Emerging from Hibernation: The Green Shoots of Emerging Markets

Introduction

Hibernation is a state of inactivity in some mammals during the winter months, characterized by low body temperature, slow breathing and heart rate, and low metabolic rate. After a decade of perceived “hibernation,” emerging markets (EMs) may finally be awakening from their slumber and a number of “green shoots” are beginning to emerge. Without question, past performance has proven to be a challenge relative to U.S. equities – the S&P 500® has been the strongest game in town over the last 10 years. So what do we expect could change for investors going forward?

Well, instead of “hibernating,” we actually view EMs similar to the grizzly bear in the children’s cartoon Masha and the Bear. The bear tries to relax in his cabin in the Russian woodlands; however, his 3-year-old human neighbor Masha repeatedly interrupts and distracts with relentless hijinks, and a comedy of errors ensues. Like the bear dealing with mischievous Masha, EMs encountered multiple macroeconomic headwinds over the last 10 years, not all of which were of their own creation. Among the issues were multiple developed market recessions, an oil price crash, a Federal Reserve (Fed) on autopilot at times, dollar strength, and, topping things off more recently, global trade tensions. Thus, from that perspective we find it quite remarkable that EM equities showed points of strength at any time in the previous 10 years, let alone managed to outperform the MSCI World ex-USA Index over the whole period on a total return basis.

In this edition of Strategy Insights, we explore the ever-evolving world of EM equities, outlining the key defining characteristics of the asset class, what role we expect EMs to play in portfolios, and why we may be approaching an opportune time to add to existing positions or initiate new ones.

Emerging Market Equities Defined

What do China, the second largest economy in the world, and Peru, a country with a population smaller than California’s, have in common? Both are part of the broad collective of countries known to investors as emerging markets. The term “emerging market” was coined in the early 1980s, and to some it may still conjure up images of investing in third-world banana republics. Quite the contrary, we believe EMs represent the global economic growth engine, making significant strides in technological innovation supported by the emergence of a growing middle class.

Let’s start by defining EM equities. While there are many ways to define EMs, the term typically refers to the 24 countries that comprise the MSCI Emerging Market Index, with the top 10 country weights listed in Table 1. As one might expect, EM countries,

<table>
<thead>
<tr>
<th>Country</th>
<th>2009</th>
<th>2019</th>
</tr>
</thead>
<tbody>
<tr>
<td>China</td>
<td>12.56%</td>
<td>28.31%</td>
</tr>
<tr>
<td>South Korea</td>
<td>12.28%</td>
<td>13.08%</td>
</tr>
<tr>
<td>Taiwan</td>
<td>12.26%</td>
<td>11.05%</td>
</tr>
<tr>
<td>India</td>
<td>6.40%</td>
<td>9.00%</td>
</tr>
<tr>
<td>Brazil</td>
<td>14.80%</td>
<td>7.64%</td>
</tr>
<tr>
<td>South Africa</td>
<td>8.83%</td>
<td>5.70%</td>
</tr>
<tr>
<td>Hong Kong*</td>
<td>5.38%</td>
<td>4.29%</td>
</tr>
<tr>
<td>Russia</td>
<td>6.23%</td>
<td>3.73%</td>
</tr>
<tr>
<td>Mexico</td>
<td>4.85%</td>
<td>2.62%</td>
</tr>
<tr>
<td>Thailand</td>
<td>1.50%</td>
<td>2.33%</td>
</tr>
</tbody>
</table>

*Hong Kong is an MSCI developed market; however, companies like China Mobile Ltd. are technically domiciled in Hong Kong.

Source: Bloomberg L.P., PNC

infrastructures, and economies vary quite a bit, resulting in a fairly heterogeneous asset class. However, they all tend to be classified in a “high growth phase” characterized by rapidly expanding and improving market environments, as measured by key factors such as:

- macroeconomic conditions;
- higher absolute levels of GDP growth;
- greater relative political stability to frontier markets;
- developing capital market processes; and
- financial market trading and settlement procedures.

