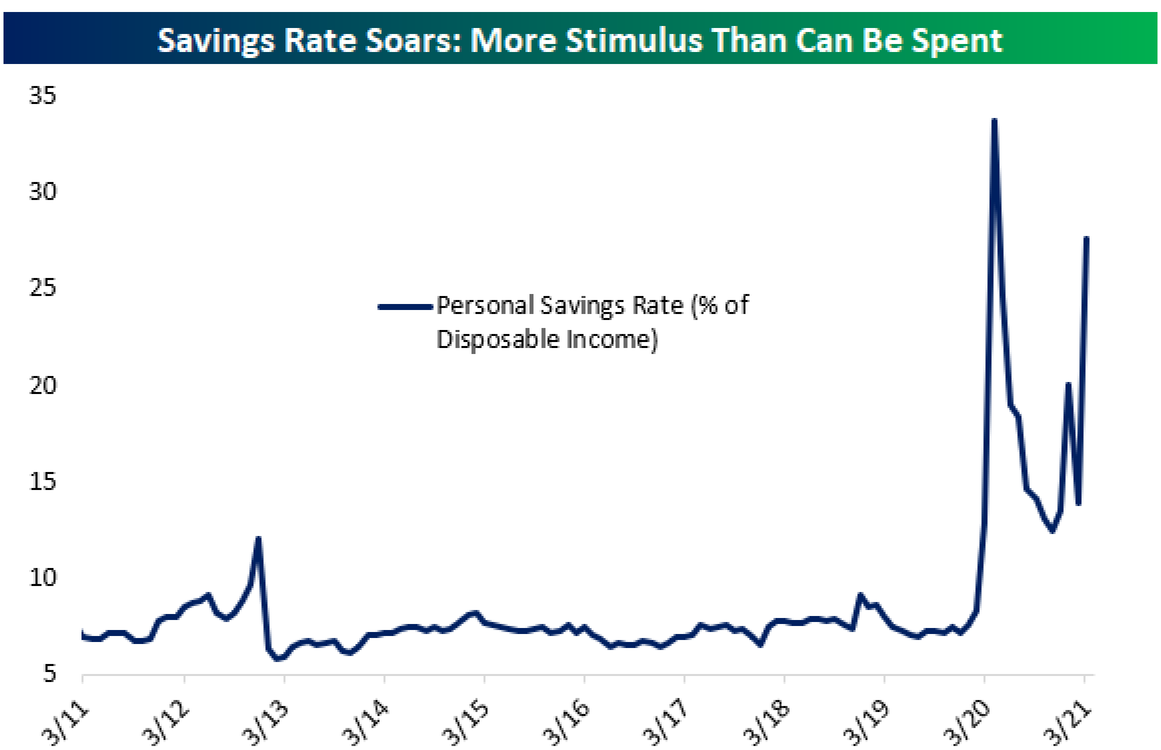


Longer-term our primary and oft repeated concern remains inflation. Two from Bespoke:

Wild Data Close To Q1

Fri, Apr 30, 2021

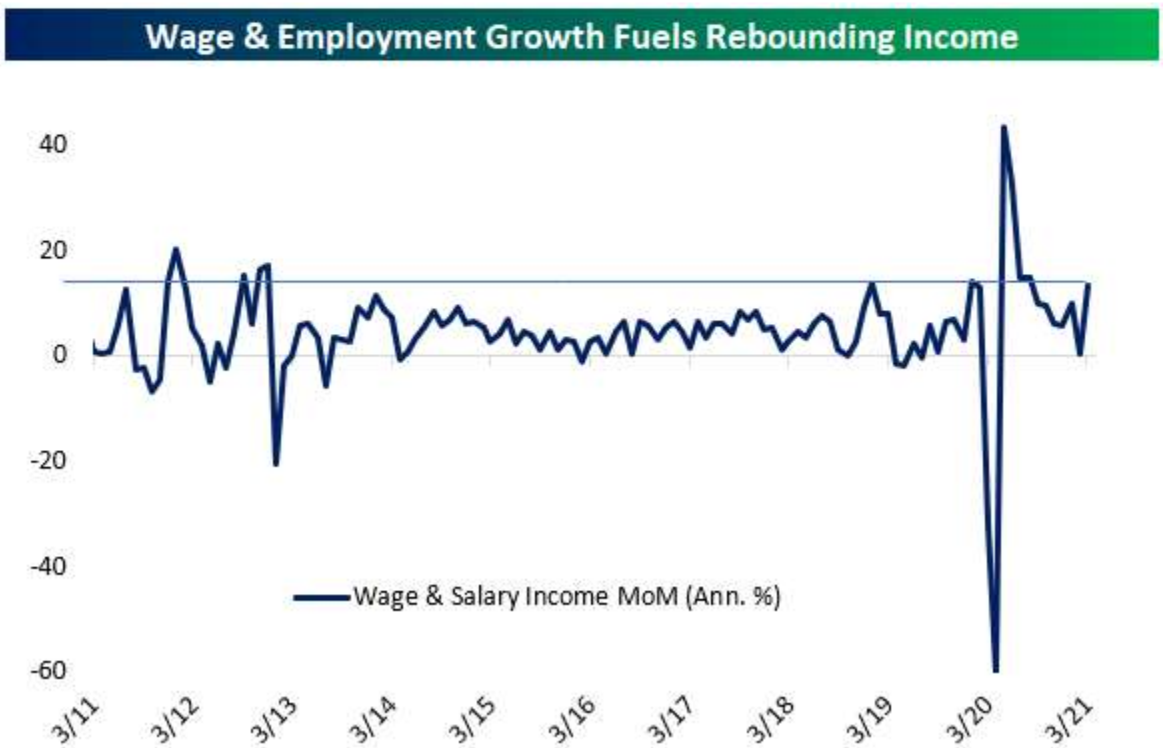
Today was quite the day for economic data, with two key releases from the Bureau of Economic Analysis (BEA) and Bureau of Labor Statistics (BLS). We'll start with BEA data on personal income and spending in March.



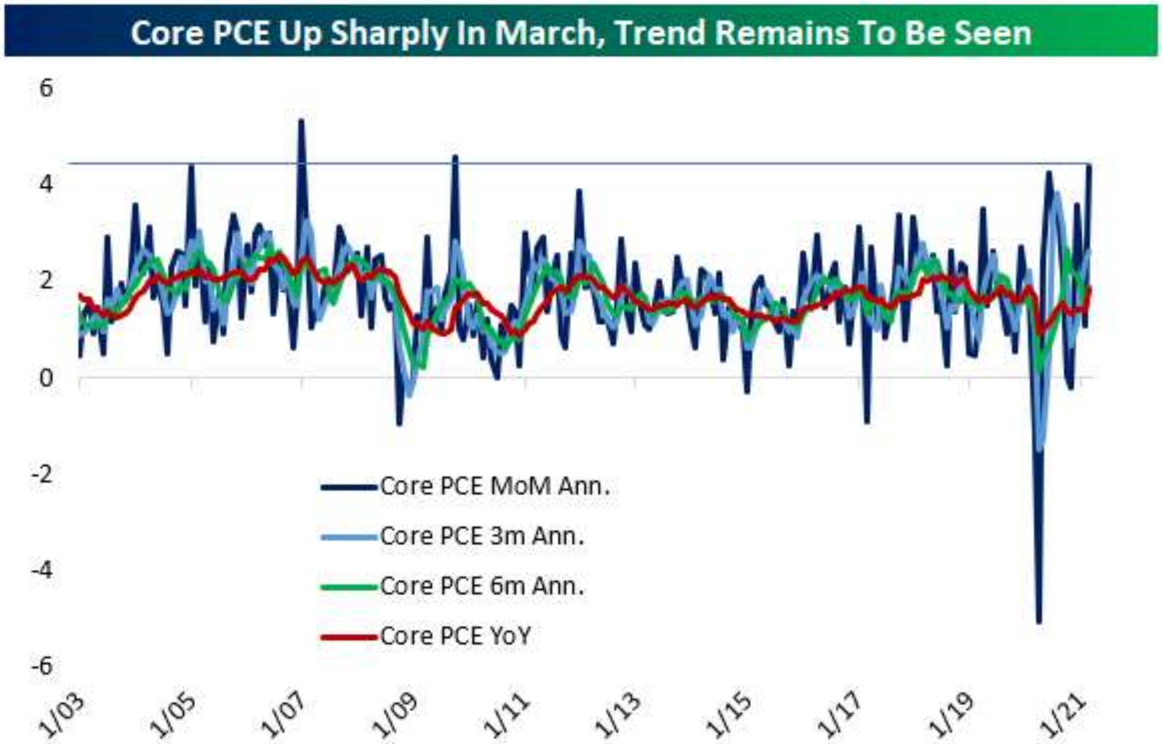
First, as shown above, the savings rate surged in the month, with households saving 27.6% of personal income net of taxes. That's a huge number, even by the standards of the elevated savings rates that we've seen over the course of the pandemic.

