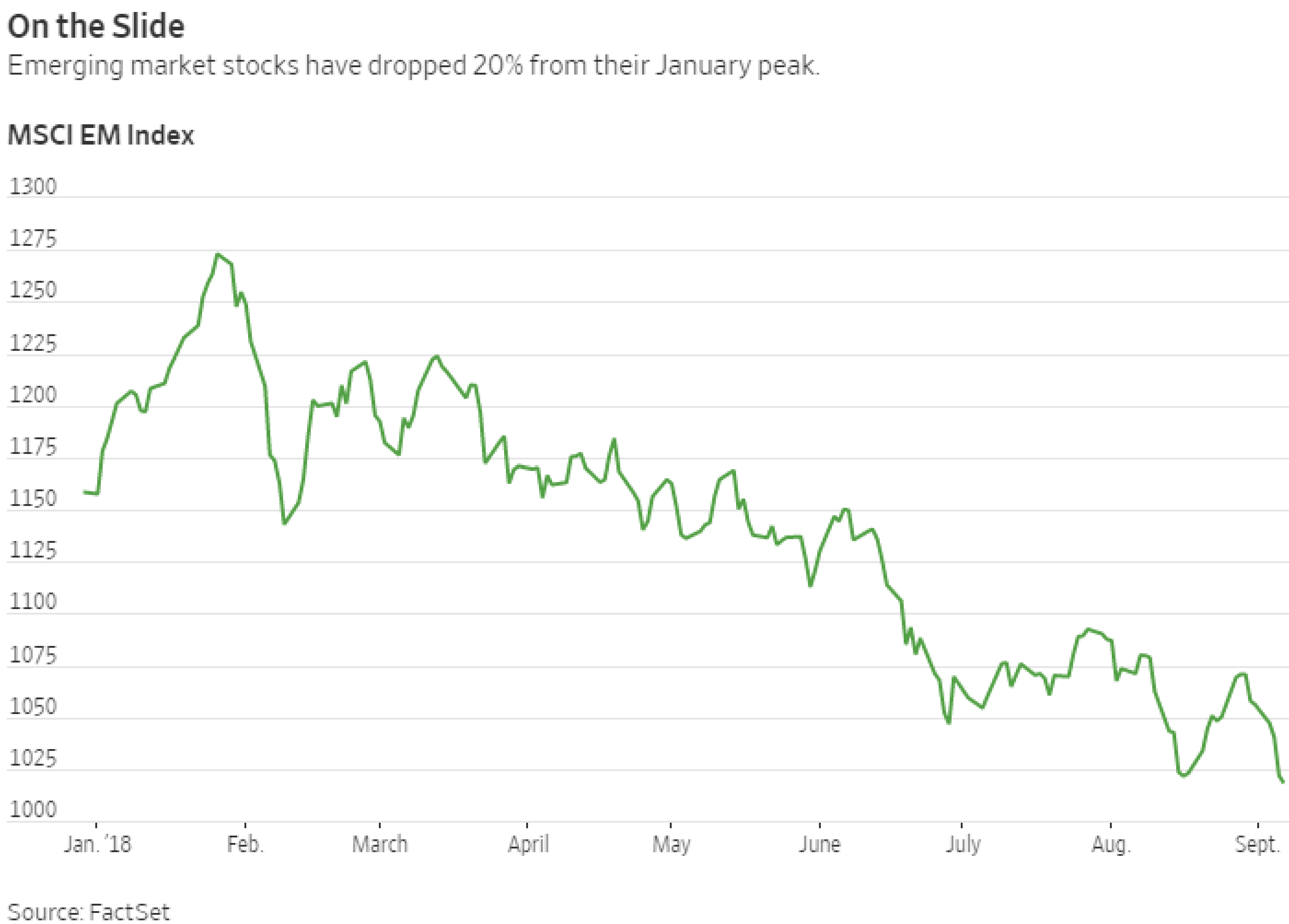
Top-down analysis within a Quantitative approach

We have repeatedly expressed our concern about Emerging Markets in a rising interest rate environment and about the geopolitical risk in far too many of these countries. From the front page of yesterday's WSJ:

Global Shift Sends Emerging Markets Into Bear Territory

By Mike Bird in Hong Kong, Riva Gold in London and Ira Iosebashvili in New York

... The MSCI Emerging Markets Index's 0.3% decline Thursday, led by selloffs in Russia and the Philippines, pushed that gauge of stocks in poorer countries 20% below its recent peak, the common definition of a bear market. The drop deepened a swoon that began last month with sharp falls in the shares and currencies of Turkey and Argentina, both of which are facing domestic economic and political crises.