Today, China has an even more significant impact on performance than it did just 10 years ago, with a weighting of more than 28% of the EM Index. Including companies domiciled in Taiwan and Hong Kong (not included in the MSCI EM Index), that figure swells to more than 40% of the index. “As goes China, so goes the rest of emerging markets,” is a phrase we’ve used in the past to describe growth trends throughout EMs. However, Latin American (LatAm) exposure should not be discounted, with the region actually having a slightly higher correlation with the MSCI EM Index than China over the last 15 years (Table 2). Similar to focusing on just Exxon Mobil Corporation and Chevron Corporation (approximately 40% of the S&P 500 Energy sector) and ignoring the other Energy stocks, focusing just on China-domiciled equities can cause one to lose sight of other potential growth catalysts and alpha generators for EMs. As the so-called “China complex” garnered an increasing share of the index over the past decade (green-shaded boxes), it was at the expense of the commodity-producing countries (that is, Brazil, Mexico, Russia) shaded in red.

In early 2019, MSCI also announced its plans to incrementally increase the weighting of China A shares into the EM index over the course of 2019. According to MSCI, the net result is expected to be a further 3% increase in weighting to China in the EM index. We believe this long-anticipated announcement by MSCI further highlights market access and transparency improvements within the EM universe.

Additionally, MSCI announced both Saudi Arabia and Argentina will be upgraded from Frontier Markets to EM at their mid-year 2019 rebalance, further demonstrating the rapid evolution of many less developed markets. Argentina actually did go into hibernation when it was removed from the EM index in 2009, and we believe MSCI’s upgrade of the embattled country is further evidence the investment community is turning positive on LatAm both in terms of economic growth prospects and improving financial reporting transparency from a global markets perspective.

Today, many of these EM economies are also experiencing significant growth from middle class consumers helping to drive increased demand across sectors. As China shifts toward a consumption-driven economy, and the middle class grows in LatAm, we’ve seen a dramatic shift away from the reliance on the Energy and Materials sectors (shaded in red) and more emphasis on Financials and Consumer Discretionary (highlighted in green, Table 3).

<table>
<thead>
<tr>
<th>Region</th>
<th>EM Correlation Since 2004</th>
</tr>
</thead>
<tbody>
<tr>
<td>Latin America</td>
<td>0.89</td>
</tr>
<tr>
<td>China</td>
<td>0.85</td>
</tr>
<tr>
<td>India</td>
<td>0.74</td>
</tr>
<tr>
<td>S&amp;P 500*</td>
<td>0.78</td>
</tr>
</tbody>
</table>

Source: Bloomberg L.P., PNC

Table 3
Sector Weight Breakdown
As of 2/28/19

<table>
<thead>
<tr>
<th>MSCI EM Sector Weights</th>
<th>2009</th>
<th>2019</th>
</tr>
</thead>
<tbody>
<tr>
<td>Financials</td>
<td>20.57%</td>
<td>24.84%</td>
</tr>
<tr>
<td>Information Technology</td>
<td>16.43%</td>
<td>14.28%</td>
</tr>
<tr>
<td>Communication Services</td>
<td>14.04%</td>
<td>14.16%</td>
</tr>
<tr>
<td>Consumer Discretionary</td>
<td>1.90%</td>
<td>10.87%</td>
</tr>
<tr>
<td>Energy</td>
<td>14.57%</td>
<td>8.09%</td>
</tr>
<tr>
<td>Materials</td>
<td>15.10%</td>
<td>7.34%</td>
</tr>
<tr>
<td>Consumer Staples</td>
<td>4.14%</td>
<td>6.54%</td>
</tr>
<tr>
<td>Industrials</td>
<td>5.09%</td>
<td>5.45%</td>
</tr>
<tr>
<td>Real Estate</td>
<td>1.76%</td>
<td>3.08%</td>
</tr>
<tr>
<td>Health Care</td>
<td>2.39%</td>
<td>2.73%</td>
</tr>
<tr>
<td>Utilities</td>
<td>4.00%</td>
<td>2.62%</td>
</tr>
</tbody>
</table>

Source: Bloomberg L.P., PNC

2 China A shares are listed on mainland Chinese exchanges, and only trade in local currency (that is, no American Depositary Receipts [ADRs]).
The Strategic View

Secular Growth Trends

“Poverty around the world is plummeting; half the world is now middle class; illiteracy [and] disease are receding. These things don’t make headlines because they are gradual, relentless and unsurprising. That is why they are worth highlighting. The problems the world faces...can be solved the same way: not by betting on miracles but by patiently applying knowledge and tools we already possess,” says Greg Ip, chief economics commentator at The Wall Street Journal. In short, we believe that is what makes the secular growth trends unfolding in EMs so appealing from an investment standpoint.

