MAKENA STRATEGY INSIGHTS – September 30, 2015

Emerging Markets: Finally Attractive Enough for a Significant Tilt?

Q3
PERIOD ENDING
September 30, 2015

Portfolio Strategy & Macroeconomic Outlook

In our last Makena Strategy Insights letter, we noted that at some point valuations in EM may become so compelling as to merit significantly tilting a portfolio in that direction. A catalyst for this could be the looming Fed tightening cycle, and so we think it is fitting to look at EM in more detail and to discuss the question of how attractive EM assets, equities in particular, are over the medium-term.

As is our custom, we begin our analysis by looking at the broad economic fundamentals which ultimately drive long-term returns. Figure 1 below shows recent and projected real GDP growth for EM, the US and the EU. EM growth has been decelerating for some time now from the levels that prevailed during the 2000-2008 period, resulting in an absolute gap between EM and DM growth that is narrower than it has been at any time since the Asian Financial Crisis. Barring substantial further deterioration in EM, EM growth is poised nonetheless to remain substantially higher (>2x) than DM growth, with attendant effects on asset valuation and returns to investors. Importantly, while it seems unlikely that EM growth will accelerate to the levels witnessed during the early 2000s, such growth is not a prerequisite for EM assets to be attractive: relative growth differentials between EM and DM are sufficient to drive superior EM returns over the next several years.

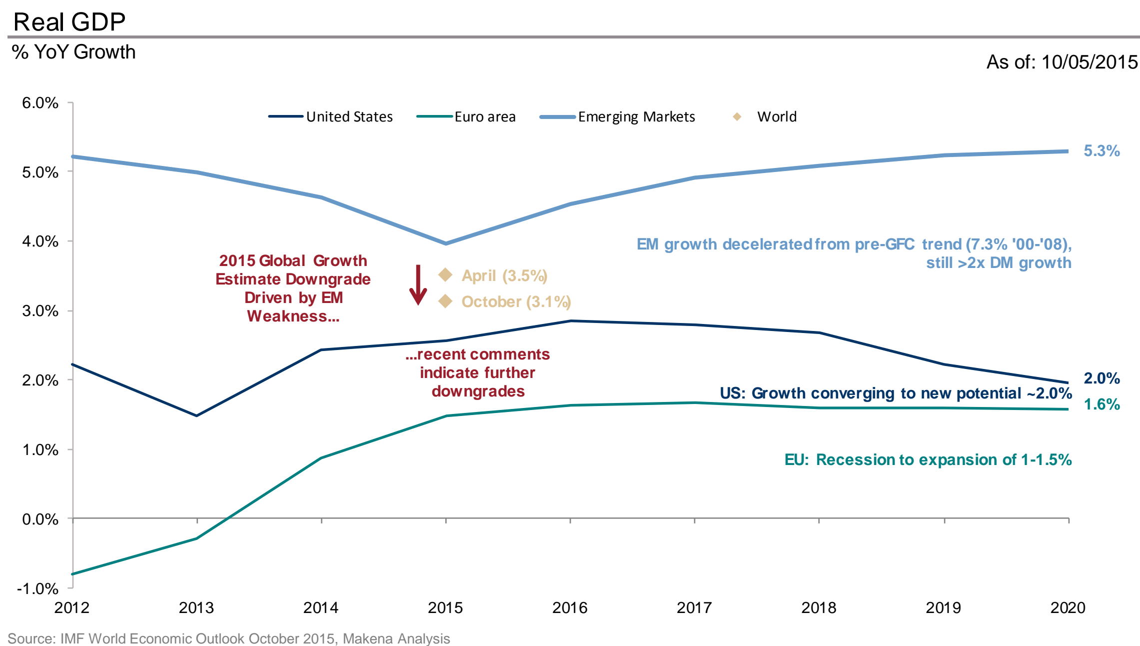


Figure 1: EM Growth Should Accelerate Modestly from Current Levels in Coming Years

Figure 2 below shows EU and US real imports over the last 20 years. DM demand for EM exports enabled the rapid growth of EM economies up until the Global Financial Crisis ("GFC") when the leverage employed to sustain that demand growth became itself unsustainable. Since then, DM import demand from EM has stagnated, with the growth rate falling to one fourth of its previous level. Recent trends are more supportive, but the growth rate is still only half that of the export-model's heyday. Accordingly, EM exporters are grappling with transitioning their economies to a services-led model not out of some altruistic sense of fairness but out of sheer necessity – with China leading the way.

This critical insight drove us to search for EM equity managers that focused on the "new" EM of services and away from the "old" EM of manufacturing and exports. Due to the exports/manufacturing-heavy nature of standard EM indices, this approach ultimately led us to build a more diversified set of country exposures across many of the non-BRIC EM countries, and also led us to focus in a differentiated way within BRIC countries.