The emerging-markets decline underscores the changing dynamics evident across financial markets, which have benefited from years of central bank stimulus and recently from a period of synchronized global growth but are now facing challenging conditions.

Tightening monetary policy, along with an upsurge of nationalism that has hampered global trade, is exacerbating the stresses in many developing countries, prompting investors to scramble to distinguish economies able to weather the storm from those too feeble to cope.

While U.S. stocks remain near records and signs of contagion are few, investors are closely watching the rout in emerging markets for signs that it is spilling over into the assets of developed countries. ...

Threading these economies together is their use of the dollar to borrow funds. When the U.S. economy looks to be in much better health than the rest of the world and the Federal Reserve lifts interest rates, pushing the greenback higher, upheaval often follows in the developing world.

Emerging markets have also been hit hard by concerns that tariffs applied by the U.S. and China on each others' goods could prompt further protectionist moves and upset global trade.

The Shanghai Composite Index has fallen 24% from its peak in January, while the yuan is down nearly 7% since June.

The recent bout of selling was partly triggered last month by sharp declines in the Turkish lira, which is down by more than 42% this year, and later the Argentine peso, which has fallen by around 50%. Elsewhere, the Indian rupee reached its weakest-ever levels this week, and the Indonesian rupiah is trading around two-decade lows. ...

Raw-materials prices have also faltered, with the Bloomberg Commodity Index falling nearly 10% since its peak in May. That puts pressure on major exporters of commodities other than oil, such as Brazil, Chile and Indonesia.

Moreover, many investors buy emerging-market assets in broad funds, rather than country by country. So when they reduce exposure, developing markets can be hit all at once. ...

The links extend into developed markets such as Western Europe, given the region's lending ties to countries including Russia and Turkey and its trading ties with China.

Why Emerging Markets Are in Crisis Across the Globe

By **IAN BREMMER**

September 6, 2018

A crisis is looming in developing economies, or what investors know as emerging markets. An economic crisis in Turkey has pushed inflation to new heights and the value of the lira to new lows. Argentina's peso is in trouble as President Mauricio Macri reaches to the International Monetary Fund for emergency help. South Africa's rand, Mexico's peso and Indonesia's rupiah are all under pressure. India and Brazil are looking volatile too.

The risk of contagion to other emerging markets is real. In part, that's thanks to investment vehicles that allow investors to buy debt and equities of multiple countries in a single bundle. In some cases, investors–spooked by weakness in one market–sell shares in all of them to reduce risk.

It might be tempting to blame President Donald Trump for this turmoil. He's declared trade wars on countries large and small. Looming tariffs on another $200 billion in U.S. and Chinese goods mark the latest use of heavy weapons in an escalating fight between the world's two largest economies. He's also battling with Europe, Canada and even Japan, while also throwing punches at vulnerable Turkey as part of a bitter political battle with President Recep Tayyip Erdogan. These confrontations doubtless create uncertainty.

Yet the current crisis follows decisions taken by U.S. central bankers, not the U.S. President. Emerging markets suffer when rising U.S. interest rates boost the dollar at the expense of their currencies. The Federal Reserve will continue to raise rates in coming months, because its governors believe this policy best serves the longer-term needs of the U.S. economy.

In addition, the longer-term weaknesses that make so many emerging markets vulnerable to higher U.S. rates existed long before Trump became President. Many governments of these developing countries haven't done enough in recent years to boost productivity. Some spend ever larger sums on various entitlements while adjusting too slowly to changes in commodity prices or the availability of cheap credit.