The growing technology-focused Consumer Discretionary sector within EMs remains a compelling case for the longer term, in our view. The generational shift toward e-commerce is helping to transform emerging Asia’s technology and telecommunication sectors at a significantly more rapid pace than in the United States. For example, digital payment systems such as Android Pay, Apple Pay, and others are starting to gain traction in the United States. However, at fewer than 10% of e-commerce transactions, the adoption rate pales in comparison to that in certain EMs. In China, 80% of e-commerce is executed through mobile devices. The point of emphasis is that we recognize long-term structural changes in China and other emerging economies such as India are still underway, with those countries slowly shifting toward consumption-oriented economies and away from industrial production and heavy-industry models.

Over time, the consumer and technology applications used in these economies will likely become significantly important not only to their local markets but also to the global economy. Our conclusion is that over the longer term, the “green shoots” forming in EM economies today will reap the benefits of a powerful consumer base and a shifting economic model. We believe longer-term trends in developing/emerging countries look both sustainable and investable and should, over time, continue to result in stronger-than-average growth tailwinds relative to the developed world.

It’s a “Chinese Dream”

The importance of China to the EM Index cannot be overstated. Thus, it is worthwhile to describe the inner dynamics of the country. The phrase “Chinese Dream” was coined by Chinese President Xi Jinping upon becoming president of the People’s Republic of China in 2013. As his presidency has become among the most powerful in China’s communist history, his vision for China was twofold: become a moderately well-off society by 2021 and a fully developed nation by 2049. Both of those dates were purposefully selected due to their importance in communist China’s history. The fact that China has a socialist market economy and is governed by a communist politburo is common knowledge. However, there are numerous distinctions between the U.S. economy and China’s that should not go unnoticed by U.S. investors.

A term such as “state-owned enterprise” (SOE), where the federal government is a whole or partial owner of various entities, is not often used in the United States, and that is because few of them exist domestically! While the U.S. Post Office is an example of an SOE in the United States, in China approximately 33% of all corporations are SOEs. By “enterprise” we are not referring to mom-and-pop boutiques or even small business manufacturing companies. SOEs in China include some of the largest corporations in the world. Case in point is China Construction Bank; if it was in the S&P 500 it would be the third largest bank based on market capitalization ($225 billion as of February 28, 2019). A list of the top shareholders includes China Investment Corporation at the top, owning more than 80% of shares; that is the sovereign wealth fund of the Chinese government. When we say President Xi will do “whatever it takes” to support the Chinese economy, it is because the state itself has significant skin in the game.

Furthermore, the aging demographics in China are well known to both investors and government leaders. We believe China’s technological push in artificial intelligence is just one method underway to alleviate the pressure associated with an aging population – the potential replacement of a shrinking workforce with automation and robotics, for example.

Furthermore, the Belt & Road Initiative is expected to support infrastructure and industrial production efforts for China in the years ahead. As the initiative is rolled out, it is expected to promote trade among China’s neighboring countries, with additional plans to expand into Africa and Europe (Chart 1).

“For the Good of It All....”

One area we believe could surprise to the upside in 2019 is Latin America. From an economic growth perspective, LatAm is the only region among both developed and emerging markets in which consensus expects GDP to accelerate from 2018 to 2019. 2018 was the year of federal-level elections in LatAm, and we believe 2019 should begin to see the effects of policy changes from those election outcomes. Mexican President Andrés Manuel López Obrador, commonly referred to by his initials AMLO, campaigned (“For the good of it all”) to stop a multibillion dollar project at the Mexico City airport, and while he is following through on his campaign platform promises, he has also shown an ability and willingness to compromise when practical. In Brazil, recently elected President Jair Bolsonaro is also expected to bring much-needed reforms to both the public and private sectors. According to the World Bank, Brazil ranks 109th out of 190 countries in terms of “ease [or lack thereof in this case] of doing business,” a low hurdle to clear.