The reason there was so much saving going on is that transfer payments rose by more than $300bn on the month, driven by the delivery of economic impact payments also known as "stimulus checks" or even shorter: "stimmies."

Incomes also rose thanks to rebounding labor market activity following winter storms in Texas during February and the longer-term trend of reopening across the economy. As shown, the 13.5% annualized growth of wage and salary income in the month was very strong. It was also helped along by wage growth ....



With spending surging thanks to stimulus checks and other factors, core personal consumption expenditure prices surged by the most MoM since 2009, over 4% annualized. The 4% move was in no small part due to the swing in activity from February to March, and isn't likely to be sustained, but it is a helpful indicator that prices may be more robust in this recovery than they were during the low inflation post-GFC period.



For broad inflation that will concern the Fed, one factor that will be needed along with steadily rising prices is strong wage growth. The second big report today was Q1 wages in the BLS Employment Cost Index (ECI). The ECI does a better job of measuring wage growth than other series because it accounts for changes in the composition of employment over time. ... Q3 saw the strongest sequential wage growth on record, with a 4.6% annualized advance in wages versus Q4. Some of that came from incentive-paid occupations, which benefit from bonuses and related payments, skewing the results ... though, there was very strong wage growth even excluding incentive-paid occupations. Anecdotal reports of very tight labor markets amidst booming reopening demand got support from this release.

Soaring Home Prices

Tue, Apr 27, 2021

We got yet another data point on surging home prices today with the monthly release of Case Shiller indices. These numbers are lagged by two months so they don't exactly provide a real-time look, but at least through February, home prices continue to soar. The table below shows month-over-month and year-over-year home price moves across the 20 cities tracked by the Case Shiller indices. The west has seen a big jump lately with San Diego, Seattle, San Francisco, and Phoenix all rising more than 2% month-over-month. Chicago and New York saw prices rise the least MoM at just 0.30% and 0.55%, respectively.

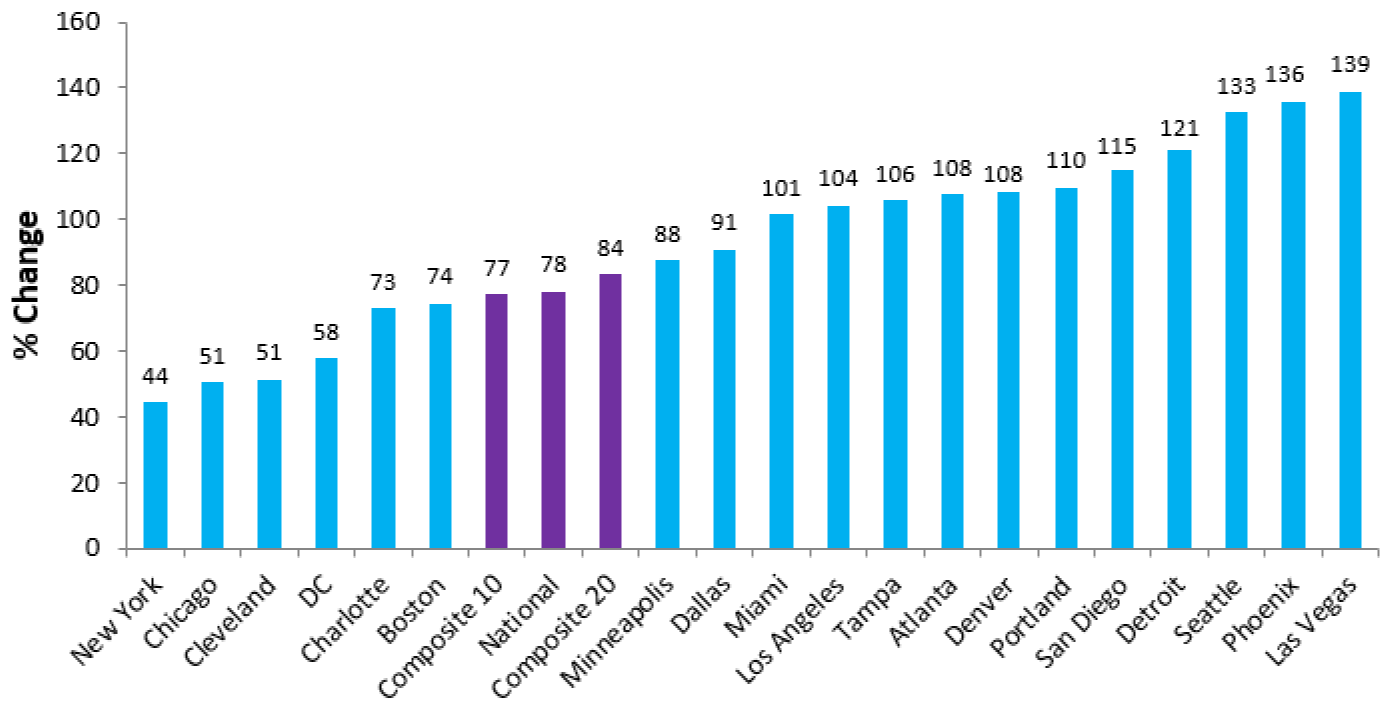
Nearly every city is up double-digit percentage points year-over-year. Phoenix and San Diego are up the most YoY with gains of ~17%, while Chicago is up the least with a gain of 8.71%.

S&P/Case-Shiller Home Prices		
City	Month over Month % Chg (Jan. 21-Feb. 21)	Year over Year % Chg (Feb. 20-Feb. 21)
San Diego	2.87	16.99
Seattle	2.39	15.53
San Francisco	2.05	10.96
Phoenix	2.03	17.40
Denver	1.77	11.24
Dallas	1.68	10.89
Los Angeles	1.32	11.97
Tampa	1.30	12.77
Portland	1.29	11.47
DC	1.04	11.13
Las Vegas	1.03	9.22
Miami	1.02	10.99
Detroit	0.98	11.68
Charlotte	0.96	11.74
Minneapolis	0.95	10.47
Boston	0.87	13.72
Atlanta	0.87	10.08
Cleveland	0.79	12.57
New York	0.55	11.63
Chicago	0.30	8.71
Composite 10	**1.14**	**11.71**
Composite 20	**1.24**	**11.97**
National	**1.05**	**12.00**