Crucially, there's also the problem of populism. Leaders in Turkey, Argentina, Venezuela, Hungary, Poland and South Africa have each pushed economic policies in recent years that delivered short-term political benefits while creating long-term economic weaknesses. Many constrain their institutions, including central banks, from making the necessary adjustments the Fed is now making in the U.S.

Take Turkey. Erdogan's various fights with Trump have led to tariffs and sanctions, but his government has badly mismanaged Turkey's economy. As Erdogan has pressed Turkey's central bank to keep interest rates low, he has made the lira artificially cheap while making dollars and euros more expensive. That, in turn, makes it harder for Turkish companies to pay down large debts denominated in foreign currencies and to borrow more money from overseas. Investors see Erdogan prioritizing political gains over stability.

Argentina offers another example. Here there's no political battle with Trump to worry investors. But Macri has not yet restored investor confidence in his country's long-term financial health. Macri has imposed enough austerity to inflict pain on Argentine voters, but some fear it isn't enough to guarantee that his government can make its debt payments.

Vulnerable emerging markets are like houses built atop faulty foundations. It's the threat of earthquakes that creates fear. But until repairs are made, those who built these homes must shoulder blame when frightening cracks appear.

Sept. 3rd's column from the WSJ's James Mackintosh:

Emerging Markets Are No Bargains

Emerging markets look increasingly chaotic, with plummeting currencies, messy politics and the biggest-ever IMF bailout capturing headlines. Emerging stocks appear far cheaper than in developed countries, especially compared with the pricey U.S. market. So is now the time to close your eyes to the headlines, ignore the sick feeling in your gut and just buy?

Frankly, no. There are times when such a pure contrarian approach makes sense, but today is not such a time. True, the MSCI Emerging Market index trades at just 11 times estimated earnings for the next 12 months, against almost 17 times in the U.S. True, the falls of roughly half in the Turkish and Argentine currencies against the dollar this year have helped drag down the currencies of even countries such as India and Indonesia with better-balanced economies. True, the biggest emerging equity market, China, is back in a bear market, and so are emerging stock indexes with big China exposure.

Yet, neither emerging equities nor the major emerging bond indexes have even given back all last year's gains and income, let alone dropped to true bargain prices. Valuations aren't especially low by historical standards. Worse, the index only looks inexpensive because it is weighted toward sectors few want to buy, even in developed markets.

The last point is perhaps the least understood. Emerging markets have far more banks and commodity producers, which trade at lower valuations than more fashionable areas. Adjust sector weights to match those of developed markets and emerging market indexes trade at the same price-to-forward-earnings ratio as the FTSE World index, according to Philip Lawlor, FTSE Russell head of global markets research.

Not Cheap, Just Different

Emerging market stock indexes look cheap compared to developed stocks because they have more stocks in unpopular sectors.

*Emerging sectors reweighted to match FTSE World weights
Source: FTSE Russell

Investors hoping to take advantage of the turmoil to buy into the emerging middle class at a discount through one of the plethora of emerging exchange-traded funds will be disappointed. Almost half the cheapest 25% of decent-size emerging stocks—those worth more than $1 billion—are in the financial sector, including many Greek, Turkish and Chinese banks. Many of the rest are in low-growth utilities or Russian oil. Only 8% of these low-valuation stocks, measured by price-to-book ratio, are in consumer sectors, and none at all in health care.

The most-expensive emerging stocks look quite different. Half are in the consumer and health care sectors, which have higher valuations than the same sectors in developed markets excluding the U.S. By market value, the biggest stocks by some distance are the major Chinese technology firms, which are also expensive even after hefty falls this year.

"Looking at the PE [price/earnings ratio] of the emerging markets index will lead you astray," says Christopher Smart, head of macroeconomic and geopolitical risk at Barings. "A lot of the index is global tech and global commodity cycle, much more than it is the emerging middle class."

The lack of widespread emerging-market bargains still leaves open the idea of searching for opportunities in the hardest-hit countries. The trouble is that Turkey and Argentina are both struggling with heavy dollar debts; devaluation helps deal with the problem of too many imports and too few exports, but makes it even harder for the Argentine government and Turkish banks to pay their debts.