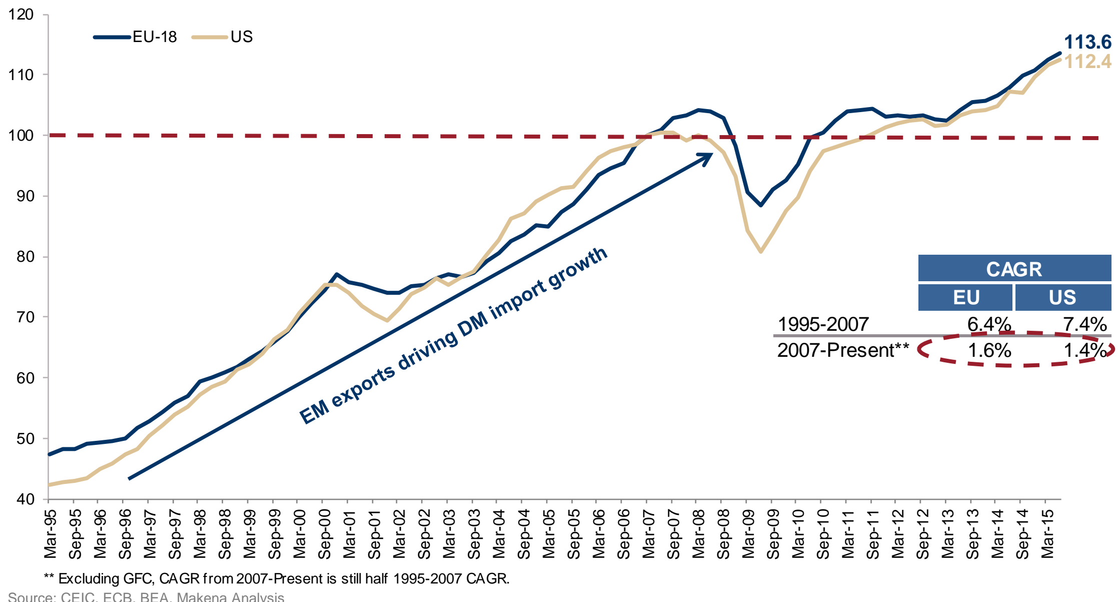


Figure 2: EM Growth Should Accelerate Modestly from Current Levels in Coming Years

The transition to services – a rough road ahead but also an opportunity for long-term investors

If it were possible to transition seamlessly from an export-led to a domestically-focused growth model, then the transition currently underway in EM would not represent a challenge. However, given that income from exports has historically been a key driver of domestic demand in EM economies, the transition has been very difficult as new internal sources of income (from services) have yet to reach a size sufficient to offset the pain caused by the slowdown in exports. Figure 3 below shows the deterioration in EM domestic demand resulting from declining DM demand. The development of an internally-driven growth model depends on structural reforms that increase productivity, enhance the purchasing power of households, and enable further development of the services sector. All of these reforms are slow-moving, politically-fraught processes relative to the rapid changes in the external demand environment that EM economies have suffered. This timing mismatch can open a window of opportunity for EM investments, if one has the ability to weather the volatility inherent in EM assets. At Makena, we believe that a long-term investment horizon allows you to take advantage of this particular opportunity, which is why disciplined rebalancing of EM exposure throughout this selloff is extremely important. The question remains: is it time to overweight EM assets?