Capital Market Assumptions

From an investment process lens, we have been and continue to be constructive on EM equities for the secular forces mentioned in the prior section, which is reinforced by our own business cycle analysis. The key distinction is time horizon: are we looking at secular or cyclical trends? These very long-term secular forces are likely to evolve over multiple business cycles.

Leading indicators such as PMI and industrial production data, while essential in traditional business cycle analysis (given their inherent high degree of cyclicality), have a fairly limited use for capturing broad, sweeping longer-term trends. Where these trends tend to be captured, however, is in our 10-year capital market projections. Thus, time horizon really matters, in our view.

Our recommended strategic allocations to EMs tend to be closer to benchmark weights (MSCI ACWI ex-US IMI) on average. While 2018 was a challenging year for EM equities affected by trade tensions, a weaker China, and dollar strength, these secular tailwinds still remain firmly in place, suggesting to us we could be due for a snap back in the not-too-distant future.

Our capital market projections continue to suggest a relatively more attractive return potential in both developed international and emerging markets than in domestic equities. EM is likely to be the primary beneficiary of persistent secular forces, which in our view should be a sustainable driver of forward returns. Developed international equities’ return prospects are being driven more by a valuation discount story, perpetuated by a decade of underperformance versus U.S equities. A laundry list of macro headwinds facing developed international equities has made them cheaper for a reason in recent years, but over the longer term we believe the asset class will revert to more historical valuation levels relative to other asset classes, namely those in the United States. Over long horizons, we believe EM equities have the potential to outperform most other equity asset classes on a risk-adjusted return basis. In Table 4 (page 5) we compare a few select asset classes and our 10-year capital market return/volatility assumptions and calculate their Sharpe ratios.
Merits and Risks of the Asset Class

In Table 5, we highlight what we believe are the key merits and risks of investing in EM equities as an asset class. EMs have historically served as a diversifier for U.S. equity investors, and the bullish thesis is relatively straightforward: long-run economic growth is expected to remain higher for longer compared to developed markets. Secular and demographic trends remain in favor of EMs, and we believe valuations (see next section) make for an increasingly attractive entry point.

The Tactical View

So why are we beginning to warm up to EM equities? In short, a more constructive cyclical backdrop appears to be developing in the form of apparent progress between the United States and China on trade, signs of an acceleration in Chinese credit growth, and a stabilization in EM currencies. In combination, we think these favorable developments could lead to a spring thaw and ultimately a re-rating of EM equity valuations in the form of relative outperformance versus developed market equity asset classes.

The only caveat we introduce before presenting our analysis is we believe it is possible that over the next few months EM equities will remain volatile. For now, it appears as if the earnings contraction in EMs will deepen, and that could serve as a governor on share prices. However, as we demonstrate below, evidence of an improvement in China’s credit cycle indicates a trough in EM earnings later in 2019.

Business Cycle Framework

The first and perhaps most important component of our overarching investment process is the analysis we perform on the business cycle given its strong influence over tactical (one- to two-year) investment performance. It is indeed the first leg of the proverbial three-legged stool. Based on examining what stage of the business cycle we are in, the attractiveness of different parts of the investable universe become more apparent. To get a better sense of the cyclical backdrop, in this section we examine:

- Chinese credit growth and stimulus measures;
- the global interest rate outlook;
- trajectory of the dollar;
- ongoing trade negotiations; and
- commodity prices.

Table 5

<table>
<thead>
<tr>
<th>Key Merits and Risks of Investing in EMs as an Asset Class</th>
<th>Merits</th>
<th>Risks</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Merits</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Global diversification/exposure</td>
<td>Currency translation for U.S.-based investors</td>
<td></td>
</tr>
<tr>
<td>Potential for faster long-run growth profile compared to developed markets</td>
<td>Unstable/volatile governments and/or political unrest</td>
<td></td>
</tr>
<tr>
<td>Key beneficiary of secular growth trends: internet disruption, health care innovation, energy efficiency, paperless payments, and emerging middle class</td>
<td>Economic risks: high inflation/deflation, unregulated markets, and unsound monetary policies</td>
<td></td>
</tr>
<tr>
<td>Valuation discount to developed market equities</td>
<td>Commodity price sensitivity</td>
<td></td>
</tr>
<tr>
<td>Greater upside capture in rising equity markets</td>
<td>Heterogeneous reward/risk potential</td>
<td></td>
</tr>
</tbody>
</table>

Source: PNC
Chinese Credit Growth

Given China’s sizeable weighting in the MSCI EM Index, we believe the cyclical outlook for EM equities is highly correlated to the Caixin China General Manufacturing PMI™, a gauge of mid and small business manufacturing activity in China (Chart 2).