Investors who think the problems will be solved without defaults can find plenty of Turkish bank stocks trading at less than half book value, with four-year dollar bonds yielding 20%-plus. The Argentine 100-year dollar bond yields more than 10%, again making the brave assumption of no default.

Recent history suggests buying stocks after a big devaluation often works out, as it did after Mexico's 1994 Tequila crisis, the 1998 Russian default or even the Argentine default of 2001. But success depended on timing, much of which is luck. An investor who put dollars into Argentine stocks at the start of 2002, immediately after the default, lost half their money within six months. Those who waited until July tripled their money in dollar terms in the next 18 months.

Recent history might be misleading. Most big devaluations in the past came when pegged exchange rates were abandoned, so there are few examples of falls in floating currencies as big as Argentina's or Turkey's to use as a guide. The political repercussions are tough to predict, but capital controls are entirely plausible, and would make it hard to realize any gains.

Investors should accept that in emerging markets right now, where assets are cheap they are cheap for good reasons. Disagree with the reasons after hard analysis, sure, but this is not the time for simple-minded contrarian buyers.

Cheaper, Not Cheap

Emerging market price-to-forward-earnings ratios have been much lower in the past.

Source: Thomson Reuters

iShares Edge MSCI Multifactor Emerging Markets ETF EMGF

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Quote | **Chart** | ETF Analysis | Distributions | Performance | Ratings & Risk | Portfolio | Fees & Expenses | Tax | Ownership | Filings

Last Price $42.82 | **Day Change** -0.23 | -0.54%

As of Thu 09/06/2018 4:14 PM EST |USD

Intraday Indicative Value $43.00 | -0.30 | -0.69%

As of Thu 09/06/2018 4:19 PM EST |USD

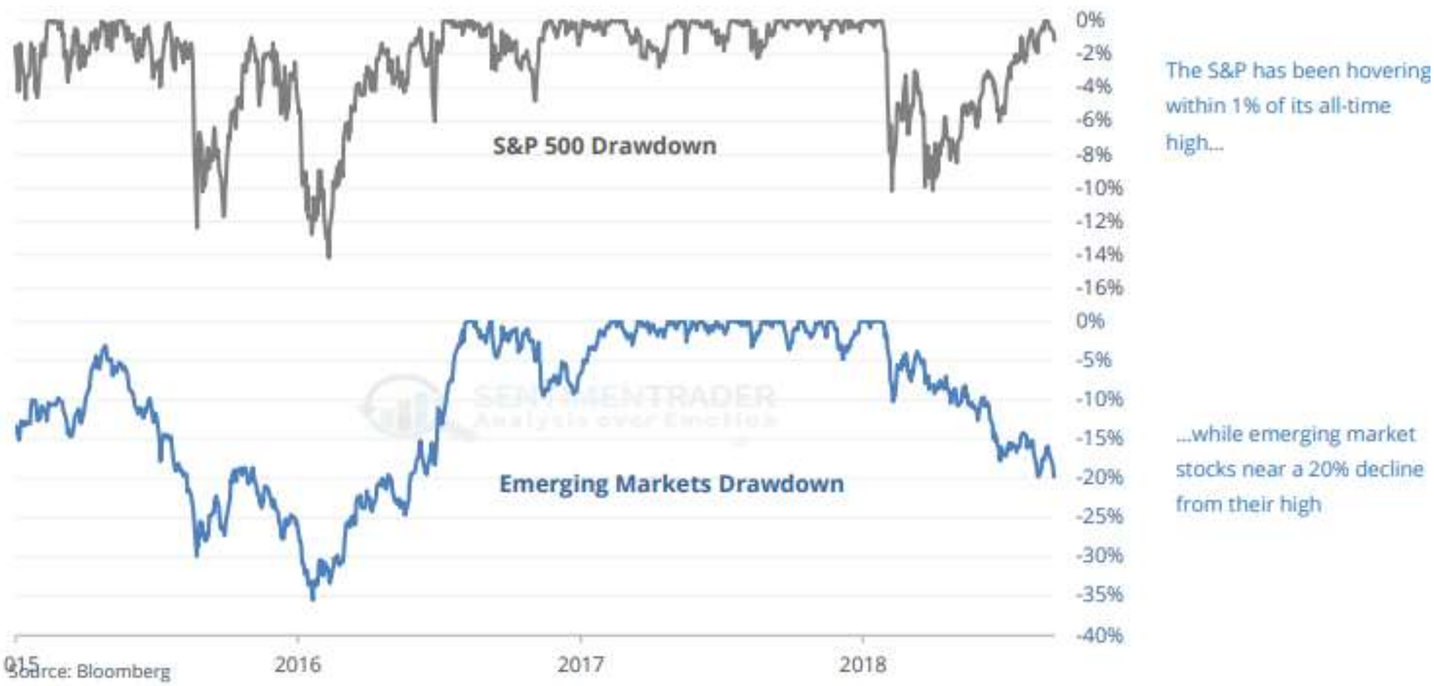
NAV	Open Price	Day Range	52-Week Range	12-Mo. Yield	Total Assets	Expenses
42.91 USD	42.99	42.65-43.02	42.53-53.84	2.28%	278.92 mil USD	0.45%