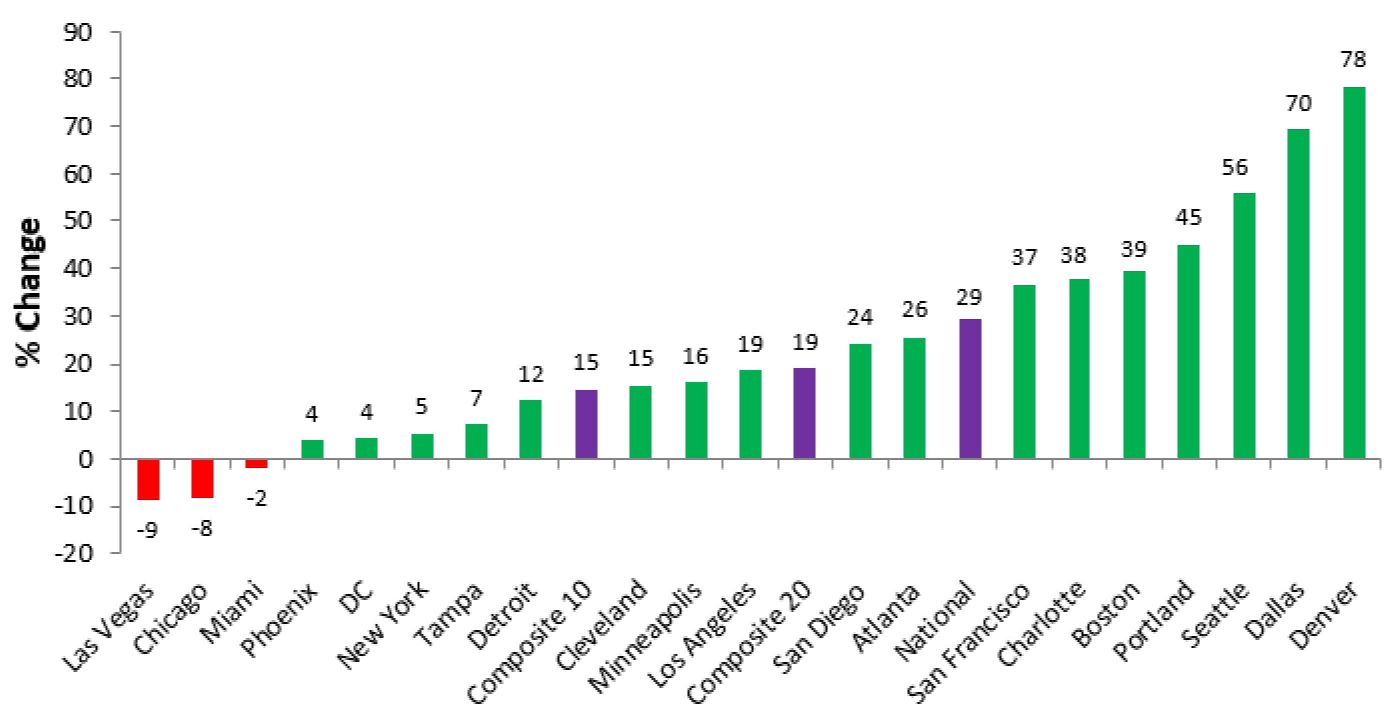
We like to look at home price trends relative to where they stood at various points during the mid-2000s housing bubble and subsequent crash. The chart below looks at where home prices stand now versus the lows that were made in the early 2010s after the bubble burst. As shown, the national index is now up 78% from its housing crash low, and eleven of twenty cities are up more than 100% from their lows. Las Vegas, Phoenix, and Seattle are up the most with gains of more than 130%, while New York is up the least and the only city that's not up more than 50%.

The better chart is the one that looks at where home prices are now relative to their high points at the peak of the prior housing bubble. We're now more than fifteen years removed from the prior peak for home prices in 2005/2006, and at this point ***only three of the twenty cities tracked have not made new all-time highs***. Those three cities are Las Vegas, Chicago, and Miami. Miami is the one closest to making new highs at just 2%, while Las Vegas prices are still 9% below their highs made in August 2006. The composite indices and the seventeen other cities have all managed to take out their housing bubble highs. Denver, Dallas, and Seattle are all up more than 50% above their prior all-time highs.

% Change from Housing Crash Lows in S&P/Case-Shiller Home Prices



% Change from Prior Bubble Highs in S&P/Case-Shiller Home Prices



Follow-ups

Friday's Global Investment Strategy Special Report is titled **How To Short Bitcoin, Or Anything Else, Without Losing Your Shorts.** We have previously shared Peter Berezin's, BCA Research's Chief Global Strategist, analysis of Bitcoin which has been updated below. As we highly recommend against shorting "anything", we have not included his system.

Bitcoin's Questionable ESG Record

Crypto critics have often blamed cryptocurrencies for facilitating illicit transactions and enlarging the world's carbon footprint. There is some truth to both claims.

Motivated to avoid detection, online scammers, smugglers, and terrorists have been drawn to cryptocurrencies. Cryptos have also been used to evade capital controls and conceal wealth from the tax authorities.

On the environmental side, Bitcoin mining now consumes more energy than entire countries such as Sweden, Argentina, and Pakistan (**Chart 1**). Moreover, about 70% of Bitcoin mining currently takes place in China, mainly using electricity generated by burning coal. A lot of the remaining mining occurs in countries such as Russia and Iran with questionable governance records.

CHART 1
How Dare You, Bitcoin

SOURCE: US EIA, AND CAMBRIDGE CENTRE FOR ALTERNATIVE FINANCE.
NOTE: ELECTRICITY CONSUMPTION VALUES ARE BASED ON THE MOST RECENT AVAILABLE YEAR (2018 OR 2019).

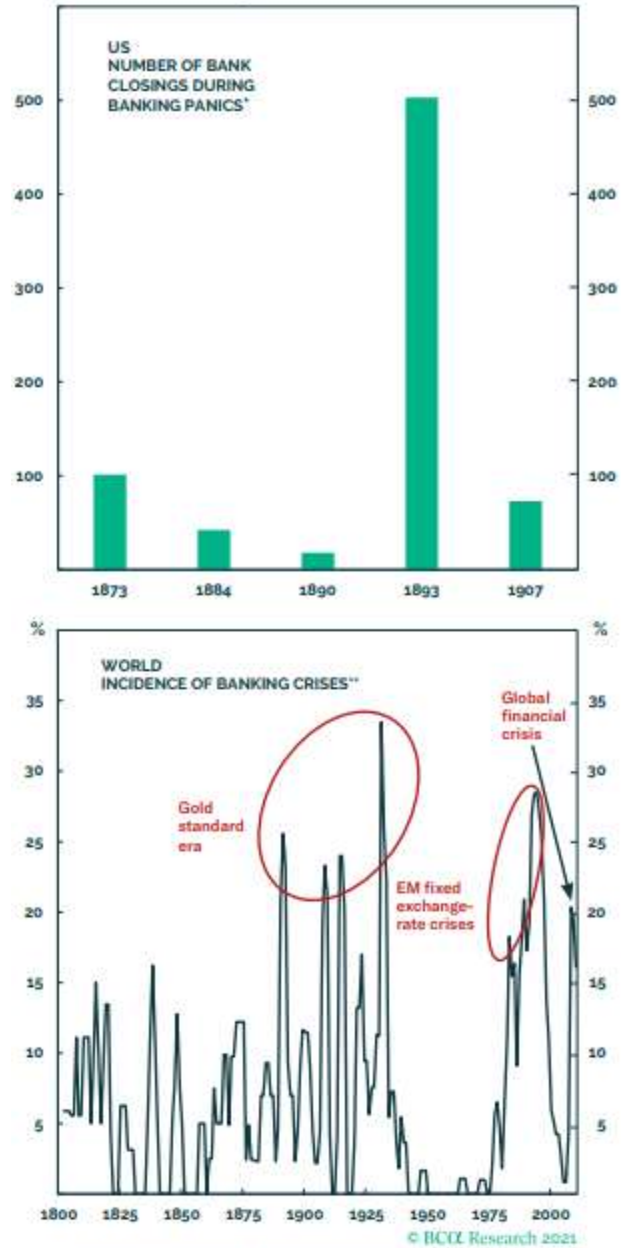
The Empire Strikes Back

... Governments also generate significant revenue from their ability to print currency and then exchange it for goods and services. For the US, this "seigniorage revenue" is around $100 billion per year (Chart 2). No government will want to part with this revenue.

A financial system where loans and deposits are denominated in cryptocurrencies would be highly unstable. Even if the supply of each individual cryptocurrency were capped, the rise and fall of competing cryptocurrencies could still result in large shifts in the aggregate cryptocurrency money supply. Moreover, wild swings in cryptocurrency prices, both versus fiat currencies and one another, could destroy any semblance of price stability.

The value of bank loans made in Bitcoin or other cryptos would experience great fluctuations. Powerless to issue cryptocurrencies themselves, central banks would not be able to provide unlimited liquidity support to commercial banks as they do now. The situation would resemble the US in the late 19th century when myriad currencies competed with one another and the financial system veered from one crisis to another (**Chart 3**).