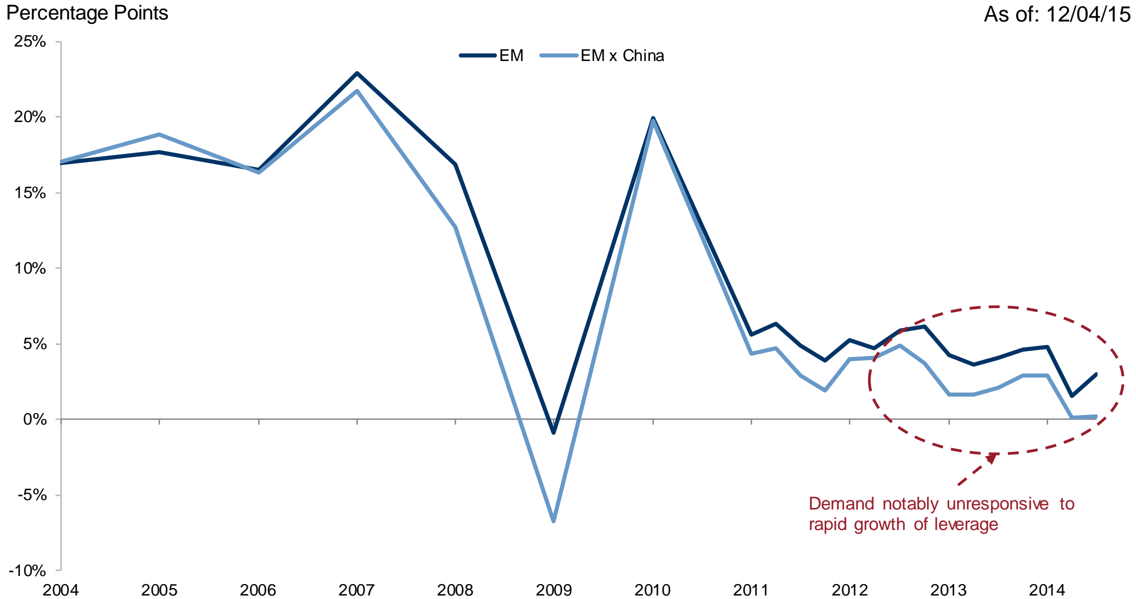


Figure 3: Domestic Demand Growth in EMs has slowed sharply

In the face of such slowing external demand, it is remarkable that domestic demand growth remained as high as it has. Unfortunately, the recent further deceleration, particularly in China, suggests that this was because falling external demand was to a large extent replaced with private sector leverage. Indeed, Figure 4 below shows that EM private sector debt increased dramatically just as Developed Markets ("DM") import demand slowed, resulting in EM debt levels rapidly accelerating to the point that private debt in EM exceeds private debt in DM.

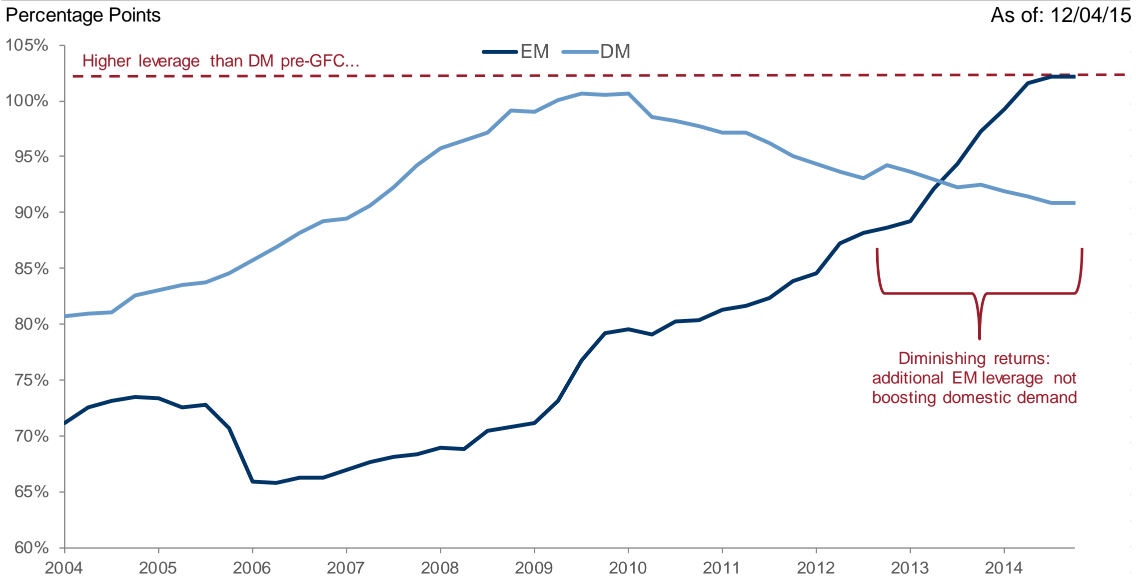
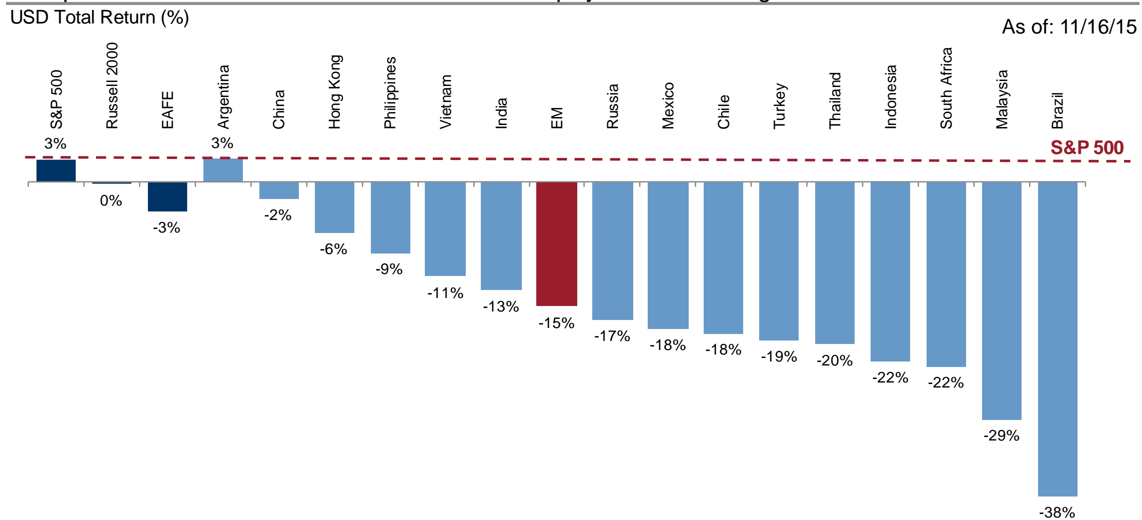