Prem/Discount	Volume	Avg Vol.	SEC Yield%	Bid/Ask/Spread	Category
-0.41%	37983	49,736	1.68	0.00/ 43.80/ 200.00%	Diversified Emerging Mkts

Our thoughts

As shown above, since the end of `15 BlackRock has provided a multifactor approach to investing in Emerging Market stocks. The question that should be answered first, however, is whether the ride is worth the risk. While we follow EMGF, for the reasons previously shared we haven't recommended an allocation. We have added iShares Edge MSCI Mltfct USA SmCp ETF (orange line) and iShares Edge MSCI Mltfct Intl SmCp ETF (green line) to Morningstar's chart.

Our preferred **Risk** metric is Maximum Drawdown, which we calculate relative to the S&P 500. As noted by SentimenTrader on September 6th, "This is the first time in history that emerging markets fell into a bear market while the S&P was still within 1% of its own 52-week high."



We still consider both Brexit and Trump's election to be negative surprises. However, unlike EMs, we didn't allow our views, which we have shared, to effect allocations. Judgment matters, even within a Quantitative approach:

A Sept. 4th Research Note from Verdad's Brian Chingona:

Fears, Facts, and Brexit

The politics of the European Union have dominated conversations about investing in European equities over the past decade. Who will stay? Who will leave? How will markets react?