In our view, the recent slowdown in China has been a material headwind to EM equity prices. Starting in 2016, China initiated a tightening of both monetary policy and bank/nonbank financial regulation. These policy changes helped constrain credit growth and, with somewhat of a lagged effect, have been a headwind for economic growth since late 2017. As shown in Chart 3, Chinese credit growth typically leads the country’s business cycle activity and economic growth by about nine months.

To combat this slowdown, policy makers have begun instituting additional stimulus measures since about mid-2018 – more than 70 separate actions as of this writing. President Xi’s economic reform agenda had been primarily aimed at targeting the material misallocation of capital and broad economic excesses within the Chinese economy; case in point, China’s debt-to-GDP ratio is estimated to have recently risen above 300% (compared to the U.S. debt-to-GDP ratio of slightly over 100%). Initially it did not seem as if policy makers were truly committed to abandoning that original plan in favor of “doing whatever it takes” to stimulate growth. However, recent loan growth data provide evidence that China’s credit cycle is bottoming, suggesting to us that President Xi has decided to pause growth-impeding efforts to deleverage and rebalance China’s economy. February credit data from China were lackluster after a blowout January, but the average credit growth rate from December through February still implies Chinese stimulus is at the very least on its way to producing a modest upturn in the credit cycle (Chart 4, page 7).

This is good for the stability of global growth. Of course, stimulus efforts do not take effect overnight, nor do they play out in a straight line trajectory. This is an indicator we will continue to monitor closely for signs of an upturn, but even a stabilization at these levels in credit would be supportive of a softer-than-expected landing in economic growth and welcomed news for EM equities.

Given the lagged effects, it should come as no surprise that economic data from China continue to look weak despite the recent credit expansion. Also, we believe the equity market has been discounting (that is, pricing in) China’s weakening economy for some time, and downside risks appear to be greatly reduced. For example, China’s official manufacturing PMI fell to 49.2 in February, the lowest level in...
three years and third straight month of contraction. In response, the Shanghai Composite fell only 0.4%.

We will need to see additional follow-through to build greater conviction that China’s stimulus efforts are indeed leading to materially higher credit growth that would be enough to reaccelerate economic growth and support earnings (Chart 5). Nevertheless, we view this as early evidence that stimulus has been large enough and targeted in appropriate areas of the economy.

The bottom-line is accelerating Chinese credit growth should be supportive of not only better growth prospects in China itself but also global economic growth and ultimately equity markets, given the fairly high correlations as shown in Chart 6.

**U.S. Interest Rates**

Because EM countries generally run current account deficits (that is, import more goods and services than they export), these countries must also rely fairly heavily on foreign capital inflows to help fund those deficits. These countries offer substantially higher interest rates than typically found in the developed world to compensate for taking on increased investment risk. When short-term U.S. interest rates were very low, the so-called “carry trade” (the practice of investors borrowing cheap U.S. capital and investing it in these higher-yielding countries) was strong underlying support for EM economies. However, rising U.S. interest rates have more recently started to put pressure on EMs and their currencies. We saw this phenomenon start to play out in a more material way in mid-2018 with the severe declines in the Turkish lira and Brazilian real.

In 2017, the relatively weaker dollar helped EM economies. However, as the interest rate differential between the dollar and EM currencies narrowed, EMs became relatively less attractive, discouraging many investors from taking on the additional investment risks. The sharp uptick in EM currency volatility led to meaningful capital outflows. With the Fed now signaling an extended pause in rate hikes, we believe the rising U.S. interest rate headwind EM countries faced in 2018 may be starting to abate.