Figure 4: EM Private Debt Now Larger than DM as EM Substitute Leverage for Export Demand

Unlike in the US in the lead-up to the Global Financial Crisis, EM private debt has predominantly been incurred by businesses rather than households and used to finance investments rather than consumption. This explains the deflationary trends we have observed globally in traded-goods prices, since excessive investment has resulted in excess production capacity. More positively, to the extent that this excess capacity does restrain inflation, it should permit relatively looser global monetary conditions for longer, which should aid in the adjustment process and reduce tail risk of financial crisis from the significant debt stock noted in Figure 4. Another silver lining is that the consumer remains relatively unlevered in EM (in China especially). Given that the EM consumer is the lynchpin of continued EM growth, it is critical that the EM consumer not be restrained by excessive debt – for now that does not seem to be the case.

The upshot of both weak DM demand and excess capacity in EM has driven the marked underperformance of EM equities in recent years. Figure 5 below shows the comparative performance of various EM and DM indices over the last 1- and 3-years, respectively.



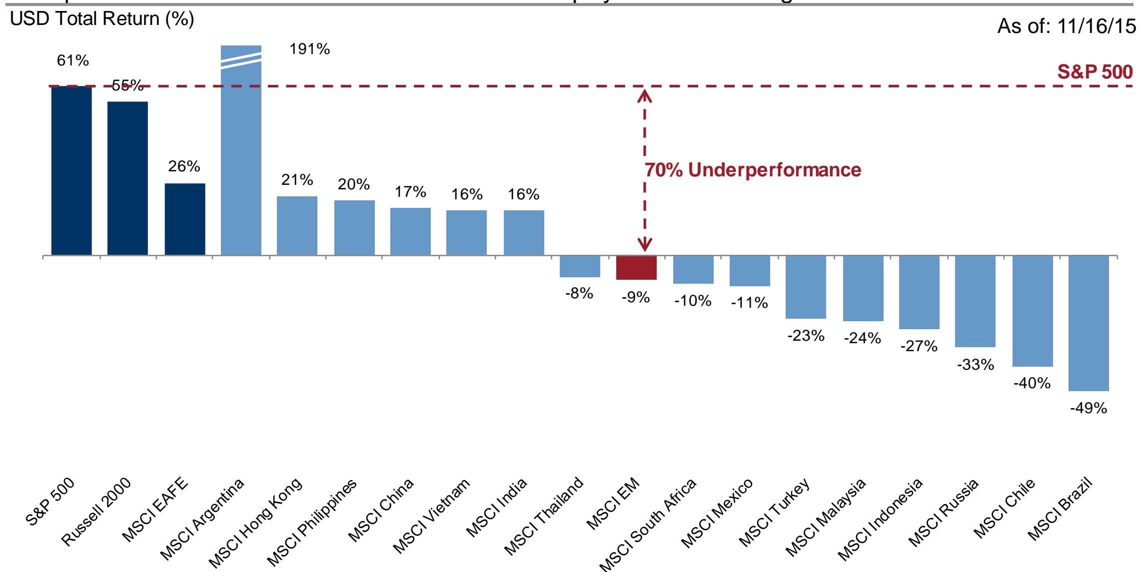


Figure 5: EM Equities Have Underperformed Developed Markets in Recent Years

It should come as little surprise that many of the worst performers are those economies highly dependent on commodity exports (e.g. Brazil, Chile, Russia) and economies suffering from structural competitive problems or political turmoil (Russia, Brazil, Turkey, South Africa), while the more competitive or reforming economies have performed better (Philippines, India).

Special FX

Much of the sell-off in EM has been due to the broad decline in EM currencies. Figure 6 below shows the equity market performance over the last year for several major EM countries in USD and local currency terms. In local terms, Russia, Mexico and Turkey would all have outperformed the S&P 500 while Brazil's sell-off would have been reduced to a mere pullback (-9.0%).