CHART 3
An Inelastic Money Supply Historically Led To More Banking Crises



* SOURCE: ELMUS WICKER, BANKING PANICS OF THE GILDED AGE (2006), TABLE 1.3.
** SHOWN AS THE 3-YEAR MOVING AVERAGE OF THE PERCENTAGE OF COUNTRIES UNDERGOING A BANKING CRISIS FOR A GIVEN YEAR. SOURCE: CARMEN M. REINHART AND KENNETH S. ROGOFF, THIS TIME IS DIFFERENT: EIGHT CENTURIES OF FINANCIAL FOLLY (2009), FIGURE 10.1.

What Is It Good For?

One might argue that the ultimate aim of cryptocurrencies is not to displace fiat money. Okay, but if Bitcoin can never truly function as a medium of exchange or a unit of account, what exactly underpins its utility as a store of value? At least with gold, you get an extremely rare metal, forged in the collision of neutron stars billions of years ago, that has great aesthetic value. With cryptos, you get fairy dust.

In past reports, we referred to Bitcoin as a "solution in search of a problem." In retrospect, that characterization was much too charitable. Bitcoin is a problem in search of a problem.

Whereas the Visa network can process over 20,000 transactions per second, the Bitcoin network can barely process five. Bitcoin transactions take 10 minutes-to-an hour to complete compared to just a few seconds for most debit or credit card transactions. The average fee for a Bitcoin transaction is around $30. This fee has been rising, not falling, over the past few years.

Look Out Below

Cryptos are heading for a world of pain. ESG concerns will force companies to step back from their newfound infatuation with these magic beans. Meanwhile, governments will tighten the screws on cryptocurrencies while rolling out their own digital monies.

As my colleague Chester Ntonifor pointed out last week, a growing list of countries have already moved to ban Bitcoin transactions (**Table 1**).

In addition, most G10 central banks have outlined their own digital currency plans (Map 1). Not only will Central Bank Digital Currencies (CBDCs) squeeze out decentralised cryptocurrencies, they will also pose an existential risk to credit card companies and online payment processors such as PayPal, Square, Venmo, WeChat Pay, and Alipay. ...

TABLE 1

A Growing List Of Cryptocurrency Bans

BANKING BAN* + TRADING BAN	BANKING BAN* ONLY
ALGERIA	CAMBODIA
BANGLADESH	CANADA
BOLIVIA	ECUADOR
CHINA	INDONESIA
EGYPT	IRAN
MOROCCO	JORDAN
NEPAL	NIGERIA
NORTH MACEDONIA	QATAR
	RUSSIA
	SAUDI ARABIA
	TAIWAN**
	TURKEY
	VIETNAM

* BANKING BAN MEANS THAT FINANCIAL INSTITUTIONS ARE NOT ALLOWED TO FACILITATE BITCOIN TRANSACTIONS.
** PROVINCE OF CHINA.

We have repeatedly warned about SPACs. From the front page of Monday's WSJ:

Insiders Gain in SPAC Deal While Investors Take Losses

BY AMRITH RAMKUMAR

Investors who bought into a special-purpose acquisition company that took a healthcare- services company public last year in an $11 billion deal have suffered steep losses. Promoters of the SPAC still stand to make millions of dollars.

The paper gains for insiders, even as shares of Multi-Plan Corp. fall, result from the unique incentives given to SPAC creators, also known as sponsors. They are allowed to buy 20% of the company at a deep discount, a stake that is then transferred into the firm the SPAC takes public.

Those extremely inexpensive shares let the creators make, on average, several times their initial investment. They also let the SPAC backers make money even if the company they take public struggles and later investors lose money, a source of criticism for the process.

The MultiPlan deal was one of the largest SPAC mergers ever, helping so-called blank-check firms become the hottest trend on Wall Street in the past year. But the stock is also among the worst performers for companies that recently went public via SPACs.

Shares of several other firms tied to blank-check companies have also been in retreat recently, raising the likelihood of a similar divergence between returns for insiders and later investors in many other SPACs.

A growing gap between returns for insiders and later investors would challenge the common view that blank-check companies democratize finance, critics said, threatening the overall popularity of the product going forward. ...

Three from Morningstar:

Does International-Stock Diversification Still Work?

Correlations have trended up, but there's still a long-term argument for international diversification.

Amy C. Arnott, CFA
Apr 21, 2021

Adding international exposure is one of the first steps toward a diversified portfolio. Even minimalist investors usually carve out a portion of their portfolios for non-U.S. stocks after adding exposure to domestic stocks and bonds. International stocks are subject to myriad factors that can lead to divergent performance, including local market conditions, currency movements, exposure to different sectors and industries, and political and economic factors. These traits mean they often show different performance patterns--both relative to the U.S. market and versus other international markets.

However, in our recent examination of asset-class correlations, the "[2021 Diversification Landscape](#)," we found that the benefits of international diversification can be surprisingly elusive.

2020 Correlations: International Stocks

With the novel coronavirus pandemic affecting economies, companies, industries, and people on a global scale, most major international markets dropped at least as much as the U.S. market in early 2020. Japan was the only major regional market to maintain a lower correlation with the United States. It also suffered lighter losses than most other global markets.

For the full year, correlations also fell in a narrow range. The Morningstar Developed Markets ex-US Index showed the highest correlation with the domestic equity market, followed by Europe and the United Kingdom. Regional indexes for emerging markets showed correlations of at least 0.84 with the Morningstar US Market Index. Cross-correlations between Japan and the rest of Asia were among the lowest, as were correlations between Japan and Latin America.

2020 Correlation Matrix: International Equity

		1	2	3	4	5	6	7	8	9	10	11	12	13	14	15
1	Morningstar US Market TR USD															
2	Morningstar Asia Pac xJpn GR USD	0.90														
3	Morningstar DM Europe xUK GR USD	0.93	0.86													
4	Morningstar DM xUS GR USD	0.96	0.88	0.99												
5	Morningstar EM Americas GR USD	0.84	0.91	0.90	0.90											
6	Morningstar EM Europe GR USD	0.91	0.82	0.97	0.97	0.91										
7	Morningstar EM GR USD	0.88	0.99	0.87	0.88	0.94	0.84									
8	Morningstar Japan GR USD	0.84	0.65	0.86	0.90	0.68	0.86	0.66								
9	Morningstar Middle East & Africa GR ...	0.91	0.96	0.88	0.91	0.91	0.86	0.97	0.76							
10	Morningstar UK GR USD	0.94	0.89	0.97	0.99	0.91	0.97	0.89	0.88	0.90						
11																
12																
13																
14																
15																

Time Period: 1/1/2020 to 12/31/2020 — 1.00 to 0.80; 0.80 to 0.60; 0.60 to 0.40; 0.40 to 0.20; 0.20 to 0.00; 0.00 to -0.20; -0.20 to -0.40; -0.40 to -0.60; -0.60 to -0.80; -0.80 to -1.00

Source: Morningstar Direct. Data as of Dec. 31, 2020.

Longer-Term Trends in International Diversification

These patterns are generally consistent with patterns shown over longer periods, with developed markets showing the strongest correlation with the U.S. equity market and emerging markets showing the weakest. Over the past 20 years, correlations for international stock markets have remained relatively stable, except for Latin America. That region's correlation with the U.S. equity market has trended down to 0.58 over the past five years, compared with as high as 0.80 in some previous periods. This probably reflects the impact of tighter trade policy in the region, as well as style and sector differences. While growth sectors such as technology have increasingly dominated the U.S. market, value-oriented sectors such as basic materials and financials have played a bigger role in Latin America.

Rolling Three-Year Correlations vs. Morningstar US Market Index: International Equity

Source: Morningstar Direct. Data as of Dec. 31, 2020.

Portfolio Implications of International-Stock Correlations

The fact that international correlations rose during 2020's market turmoil might have some investors questioning whether international diversification is still worthwhile. Over longer periods, though, international assets don't always move in lock step with the U.S. market and have still provided diversification benefits. Currency exposure is another important aspect of international diversification. Now that the U.S. dollar has started showing signs of weakness, international diversification could become increasingly important.

Value Funds Post Best Quarter vs. Growth in 20 Years

The long-term return gap between the two remains wide.

