FIVE KEY REASONS TO EXPECT EMERGING MARKETS TO DO WELL IN 2019

Emerging markets equities came under intense pressure in 2018, as concerns about the impact on global growth of Fed tightening and the U.S.-led trade war intersected with slowing growth in China and currency crises in Argentina and Turkey. By September, the MSCI Emerging Markets (EM) Index had entered a bear market with a 20% decline from its peak level of January and finished the year with a loss of -14.5% on a total return basis (in U.S. dollars). In contrast, amid the same challenging environment, the S&P 500 Index and the MSCI World Index of developed market (DM) equities posted losses of -4.4% and -8.2% respectively.

Although the jury is still out on whether the U.S. and China will be able to reach a meaningful truce on the trade war – and recent signs are encouraging – we think there are five key reasons to expect emerging market equities to do well in 2019:

- Pessimism is Extreme
- Valuations are Compelling
- Fears of Global Recession are Overdone
- The U.S. Dollar is Vulnerable to a Reversal
- EM Has Started to Show Signs of Relative Strength

Let's examine the evidence that supports each of these points.

Pessimism is Extreme

There are numerous ways to assess investor optimism or pessimism with respect to EM. One of the most comprehensive measures we have come across comes from strategists at the Bank of America/Merrill Lynch (BofAML). They look at measures of investor positioning, put-call ratios, investor surveys, market technicals, volatility, credit spreads, and correlations and have concluded that both EM and Global risk aversion had fallen into panic territory by the end of last year (Charts 1 and 2).[1] Panic levels of both indicators have historically acted as bullish signals for subsequent market performance.

The BofAML team also creates risk aversion measures for individual countries and notes that 10 of 19 EM nations have markets that are in "deep panic," including those of China, India, Korea, Thailand, and Turkey (Chart 3). One notable exception is Brazil, which has been celebrating the appointment of President Bolsonaro. Poland is another, based on earnings optimism and its recent promotion to DM status by index provider FTSE Russell.

One of our favorite market-based measures of investor optimism or pessimism is based on valuation spreads within equity markets. These function much as credit spreads within bond markets, whereby bonds by low-quality issuers cheapen (yields rise) more than those of high-quality issuers when investors become nervous about the economic outlook and potential defaults. In equity markets, we track the difference between estimated earnings yields (on fiscal year two) at the 75th versus 25th percentile within a nation's equity market. When the cheapest stocks – those with high earnings yields – get even cheaper versus other stocks, as occurs when investors become nervous about the economic outlook, their earnings yields rise on a relative basis and valuation spreads widen.

1 Bank of America Merrill Lynch, "A Widespread Panic – Tactical Upside," January 9, 2019