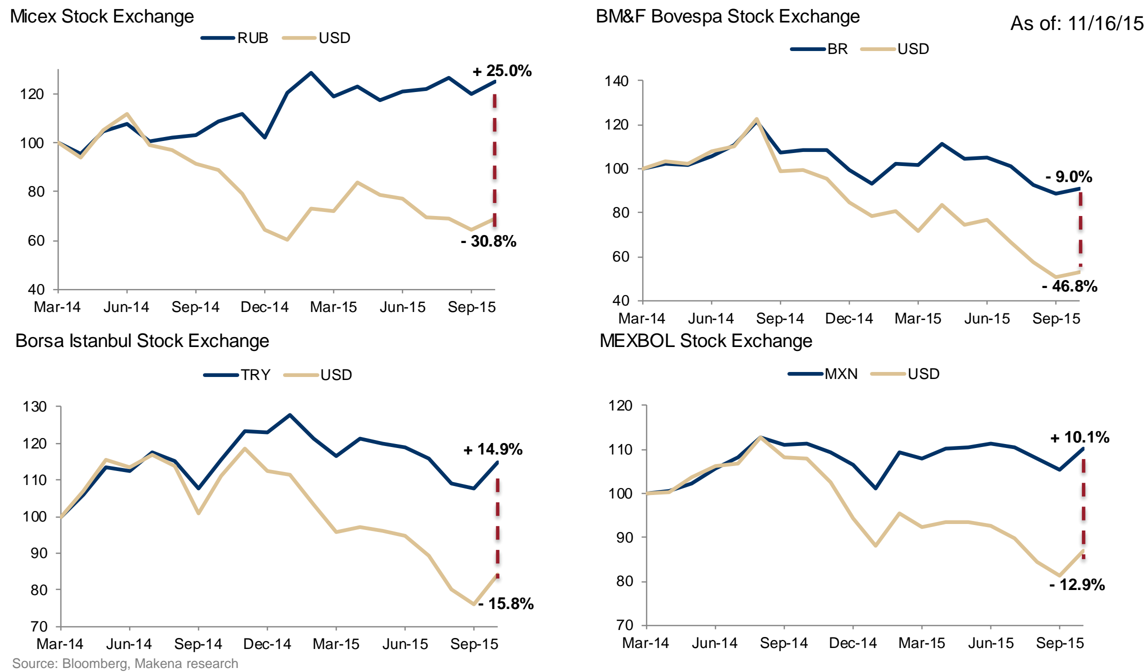


Figure 6: EM Equity Sell-off Largely Driven by FX

If we look through to earnings, we see that while there have indeed been sizeable declines in earnings from their peaks (for the reasons that we just discussed), the appreciation of the dollar has magnified the perceived decline substantially (see Figure 7 below).