Katherine Lynch
Apr 15, 2021

Following the worst year for large-value stock fund performance relative to growth, value funds recorded their greatest quarterly advantage in 20 years during the first three months of 2021.

While the recent gains of small-value funds pushed the Morningstar Category average ahead of small growth for the last 12 months, for other market capitalization categories, and for time frames of three years or longer, value has a considerable gap to close.

Still, it was good news for value investors whose funds were left far in the dust during 2021. Value's outperformance over growth was widest among small-cap funds, as the average small-value fund gained 21.5%, while the average small-growth fund returned 6.8%. And thanks to the especially large declines by small-value funds during the coronavirus-pandemic-driven stock market collapse a year ago, small-value funds are up on average 100% for the last 12 months, a 6-percentage-point gap over the average small-growth fund.

The last time small value beat growth by this wide a margin was in 2001 when value funds outperformed growth by 18 percentage points in the first quarter. Likewise, large-value funds bested growth funds by 14 percentage points in the same quarter, and mid-cap value funds beat growth by 19 percentage points in the third quarter of 2001.

Heading into 2020, the track records on many value strategies relative to growth funds were already weak. Then came the COVID-19 pandemic, and value funds, which tend to be invested in more economically sensitive

Value vs. Growth

	Q1 (1/1/2021-3/31/2021)	1-Year (4/1/2020-3/31/2021)	3-Year (4/1/2018-3/31/2021)	5-Year (4/1/2016-3/31/2021)	10-Year (4/1/2011-3/31/2021)
Large Value	11.38	56.22	10.26	11.40	9.94
Large Growth	2.24	63.21	20.20	19.16	14.29
Value Performance Gap	9.14	-6.98	-9.94	-7.76	-4.36
Mid-Cap Value	15.82	76.68	9.83	11.05	9.73
Mid-Cap Growth	3.89	79.93	19.91	18.75	12.85
Value Performance Gap	11.92	-3.26	-10.08	-7.70	-3.12
Small Value	21.49	100.21	10.00	11.68	9.21
Small Growth	6.83	94.17	19.75	19.93	12.81
Value Performance Gap	14.66	6.04	-9.75	-8.25	-3.61

Source: Morningstar Direct. Returns are annualized.

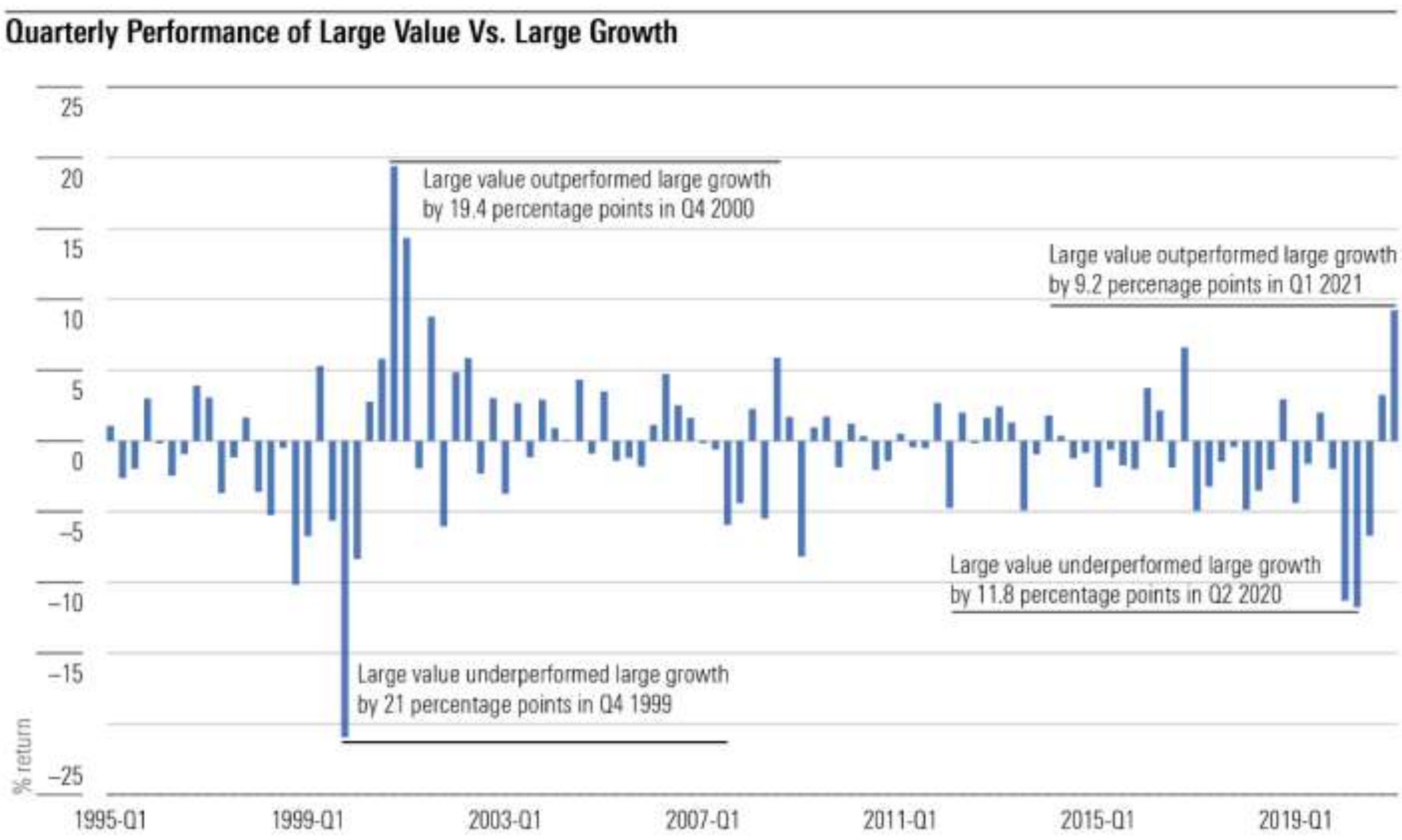
sectors, were hit hard by the economic collapse and underperformed growth funds by wide margins for the first eight months of 2021.

The reversal in value's favor began in September, during a time when stocks were selling off, notes Morningstar's director of manager research, Russ Kinnel: "At first, value was simply losing less than growth, and we saw that again in October. And then in November, the rally really kicked in, and value outperformed on the upside, and it's been doing that ever since."

The late-2020 revival was small. Large-value funds still ended the year with the largest underperformance gap to the average large-growth fund on record.

But what was a trickle in 2020 turned into a flood in the first quarter of 2021. Record fiscal stimulus and a broader economic recovery lifted value-oriented sectors, and in February and March, value funds took off.

