We are in the midst of a synchronized global recovery, which usually augurs well for the earnings outlook and performance of emerging market (EM) equities. However, the U.S. is undoubtedly late-cycle, and several dark clouds have recently appeared on the horizon.

The cyclical argument regarding EM equities would be more compelling if the USD continued to weaken, as often occurs in the late stages of the cycle. This is doubly relevant today as U.S. fiscal imbalances have deteriorated conspicuously, creating a blustery headwind for the greenback.

One of our key investment themes is “Tech is the New Macro,” a topic we have written extensively about. This theme is relevant here as EMs in Asia are the best place, outside of the U.S., for investors who wish to gain tech exposure.

EMs almost always trade at a valuation discount to developed markets (DMs), a discount that doesn’t appear to be justified by fundamentals and is likely to narrow going forward.

Many investors fret about EM exposure because of painful memories from the crises in the ’80s and ’90s. However, over the last decade most EMs have dramatically improved their macroeconomic stability, possess fewer imbalances, and are less crisis-prone.

As a consequence, we believe the “emerging” vs. “developed” market dichotomy is much less meaningful today that it was previously. Similarly, given the huge differences across countries, we don’t believe the “emerging market” category is an especially useful one.

Additionally, over coming years and decades we expect the EM share of global market cap, currently 12%, to at least triple, so that it converges with the EM share of global GDP.

Still, there are three key risks to investing in EMs. One is a trade war which, although a low probability event, would inflict the most damage on Asian economies, as well as the tech and materials sectors.

The second risk concerns the transition from QE to QT, which should eventually tighten financial conditions and USD liquidity. This normally leads to higher volatility and credit spreads, all of which are typically bearish for EM equities.

Third, the leverage of the Chinese corporate sector has soared over the last decade, although many of the worst offenders are SOEs which bear an implicit government guarantee.

Finally, regardless of whether investors are considering opportunities in DMs or EMs, we believe they should focus on companies that have demonstrated an ability to produce free cash flow on a sustainable basis and possess superior managements with a proven track record of allocating that cash flow wisely between return of capital options and reinvestment/acquisition opportunities.
EM equities typically produce positive returns when the global PMI is above 51.

The cyclical argument in favor of EMs (Figure 1) is well known and frequently cited. However, after 106 months of expansion, the U.S. is already late-stage, so much closer to the end than the beginning of this cycle. Still, provided the global PMI remains moderately above the 50 breakeven mark, EPS growth benefits from a nice tailwind and EM equities usually perform well.

A weaker USD provides a nice tailwind for EM equities

As the cycle matures, the USD typically weakens as growth accelerates even more in overseas economies, leading capital to flow abroad in search of opportunities with higher expected returns. Acting in the same direction is a problematic development that is quite unique to this cycle, which is that U.S. fiscal imbalances have deteriorated conspicuously. Following the Tax Cuts and Jobs Act of 2017, the U.S. budget deficit is set to skid even further into negative territory, especially worrisome given that it is occurring against a backdrop of an extremely low savings rate. The fiscal binge means even more borrowing from abroad, and a further widening of the overall current account deficit. This has created a stubborn structural headwind for the USD whose effect will be felt for years to come.

To be more specific, the U.S. federal budget deficit is projected to almost double from its 2014 – 2016 average of 2.8% of GDP to 5.3% in 2019. This would constitute the worst budget deficit ever, excluding periods of war and recession. Further, the U.S. personal savings rate (a percentage of personal disposable income) has collapsed from 6.3% in late-2015 to 3.2% today (for context, the post-1960 average is 8.2%). With government revenues set to plummet and the households savings rate extraordinarily low, the U.S. will need to attract more and more foreign capital. This means a lower greenback over the medium-term appears more likely than not.

Additionally, the U.S. trade balance is approaching historical deficits. It averaged $42 bn per month in 2016, but has fallen to $56bn, quickly approaching its worst level ever ($66bn in August 2006, toward the end of the housing bubble). Further, the net international investment position has degenerated to levels never seen in any major economy (Figure 2). While currency markets are among the most difficult to forecast, the current confluence of USD negatives is striking indeed.