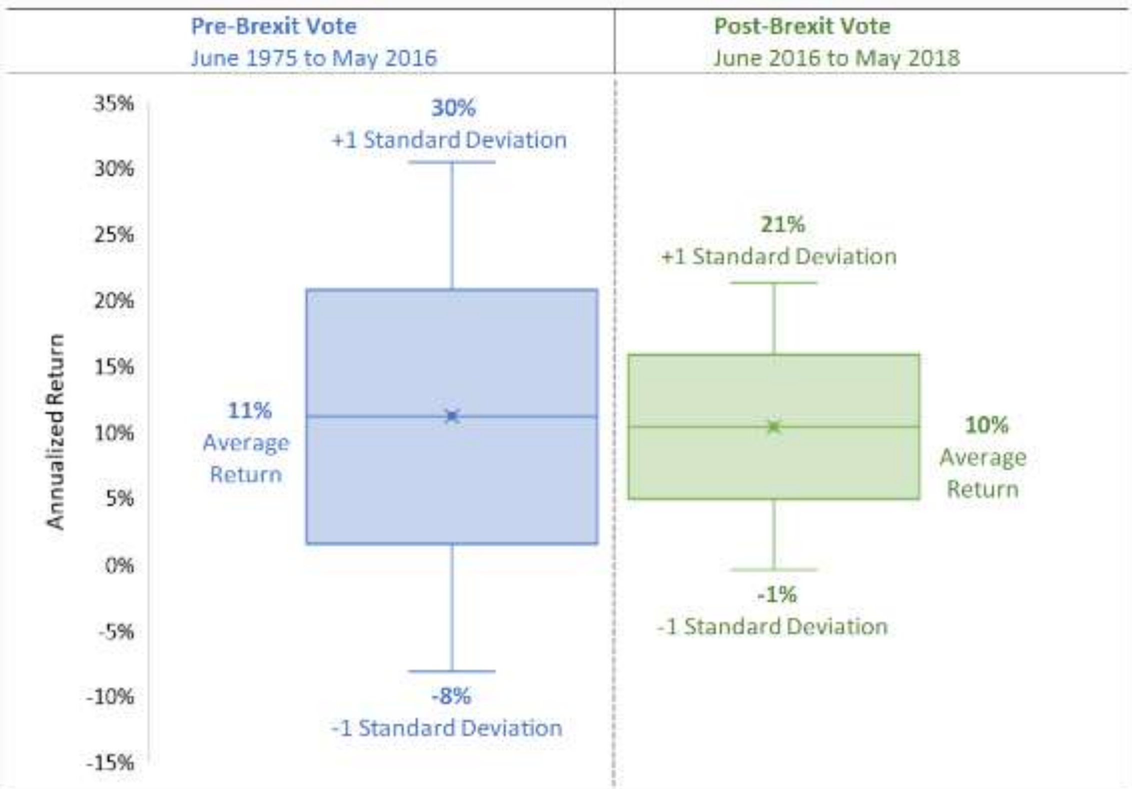
Britain's vote to leave the European Union provides an excellent case study to evaluate the impact of EU politics on equity markets. In the months leading up to the Brexit vote, economists, bankers, and investors predicted that a vote to leave the EU would be a major destabilizing event, with devastating consequences for Britain and British equities. But have these fears been justified? And since the UK's referendum to leave the EU in June 2016, what can we learn from British equity markets over the past two years?

In this week's note, we contrast the fears and the facts.

Fear: Voting to leave the EU would create uncertainty and wreak havoc on UK financial markets.

Fact: The UK equity market has compounded at a 10% annualized rate in the two years since the Brexit vote. This return is similar to the UK equity market's long-term average return of 11% since 1975. Notably, the UK equity market has been relatively calm in the two years since the Brexit vote (11% volatility) versus an average volatility of 19% over the 41 years prior to the Brexit vote.

Figure 1: UK Equity Market Return before and after Brexit Vote (1975—2018)