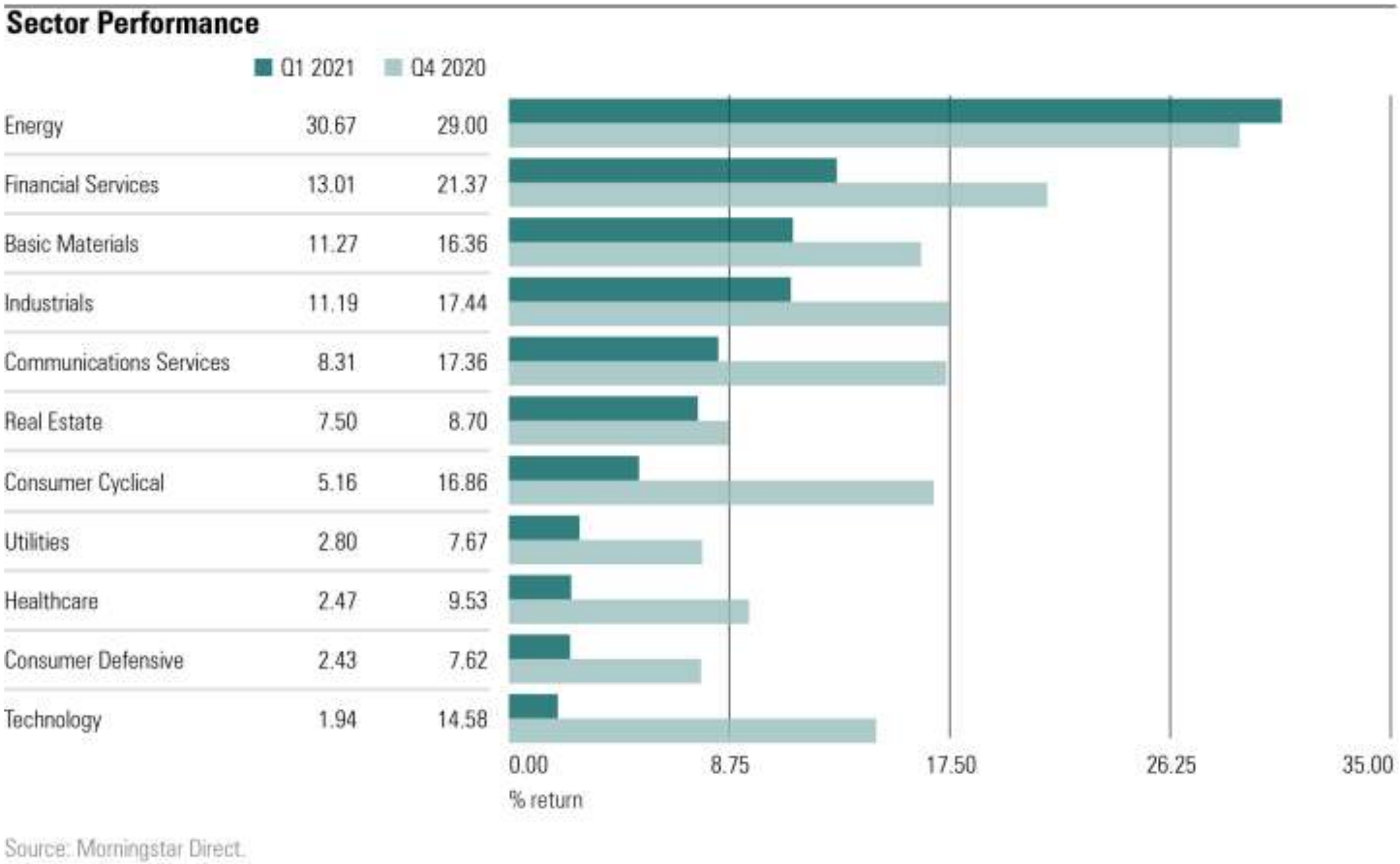
On a quarterly basis, large value hasn't outperformed growth for two consecutive quarters since 2016.



Source: Morningstar Direct.

Over long-term periods, however, there's still substantial ground for value strategies to make up. Growth funds have outperformed value for five out of the past six years, and in 2020 by the widest margin ever, making it difficult for value, despite the stellar quarter, to dig itself out of a hole. ...

This resurgence is owed in part to the rotation in the equity market. Sectors that suffered initially--energy, financial services, and basic materials--have gained in the past two quarters. Conversely, rising interest rates have benefited these sectors and hurt technology stocks.



Emerging-Markets Equities: A Promise Half-Fulfilled

Their economies have astonished; their stock gains, not so much.

John Rekenthaler
Apr 8, 2021

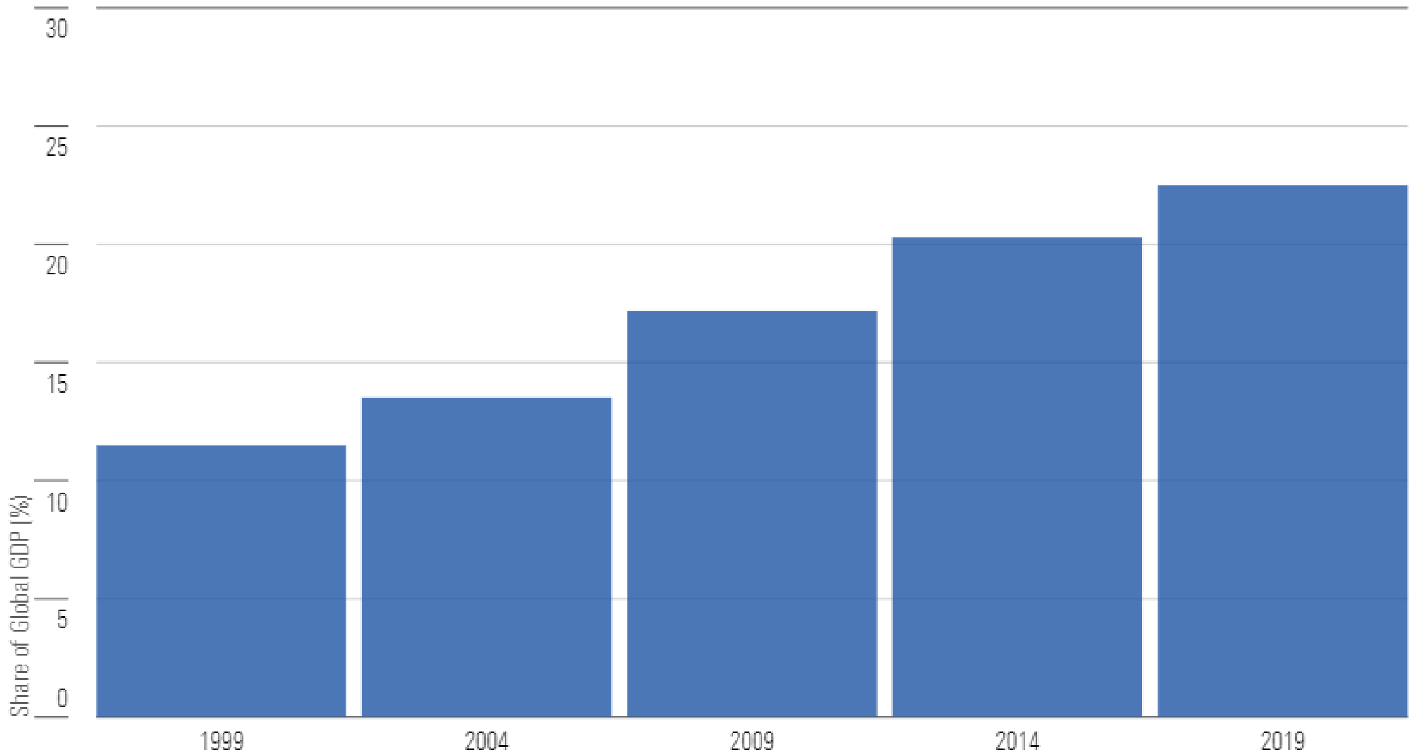
High Hopes

Hop into a time machine, journey to 1999. Much seems familiar. Technology companies are booming, discount brokers attract millions of new customers, and children teach their grandparents about the Internet. Perhaps, some speculate, the Dow Jones Industrial Average will reach 36,000. One thing, however, is quite different: American investors are intrigued by emerging-markets stocks.

The reason for it is their economic prospects. The Asian Tigers of Hong Kong, Singapore, South Korea, and Taiwan have enjoyed remarkable development, to the point where many no longer consider those nations to be emerging. Attention has now turned to their successors: Brazil, Russia, India, China, and South Africa, later to be nicknamed “the BRICS.” Those countries are expected to grow rapidly.

That they very much did. In 1999, per the World Bank, the BRICS accounted for 11.5% of global gross domestic product. By 2009, their share was 17.2%. In another 10 years, they had reached 22.5%. Their economic explosion--which, admittedly, owed primarily to China, secondarily to India, and little to the remaining three countries--was unprecedented.

Exhibit 1 BRICS' Share of Global GDP (Brazil, Russia, India, China, South Africa)



Source: The World Bank.

Investment Success

One would expect those who bought emerging-markets stocks in 1999 to have benefited from their decision. After all, many emerging markets had recently been rocked by the 1997 Asian financial crisis. Then Russia defaulted on its debt. Although the consensus was that the emerging countries would eventually overcome their problems, the streets nevertheless contained some blood. It was an opportunity for the bold.

The bold were not disappointed. Below are the total returns for Morgan Stanley Institutional Emerging Markets (MGEMX)--one of the industry's early diversified emerging-markets stock funds, and among its most typical--and Vanguard 500 Index (VFINX) from January 1999 through March 2021. Vanguard's fund performed well; those who held blue-chip U.S. stocks almost quintupled their money. However, emerging-markets equities fared better yet.