The likelihood of a weaker USD is important because EM equities and the greenback are highly negatively correlated (Figure 3). A recent publication from the BIS ("The dollar exchange rate as a global risk factor," January 2018) explains one of America’s negative NII position is without precedent in any major economy. This is particularly worrisome given the U.S. possesses a host of other fiscal imbalances.

FIGURE 2: The net international investment position of the U.S. has deteriorated dramatically

Source: BEA, Bloomberg, U.S. Treasury, March 26, 2018
The USD faces a number of headwinds, a situation that is usually positive for EM equities.

EMs almost always trade at a valuation discount to DMs

In fact, this observation regarding the valuation discount in EMs applies more broadly to the overall market, and not just to the IT sector (Figure 6). Further, this EM vs DM markdown doesn’t appear...
to be justified by fundamentals (Figure 7), suggesting it is likely to narrow going forward and constituting an additional reason to be constructive on EM equities over the medium-term. However, this argument doesn’t apply to all sectors. For example, fundamentals suggest at least four EM sectors (industrials, consumer discretionary, consumer staples and telecoms) appear expensive relative to their DM analogues.

**Greater macro stability and convergence of EM and DM inflation**

One reason why EM equities might trade on a lower multiple than DMs is because they are perceived as carrying more macro risk. It is certainly plausible that some investors fret about EM exposure because of painful memories from the crises in the ’80s and ’90s. However, over the last two decades most EMs (especially those with the highest weight in the MSCI index) have dramatically improved their macroeconomic stability, possess fewer imbalances and are much less crisis-prone.

Latin America suffered from a series of debt crises for much of the 1990s and into the early 2000s (e.g., Mexico’s “Tequila” crisis in 1994, Brazil’s in 1999 and Argentina’s from 1999 – 2002), while the Asian crisis hit from 1997 to 1998 (most dramatically affecting Korea, Indonesia and Thailand) and was closely followed by the Russia financial crisis of 1998 and Turkey in 2000. However, since then almost all of the major financial crises have emanated from DMs rather than EMs. For example, the tech bubble collapse of 2000 – 2002, the GFC of 2007 – 2009 and the European sovereign debt crisis from 2010 – 2012.

The greater macro stability of most EMs reflects enhanced monetary policy credibility, as well as increased balance sheet resilience (including a shift from debt-based to equity-based financing), which has reduced the frequency of EM crises. Improved central bank policy has helped lead to a dramatic decline in EM inflation, which has converged to the low level...
The macroeconomic stability of EMs has improved markedly over the last two decades with EM inflation converging to that of DMs.

**FIGURE 8: The difference between EM and G10 core inflation has narrowed to just 1.0%**

The EM share of global market cap is only 12%, leagues below its share of global GDP and global GDP growth.

**FIGURE 9: EM % share of global market capitalization, GDP and GDP growth**

As a consequence of the improvements in macro stability and competitiveness, we believe the “emerging” vs. “developed” market dichotomy is much less meaningful for investors today than it was previously. Similarly, given the huge differences across countries, we don’t believe the “emerging market” category is an especially useful one.

EMs now contribute 37.4% to global GDP when measured on a USD-basis (the metric is much higher, 59.4%, on a PPP-basis which takes into account the low price in less developed countries of non-tradeables like haircuts). Additionally, EMs contribution to global GDP growth is 58.9% when measured in USD (and 71.6% using PPP). Moreover, the contribution from EMs has been growing by 0.5 to 1.0 ppts per year over the last decade or so. While this cannot keep increasing indefinitely, the contribution from EMs is likely to keep rising at a similar pace for at least another decade.

In sharp contrast to their contribution to global growth, EMs account for only 12.1% of global market cap (Figure 9). While it might take a generation to approach
With the transition from QE to QT, we expect volatility to move higher, with credit spreads eventually following.