**U.S. Dollar**

Since 2004, the correlation between EM equities and the dollar (USD) Index has been −0.62. Dollar strength has been a headwind for EM equities, particularly
in 2018, with the dollar up 7.9% year over year as opposed to down 7.5% in 2017. The PNC Economics team expects the dollar to stabilize if not weaken, with larger U.S. fiscal deficits, slowing U.S. economic/earnings growth, and the end of the Fed’s rate hike cycle taking some wind out of the dollar’s sails.

The flip side of this is the potential for EM currency strength. With a number of significant elections in EMs over the course of 2018, a backdrop of political uncertainty remained quite high. With a much lighter election calendar in 2019, we would expect to see greater political stability, which should be supportive of stable if not strengthening EM currencies. After a short period of redemptions, capital flows have also started to return to EMs, which we would expect to continue should this more favorable currency backdrop hold.

**U.S.-China Trade Negotiations Improving**

After tough sledding during most of 2018, the headlines are finally starting to improve around U.S.-China trade negotiations. In our view, both sides appear motivated to reach an agreement. However, a key question remains: what does “success” or a “win” actually look like? Mid-level talks have been well received this year. Reports suggest the next round of tariffs could be delayed if progress on trade talks continues. At the time of this writing, there have been reports of an agreement around currency controls, though no details have been disclosed. While the United States and China have yet to find common ground on key structural issues such as intellectual property and forced technology transfers, updates regarding the collaboration have been mostly upbeat, and EM equities in general have started to breathe a sigh of relief.

**Energy/Commodity Prices**

The composition of the MSCI EM Index has evolved quite a bit over the course of this cycle, making actual exposure to commodity-linked sectors a much smaller proportion than in previous business cycles. That said, we are still mindful of the trajectory of commodity prices as both a key supply chain input and an exported good. As the exposure to the sector has fallen over time so has the correlation, which is now just 0.45 for Brent crude and the EM equity index. After the significant swoon in commodity prices since early October 2018 (West Texas Intermediate -33%), we have seen a sharp rebound to date in 2019 (mid-March).

The PNC Economics team expects some additional strength from here, but the base-case view is more of a stabilization than a return to prior highs. Although production agreements from both OPEC and non-OPEC countries have had a small impact on global supply, those cuts continue to be more than offset by expanding U.S. shale oil production. We do not expect commodity price strength to be a key driver of EM equity performance, but a likely stabilization in oil prices would certainly be supportive at current levels, in our view.

As discussed in the next section, we think the valuation story has become increasingly compelling, presenting an opportunity to capture additional exposure to these cyclical and secular growth trends at a marked discount to other equity markets.

**Valuation Methodology**

The second component of our investment process (that is, the second leg of the stool) is an in-depth examination of global valuations. Once we have identified the current phase of the business cycle, our valuation work tells us about the long-term return potential of an asset class versus its own historical return profile and compared to other competing asset classes. Despite outperforming the S&P 500 in 4 of the last 10 years, the MSCI EM Index has lagged by nearly 500 basis points on an annualized basis for a decade (Table 6). What we found more interesting,
however, are the statistics on operating margins and return on equity (ROE), which are actually quite comparable to S&P 500 levels. Despite this, the MSCI EM Index still trades at a four multiple point discount on a forward price/earnings (P/E) basis.

Despite exhibiting a substantial relative valuation discount, the EM forward P/E multiple is slightly above its historical average on an absolute basis, as depicted by the blue line in Chart 7. However, this seems intuitive to us. Sectors with traditionally lower valuation multiples, such as Energy and Materials, have seen their weightings dramatically reduced in the EM Index, putting upward pressure on forward earnings multiples simply due to index composition shifts over time. Therein lies the challenge of valuing EM equities on a relative or historical basis – making apples-to-apples comparisons can be difficult. Thus, we look at valuations from multiple (pun intended) lenses: forward earnings, trailing earnings, and trailing sales per share.

From a trailing earnings multiple perspective, the EM Index is below its historical average and, like the forward P/E, is below both the S&P 500 and the MSCI World ex-US Index (Chart 8).

On a price/sales perspective, the multiple is in line with its longer-term average but well below the S&P 500 on an absolute basis (Chart 9). Although valuations are not a particularly useful short-term indicator or timing tool, on an absolute basis EM equities remain more attractively priced compared to both the S&P 500 and MSCI World ex-US Index.