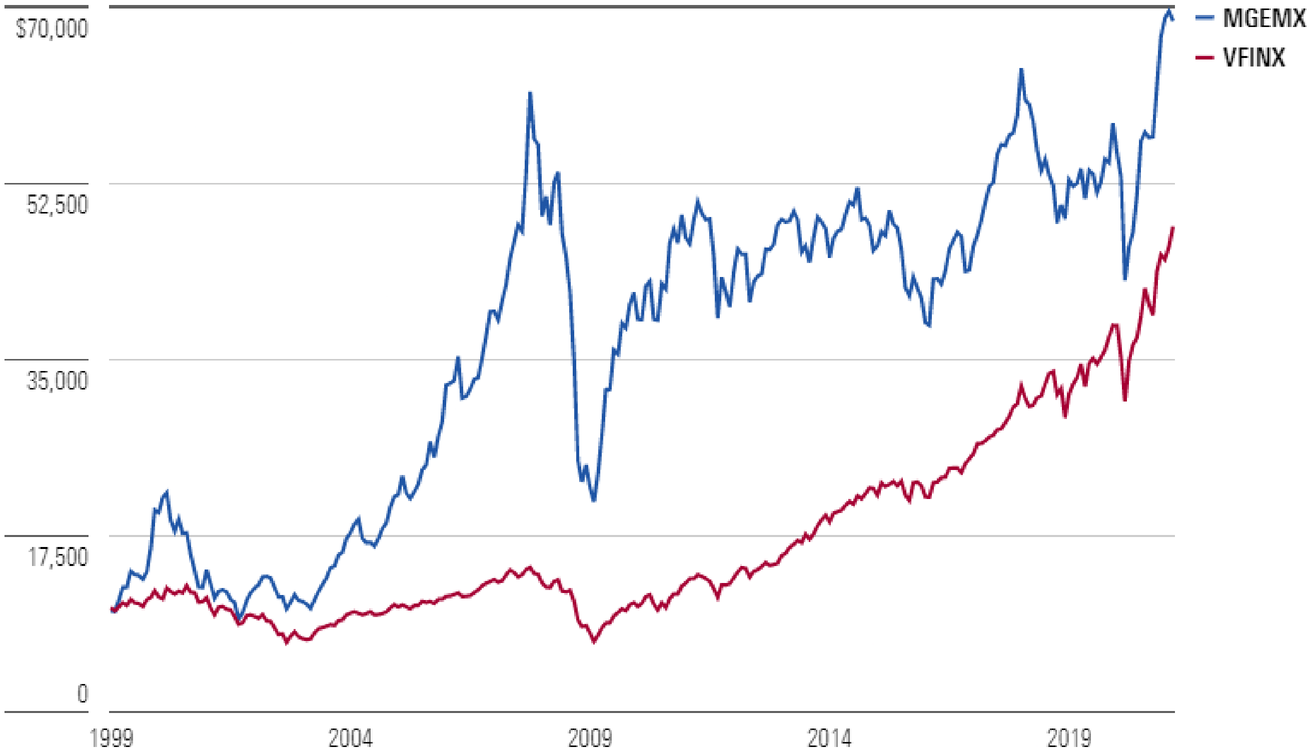
So far, this has been a predictable story. Not all higher-risk securities deliver higher returns; were that to occur, those securities would no longer qualify as "higher risk." But when the fundamental outcome exceeds even the optimists' forecasts, we expect the brave to prosper. They had the courage of their convictions. Consequently, by the theory, they received their just rewards.

Not so Fast

All fine and good. But as you may have noticed, much of emerging markets' performance arrived early. After the early 2000s, it's not clear that emerging-markets stocks continued to outgain the S&P 500, nor that their total returns were particularly impressive. Their success appears to have been transient.

Such was the case. The next graph is identical to the previous version, except that it begins in 2004 rather than 1999. Bumping the buy decision by five years flips the outcome. Now, Vanguard 500 Index enjoys the stronger

Exhibit 2 Long-Term Success (Growth of $10,000, January 1999-March 2021)



Source: Morningstar Direct.

return, with Morgan Stanley Institutional Emerging Markets' annualized gain registering a moderate 6.5%, below that of the relatively conservative Vanguard Balanced Index (VBINX).

Exhibit 3 Without the First Five Years (Growth of $10,000, January 2004-March 2021)

Source: Morningstar Direct.

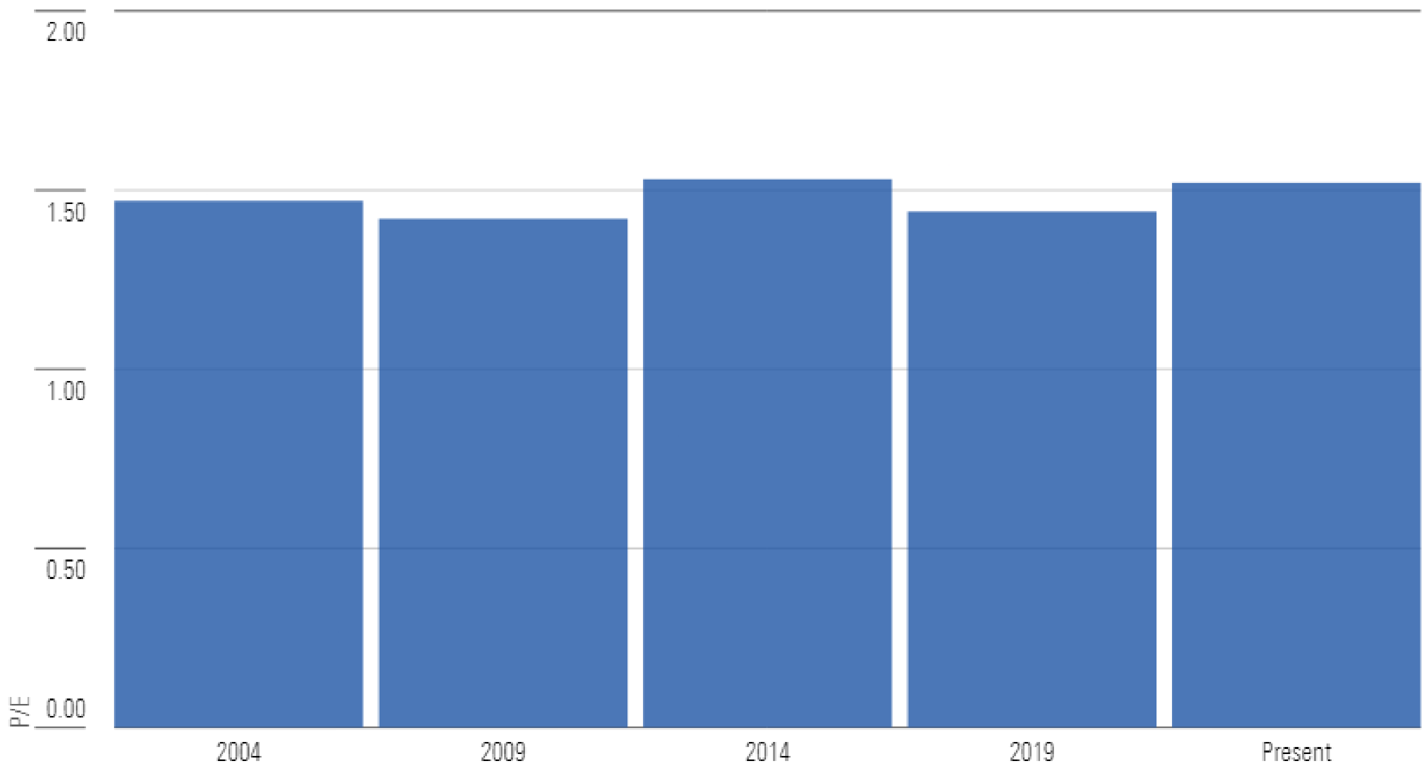
Notably, this revised period includes emerging markets' best stretch, from 2005 through 2007. Move the calculation forward another three years, to January 2008, and the Morgan Stanley fund is barely in the black, posting an annualized return of only 0.8% from 2008 until the present.