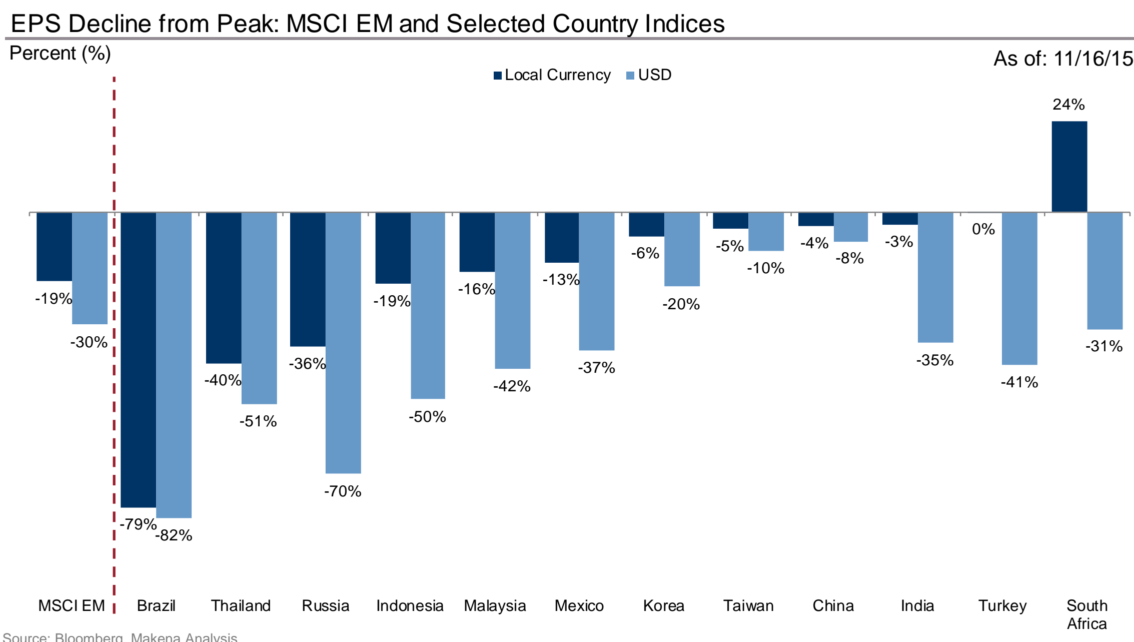


Figure 7: EM Earnings have declined broadly but amplified by FX

With a Fed rate hiking cycle looming, and with domestic conditions in most EMs arguing for monetary support, it seems likely that rate differentials will decrease between EM and the US. Taken by itself, this would suggest further EM currency weakness. However, this would ignore the extent to which current currency levels already take into account the future path of rates. Furthermore, as we have regularly highlighted over the past three years, we are facing a gradual Fed hiking cycle to a lower terminal point for rates. At this stage we therefore believe that the critical question for EM equities is now less dominated by the outlook for FX, and instead more dependent on our fundamental favorites: earnings growth and valuations (multiples).

Make money, diversify, or both

We suggest an investment framework using a simple two-pronged approach: can we expect to make money in a particular investment, or does it add a diversifying element to the portfolio (and if we are lucky it does both). We focus on each of these two prongs in order: first on making money, i.e. are EM equities a "buy;" and second on the diversification aspect of EM equities.

Make money…

As long-term investors, we favor cyclically adjusted price-to-earnings ratios (CAPE) over either trailing or forward looking ratios, as these dampen the effect of near-term earnings volatility associated with the business cycle. [1] In particular, we look at the standard deviation of an index's current valuation relative to its own history, focusing our interest on valuations that are at least one if not two standard deviations "cheap."[2] Finally, we also consider whether we are getting "growth at a reasonable price," which is price-to-earnings divided by expected earnings growth (the so-called PEG ratio). Given our preference for CAPE over just the P/E ratio, the analogue to the PEG ratio is the (CAPE)G ratio, i.e. CAPE divided by expected earnings growth. The (CAPE)G should be the long-term investor's metric of choice when assessing whether EM growth is "at a reasonable price."

Figure 8 below applies our framework to some core EM markets. If we look only at MSCI EM, the case for investing in EM is fairly weak. The CAPE is only roughly a standard deviation below its historical average but the earnings outlook is lackluster (in accordance with our earlier analysis) with the result that valuations on a growth adjusted basis are only marginally better than in

[1] In EM, this is even more important since the volatility of individual company earnings can have relatively larger effects on index earnings than in larger, better-diversified indices (e.g. S&P 500, EuroStoxx 600 etc.).
[2] Index-to-index comparisons can be tricky across countries, since the numeric valuation levels reflect different country-specific risk premia. We find it essential to consider CAPEs relative to an index's own history by taking the CAPE Z-score for that country.

the S&P 500. Why add the risks associated with EM assets when expected returns do not seem to offer much more than S&P 500 expected returns?

Looking "under the hood;" however, highlights how treating EM as a monolith can be a dangerous simplification. Some countries offer similar historical valuations relative to the S&P 500 and also similar growth-adjusted valuations (e.g. Indonesia, Philippines); others have higher historical valuations and worse growth-adjusted valuations to the S&P 500 (South Africa); finally there are countries that have moderately attractive historical valuations but similar-to-worse growth-adjusted valuations than the S&P 500 (China, Malaysia). None of the aforementioned are priced to reward the investor for taking EM risk. What remains are countries that offer similar or better historical valuations with attractive growth-adjusted valuations (Chile, Turkey, Russia, and India).

Note that for large countries such as China, the fact that the standard equity index does not appear attractive does not imply that there are no interesting investment opportunities: for large countries, the opportunity set is large enough that a dedicated in-country manager building thoughtful portfolios can still generate attractive returns. This is precisely why for the largest countries we recommend employing in-country specialist managers.