**FIGURE 10: EM investment grade spreads and the VIX are 86.5% correlated**

![Graph](source: Bloomberg, NBER, Epoch Investment Partners, March 26, 2018)

Convergence and for the bulk of this gap to close, it seems reasonable to expect that over coming decades the EM share of global market cap will at least triple. This would go a long way towards narrowing the enormous disparity between the huge role EMs play in global GDP growth and their understated role in global financial markets.

**Three key risks to investing in EMs**

Having considered several of the key cyclical and structural bull arguments, we now turn to three bearish developments. The first concerns the possibility of a trade war. We keep our discussion here short as we have previously written extensively on this topic. Please see: “Trump and Trade: What are the Risks?” February 2017; “The Case for Trade Remains Overwhelming, But Dislocated Workers Need More Help,” May 2016; and “A Really Bad Idea,” February 2009. Although this is low probability event and in nobody’s interest, recent actions from the Trump administration have increased the chance of a policy error (out of either D.C., Beijing or Brussels) that could escalate into something truly ugly. Such a development would inflict the most damage on Asian economies and markets, as well as the tech and materials sectors.

**The Winds of Change**

The second risk concerns the transition from QE to QT, which should eventually tighten financial conditions and USD liquidity. Given that one of the purposes of QE was to dampen market volatility (thereby encouraging investors to move out the risk curve), it seems reasonable to expect the transition to QT to result in higher volatility. With this we would expect credit spreads to widen, a series of developments which are typically bearish for EM equities (**Figures 10 and 11**). For a more detailed discussion please see our paper, “The Winds of Change: The Transition from Quantitative Easing to Quantitative Tightening,” December 2017.

**China’s debt binge: In a league of its own**

The third risk concerns the leverage of the Chinese corporate sector, which has soared since the GFC. In fact, China accounted for 82% of the overall increase in corporate debt in EMs over the last decade. As a result, its corporate debt-to-GDP ratio has

**EM credit spreads have become extremely tight, due to the effect of QE policies in the G4. The possibility of markedly higher spreads constitutes a significant risk to EM equities.**

**FIGURE 11: The performance of EM equities is highly (negatively) correlated with EM investment grade credit spreads**

![Graph](source: Bloomberg, NBER, Epoch Investment Partners, March 26, 2018)
rocketed to over 160%, while that for EMs ex-China remains moderate and below 60% (Figure 12).

However, there are three reasons why we shouldn’t be overly concerned about China’s binge. First, the other two sectors of the economy have been relatively restrained, with household debt at 44% of GDP (vs. 80% in the U.S.) and government debt at 56% of GDP (vs. the U.S. at 109%). Second, EM debt crises are often triggered by problems paying down external or “hard currency” debt. However, very little of the debt burden of Chinese non-financial corporations is external (representing only 6% of domestic GDP). Finally, many of the worst offenders are SOEs, which bear an implicit government guarantee. Even though Chinese SOEs make a lot less money and are much deeper in debt than other firms, Beijing has the fiscal capacity to keep any problems contained and prevent contagion to the broader economy.

Implications for Investors

On balance, the backdrop for EM equities is positive. However, there are significant differences between countries in terms of the economic environment, monetary policy, the political situation, and regulatory conditions. And at the corporate level there is a wide disparity in terms of the quality of corporate governance and capital allocation policies. So we still need to evaluate opportunities on a company by company basis. In our International equity portfolios, we have found a number of attractive investments across countries and sectors, primarily in the small and mid-cap space. However, we still see a relative lack of suitable investment candidates for our income-oriented Global Equity Shareholder Yield strategy and our concentrated, high conviction Global Choice strategy. As EM markets and companies mature, we anticipate capital allocation and corporate governance will improve, expanding the opportunity set for our Global Equity Shareholder Yield and Global Choice portfolios. In the meantime, we can access many of the economic attractions and structural growth trends of the EMs by owning DM domiciled companies with significant operations in EMs.

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