Value Stocks?

A common justification for emerging markets' recent struggles--if 13 years can be called "recent"--is that such issues have become unpopular. By this explanation, the problem lies not with emerging markets' businesses, but instead with reduced investor expectations. Emerging-markets stocks have become value investments. When they return to fashion, their price multiples will expand, permitting them to lead the way once again.

Perhaps. However, while there's no doubt that emerging-markets equities have lost their U.S. buzz, their global appeal does not appear to be diminished. By Morningstar's calculations, emerging-markets stocks have not become relatively cheaper than American equities. Rather, the ratio of the S&P 500's price/earnings multiple to that of MSCI Emerging Markets Index has remained virtually unchanged. Year in and year out, the P/E ratios on U.S. equities are about 50% higher than those of emerging-markets stocks.

Exhibit 4 Relative Price/Earnings Ratios (S&P 500 P/E Ratio divided by MSCI EM P/E Ratio)



Source: Morningstar Direct.

Switching from price/earnings to price/book ratios yields an even stronger conclusion, because the valuation gap between the two indexes has narrowed. The S&P 500 currently trades at a price/book ratio that is 25% above 2004's level, whereas over that same period the MSCI Emerging Markets index's price book ratio has increased by 50%. By that measure, emerging markets have become less attractive to value investors, not more.

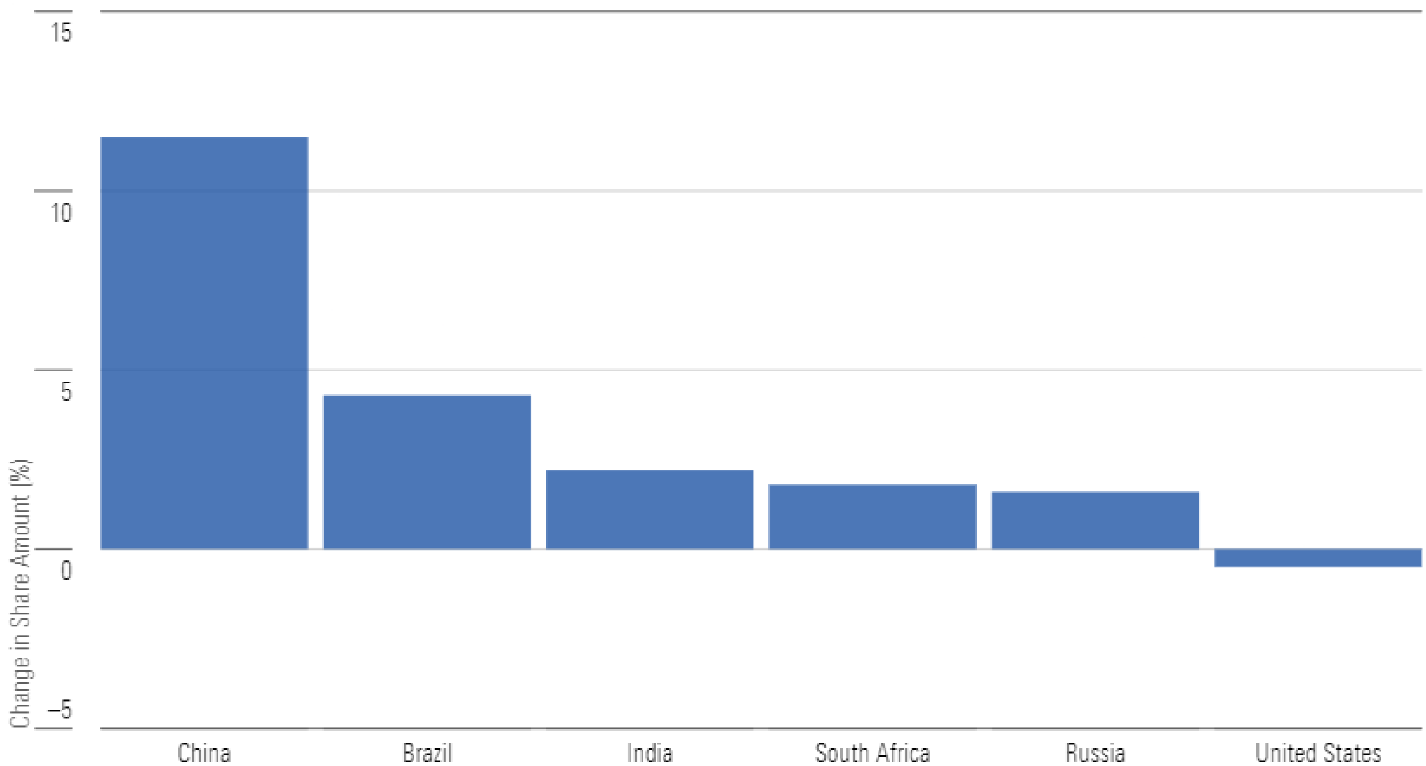
The Fundamental Problem

Regrettably, the reason that emerging-markets stocks have lagged has been fundamental. Although the countries have grown impressively, the per-share earnings of their publicly traded companies have not followed suit. As outlined in a 2019 report by Aoris Investment Management, "The Emerging Market Fallacy," there have been three major slips 'twixt the cup of GDP growth and the lip of shareholder returns.

1. GDP growth has exceeded the growth in corporate profits.
2. Not all of the most profitable companies are publicly traded.
3. New share issuance has severely diluted shareholder returns.

To the third point, consider the annualized rate of new share issuance in the five BRICS countries, as well as the United States, from 2008 through 2018.

Exhibit 5 Annualized Change in Share Amount (2008-2018)



Source: Aoris Investment Management.

That is a very large disparity! While 2018 China was unquestionably larger and wealthier than the 2008 version of the country, it also had floated 3 times as many shares. Consequently, if aggregate profits for all publicly traded companies in China had tripled during those 10 years, shareholders wouldn't be better off at the end of the decade than they were at the start.

In emerging markets, outside shareholders typically place low on the corporate totem pole. Whereas in the U.S. the precept of shareholder value largely holds, most emerging-markets companies have other priorities. Management often consists of family relationships. In addition, government officials are far more involved than in the U.S. (In 2018, reported *The New York Times*, China's parliamentary members had an average net worth of $4 billion.)

What's more, emerging-markets firms are more willing to sacrifice profitability to maintain employment than their U.S. counterparts. For example, China and India recorded only slight rises in unemployment during the 2008-09 global financial crisis. While those governments' official figures should be taken with a heaping of salt, the fact remains that during a severe slowdown, emerging-markets CEOs are less likely than American executives to preserve profitability by slashing costs.

In Conclusion

Ten years ago, many pundits foresaw a rebound in emerging-markets stocks, on the theory that they were worthy investments that had temporarily lost popularity. This “fashion argument” has failed the test of time. Such stocks have languished for good reason. Emerging-markets countries have treated their insiders much better than they have their outsider shareholders. For their stocks to appeal to long-term U.S. investors, that habit must change.

John Rekenthaler (john.rekenthaler@morningstar.com) has been researching the fund industry since 1988. He is now a columnist for Morningstar.com and a member of Morningstar's investment research department. John is quick to point out that while Morningstar typically agrees with the views of the Rekenthaler Report, his views are his own.

Positions

WCMSX - Purchased a 10% position in this OEF with a **Risk** ratio of **1.1** for our newest client. We have added the 3* Gold rated Vanguard FTSE All-Wld ex-US SmCp ETF (VSS, orange line) as the most appropriate benchmark for comparison to Morningstar's chart since WCMSX's inception. The $100,000 Min. Initial Investment is waived for RIA clients.

WCM International Small Cap Growth Instl WCMSX ★★★★★

NAV / 1-Day Return	Total Assets	Adj. Expense Ratio	Expense Ratio	Fee Level	Longest Manager Tenure
27.68 / ↑ 0.65 %	708.9 Mil	1.250%	1.250%	High	5.35 years
Category	**Investment Style**	**Min. Initial Investment**	**Status**	**TTM Yield**	**Turnover**
Foreign Small/Mid Growth	Mid Growth	100,000	Open	0.00%	67%