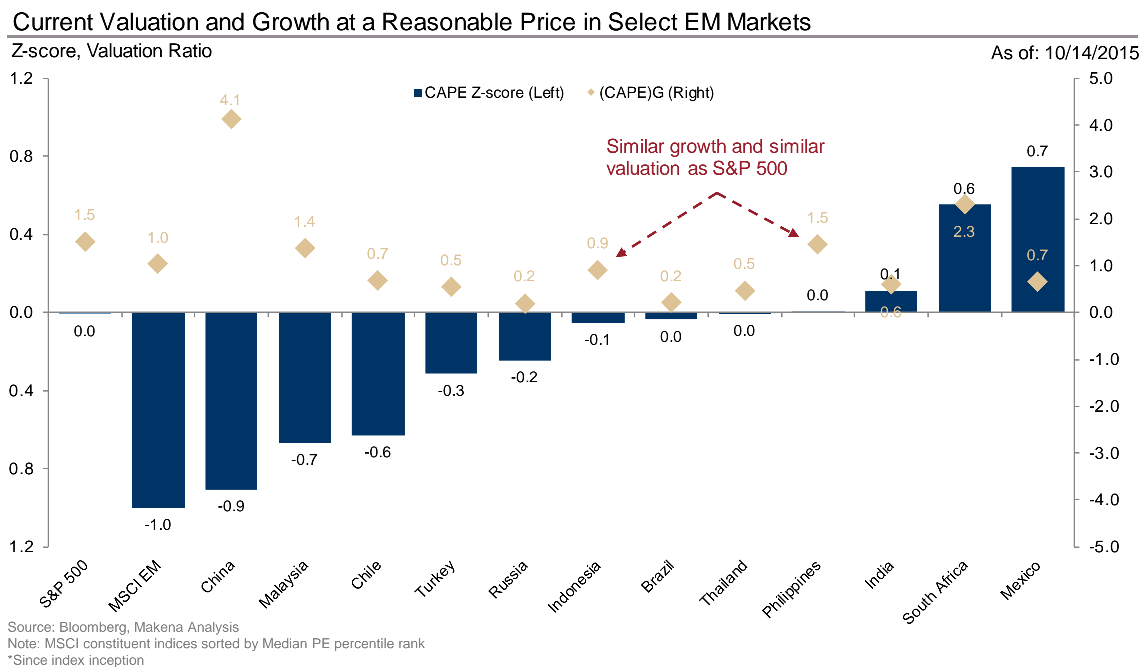


Figure 8: Makena Framework Reveals Nuances within EM Sell-off

…diversify

Even if one is not expecting particularly strong investment returns, a diversifying investment serves an important purpose in any portfolio construction process. Therefore, it is important to ask whether an EM exposure is diversifying. In the context of EM, this boils down to whether an index actually provides access to an EM-specific risk factor, or whether that index is just a global equity risk factor disguised in EM clothes. Figure 9 below shows the Beta of various EM country indices to the MSCI World (Developed Markets) index: the higher the Beta, the more "DM"-like the exposure; conversely, *the lower the Beta to MSCI World, the more "EM"-like and therefore diversifying to a DM-biased portfolio.* Not surprisingly, commodity exporting countries in general exhibit high Betas relative to DM markets, as does the MSCI EM index as a whole, given that both indices have significant global export-led company exposure. By contrast, the more "frontier" markets offer the lowest Betas and therefore the greatest diversification benefits. Returning to our framework analysis, Turkey and Russia look less attractive from a diversification perspective, whereas India, Indonesia and the Philippines look more attractive.