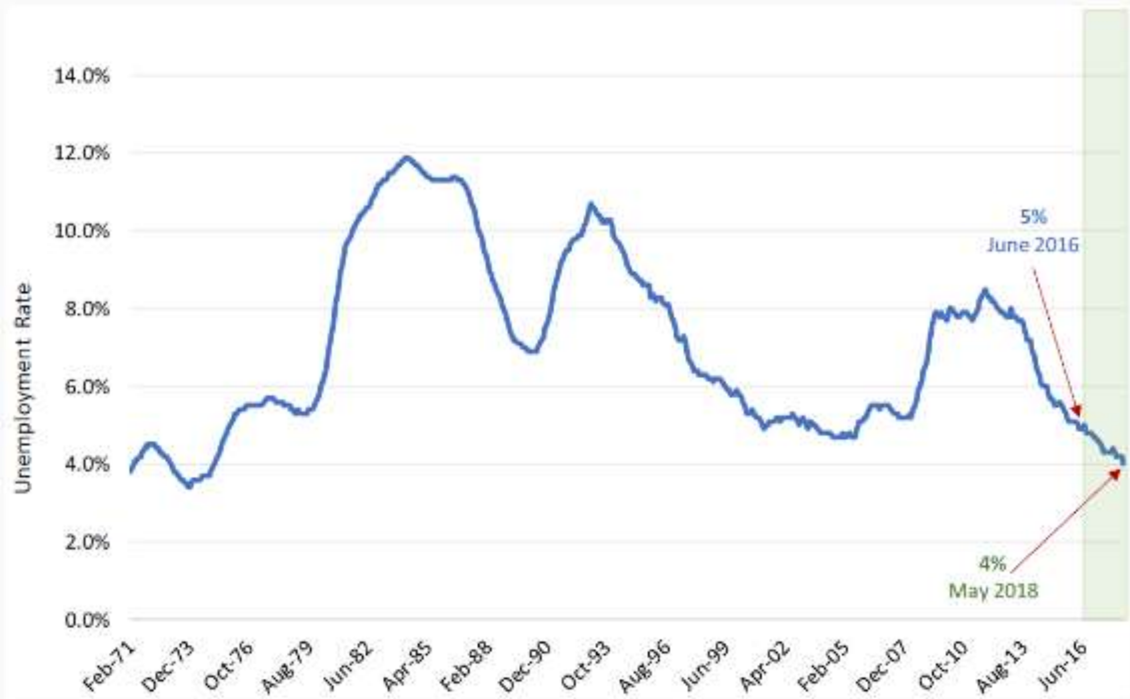


Sources: Ken French Data Library and MSCI

Fear: Leaving the EU would create job losses in the UK as companies relocate to mainland Europe.

Fact: The UK unemployment rate was 5% at the time of the Brexit vote in June 2016. Since then, it has declined to 4% as of May 2018.

Figure 2: UK Unemployment Rate before and after Brexit Vote (1971—2018)

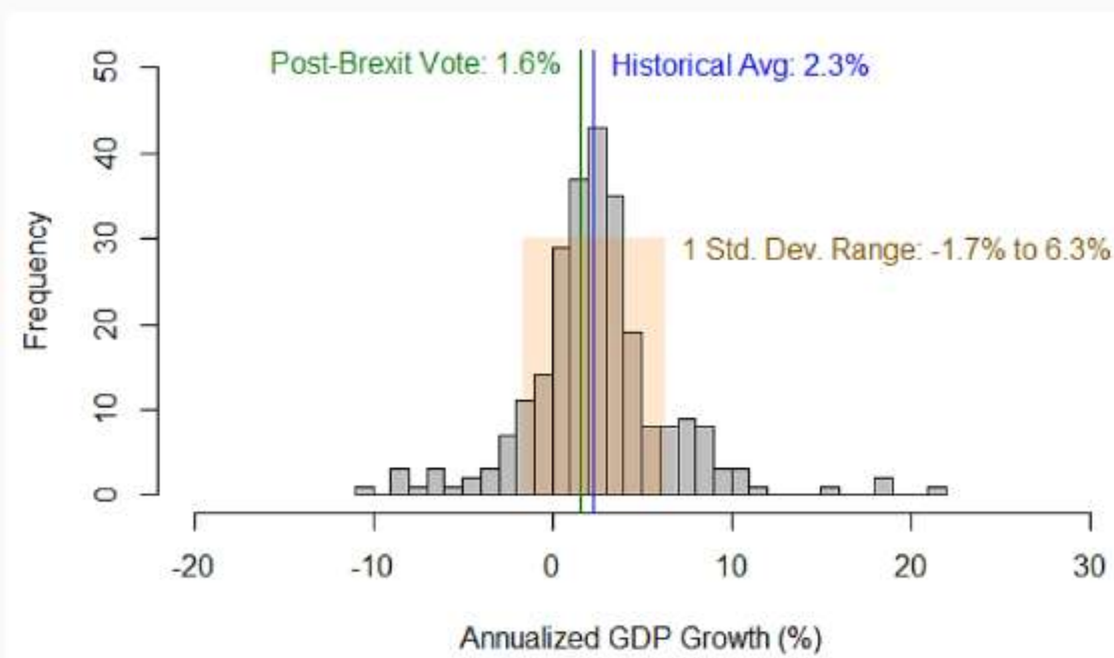


Source: Office for National Statistics

Fear: Leaving the EU would make the UK economy less competitive due to a loss of trade agreements.

Fact: Since the Brexit vote, the UK's GDP growth has averaged 1.6% per year. While this is slightly lower than the historical average growth rate of 2.3% since 1955, there is nothing unusual about a 1.6% GDP growth rate

Figure 3: UK GDP Growth before and after Brexit Vote (1955—2018)



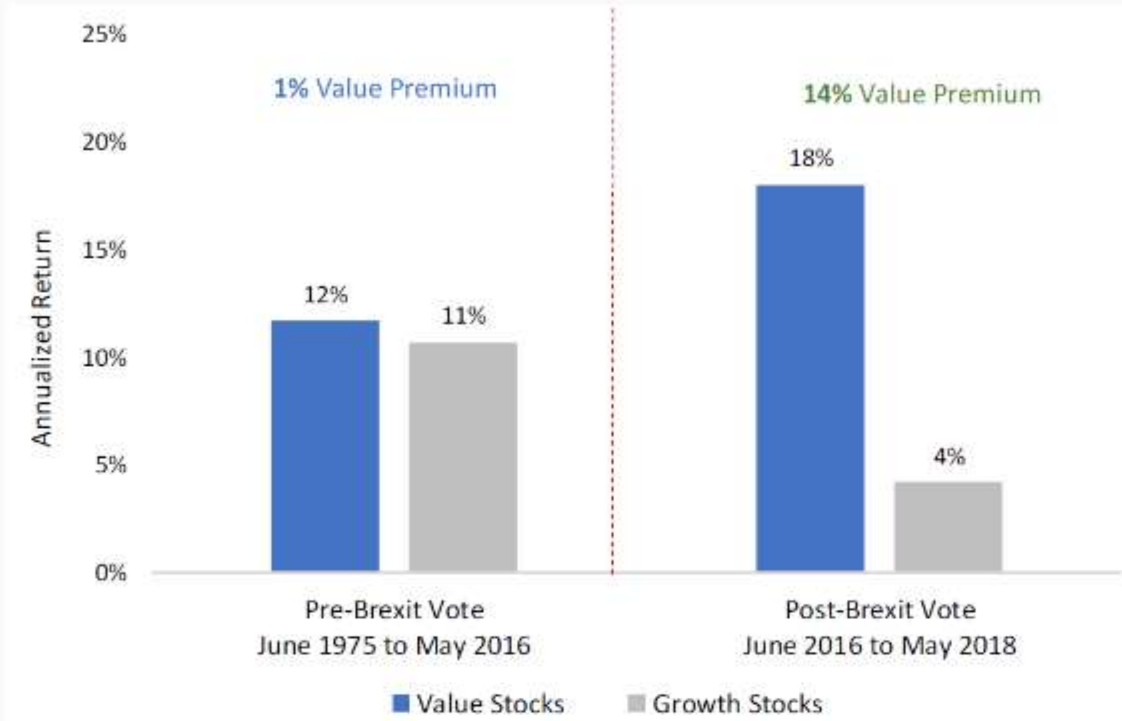
Source: Office for National Statistics

in the UK. Over the past 63 years, GDP growth in the UK has usually been somewhere between -1.7% and 6.3% (i.e., one standard deviation from the historical average). The 1.6% GDP growth rate over the past two years falls squarely within that range.

Fear: Brexit would create massive uncertainty in markets, making it extremely difficult to make good investment judgments.

Fact: Value investors who stayed the course in UK markets since the Brexit vote have been handsomely rewarded for their discipline. The uncertainty created by Brexit has indeed had a negative impact on growth stocks, but value stocks have thrived in this environment.

Figure 4: UK Value Premium before and after Brexit Vote (1975—2018)



Sources: Ken French Data Library and MSCI

The fears about Brexit were overstated. Too many investors let political commentary influence their investment decisions, but the facts suggest that tuning out this type of noise in favor of judgments based on long-term historical base rates might be the better course of action.

Acknowledgements: Verdad summer interns Sam Clayman and Sebastian Schwartz contributed to this article. Sam is a second-year MBA student at Stanford GSB. Prior to business school, Sam worked at Apax Partners and KKR. Sebastian is a junior at Harvard where he is majoring in Computer Science.