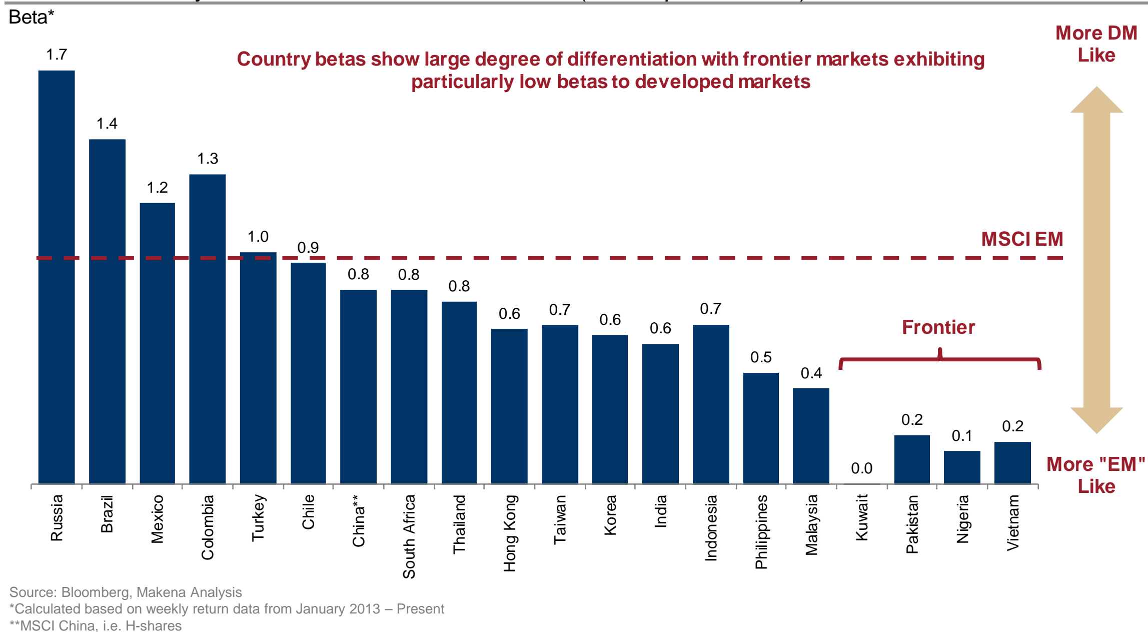


Figure 9: Some Indices Emerging Markets in Name Only

We don't pretend to think that our analysis is definitive or without flaws. It is rather the beginning of a way to think about the various critical considerations in choosing to invest—or not to invest—in a particular market. There are tradeoffs in applying different weights to the factors in our framework—for example, how to balance valuation versus growth versus diversification – and before any final decision is made, one must take a more detailed look at the macroeconomic drivers and market conditions in an individual country or index. Nonetheless, we believe our framework can be a valuable tool for investors who are keen on taking advantage of the opportunities afforded by a nuanced analysis.

Summary of Investment Strategy

In our Q2 2015 Makena Strategy Insights letter we outlined a series of investment recommendations. The above analysis lends further support to these recommendations and suggests several additional strategies:

i. *Caution over growth companies during the run-up to and immediate aftermath of the Fed's first hike.*
   Growth companies will likely exhibit heightened sensitivity to the effects of a rate hike. However, in a world of scarce growth, they may be able to attract and sustain higher valuation multiples than they have attracted historically, suggesting that risk is perhaps somewhat muted.

ii. *Similar to (i) above, buy into long-term growth via EM equities should there be a significant sell-off*
   Growth *countries* will also likely exhibit heightened sensitivity to the effects of a rate hike. Indeed, many EM markets seem to have already priced-in the effect of lift-off. Moreover, in a world of scarce growth, they should be able to attract and sustain higher valuation multiples than they have historically. Said differently, some EM countries currently represent "growth at a reasonable price."

iii. *Longer duration vs. shorter duration in Fixed Income portfolios*
   Uncertainty over the timing and pace of the coming Fed hiking cycle is likely to continue generating substantial volatility in the short end of the curve and potentially less in the longer end. Additionally, should market expectations price a lower growth rate and a lower inflation outlook following a rate hike, we could actually see a rally in the long end.

iv. *Continued overweight to US dollar in currency portfolios*

As we predicted, strong Q2 data suggests that Q1 weakness was anomalous, leaving intact our thesis for continued US dollar strength. However, recent volatility may continue as market predictions for lift-off change and thus the implied interest rate differentials on the major crosses (e.g. EUR).

v. *US small and medium enterprise (including Private Equity) vs. large-caps*

With a strong dollar and therefore weaker commodity prices, the US consumer will have newfound disposable income to spend, favoring more domestically-oriented companies.

vi. *Competitive EM over commodity EM (across asset classes)*

While weaker commodity prices hurt commodity exporting nations, it also benefits manufactured goods producing nations through lower input costs. The stronger dollar and increased disposable income available to the US consumer should also benefit manufactured goods-producing nations.

vii. *Long Europe exporters and periphery intra-Europe exporters*

Between lower commodity prices and lower wages, thanks to internal deflation across most of Europe, European exporters should see margins continuing to improve. The weaker Euro will also bolster exports to outside the Eurozone and from peripheral Europe to the core as a substitute for imports from outside the Eurozone.

viii. *Long US services / non-traded goods companies vs. US exporters*

The flip side of a strong dollar is that export-led US companies will likely see earnings and earnings growth hampered from overseas operations. On the other hand, due to weak wage inflation dynamics, US services will benefit from a slower unwind of high margins as it takes time for declining labor slack to drive wage pressures.

ix. *Long EM reformers vs. laggards (across asset classes)*

Some countries have embraced reforms since the last few crises, implementing flexible exchange rates, minimizing interventions in their domestic economies, and in general fostering an environment where private industry can thrive. These countries should be able to navigate volatility driven by exchange rates and the Fed's moves more successfully than the laggards who have not reformed.

The Partners of Makena Capital Management[3]

Analysis by

Michel Del Buono, Global Investment Strategist

[3] The research referenced and cited in this letter, including the information used to develop the opinions herein, was gathered from sources believed to be accurate, including but not limited to; economic and market data from government and private sources and major external databases, but no independent verification has been made and accuracy is not guaranteed. It should be further noted that, while based on reasonable belief and research, the opinions, projections, and estimates contained herein reflect those of Makena only and should not be construed as absolute statements and are subject to change without notice to you.

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