Technical Analysis

The third leg of our investment process “stool” focuses on technical analysis. In our view, it helps forecast the direction of security prices through a study of past market trends. There is a distinction between market timing and using technical analysis for the appropriate time to move in or out of an investment (that is, when is the right time to not fight the market on entry). An investment opportunity could look attractive based on business cycle and valuation analysis for a long time, but it could be so-called “dead money” if the market is directionally working against it. In other words, technical analysis may be able to highlight periods of adverse momentum. The technicals help us identify what those forces might be and if the tide might be turning.
Although the technical backdrop for the MSCI EM Index had been looking quite weak, particularly over the latter half of 2018, we have started to see a stabilization and perhaps the early innings of a sustainable rally. The index pushed through the 200-day moving average in early 2019 and has now become the new support level, suggesting to us a continuation of current trends is possible (Chart 10). Through mid-March, the index is up more than 10% year to date; however, it is still more than 10% below the highs reached all the way back in January 2018.

A Few Thoughts on Implementation

Selecting a benchmark can sometimes be a fairly straightforward task and, at other times, can become a more challenging exercise. In the case of publicly traded EM equities, we think the benchmarking decision is quite simple since the most widely accepted representation of the EM equity asset class is indeed the MSCI EM Index, which we have referenced and cited consistently throughout this paper.

However, EM as an asset class is neither homogeneous nor efficient. On a rolling three-year basis, at no time has the MSCI Emerging Markets Index ranked in the top quartile of the EM peer universe (Chart 11). Yet over the last 10 years the EM Index has beaten the S&P 500 roughly 40% of the time. In other words, the heterogeneous dynamics of the EM universe of stocks, coupled with relatively low correlation with the S&P 500, suggest to us EM active management not only has the potential to enhance diversification relative to the so-called “China complex” (combination of China, Taiwan, and Hong Kong) weighting of the index but also has shown the ability to generate meaningful alpha for investors.

Thus, our preferred method of accessing exposure to EM equities is not via an index tracker but rather through the use of a complementary pair of high active share, lower turnover, and fairly concentrated active managers. An example could be pairing an active EM equity manager that is overweight consumer and internet-based exposures with a manager focused on higher quality financials and commodity-based industries and companies. Taking it a step further would be looking for managers with experience in specific countries or regions rather than EM generalists.

For those investors interested in pursuing a Responsible Investing-oriented strategy in EM, there are both actively managed and passive solutions. For example, tracking the MSCI EM ESG Leaders Index could be an effective option. The index was created in 2007, and performance correlation with the EM Index is 0.989 over that time period.

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6 The MSCI EM ESG Leaders Index provides exposure to companies with high environmental, social and governance (ESG) performance relative to their sector peers. MSCI EM ESG Leaders Index consists of large- and mid-cap companies across the EM universe. The index is designed for investors seeking a broad, diversified sustainability benchmark with relatively low tracking error to the underlying equity market.
Green Shoots Forming on EM, not “Hedges”

In an international equity portfolio with exposure to a basket of currencies, some will likely have positive returns in local currency terms while others will be negative at times. In theory, this counterbalancing effect should result in currency exposures netting themselves out over time. In addition, currency returns are largely uncorrelated (or at least not strongly positively correlated) and, as such, tend to help an equity portfolio on the diversification front. Further, there is ample empirical evidence (cited by CFA® Institute and others) suggesting the standard deviation (that is, volatility) of currency is only about half the standard deviation of stock prices. This suggests to us that an unhedged currency exposure may actually help reduce an international equity portfolio’s volatility over time. As currencies also tend to revert to a theoretical fair value/mean over time, currency-related volatility/risk tends to fall or wash out, becoming a less critical component of equity risk. Thus, over the long term (that is, on a strategic basis) our preference is to be unhedged.

Conclusion

Due to the numerous short- and long-term catalysts, we believe EM equities are beginning to emerge from a period of what some investors may have mistaken for “hibernation.” In our view, a number of macroeconomic issues such as federal-level elections and trade tensions heightened business uncertainty across many EM countries in 2018. Therefore, we believe the proverbial EM grizzly bear was not “hibernating” and should once again emerge “roaring” with the potential for upside surprises.

Our longer-term view on EMs continues to be a belief in the demographics and societal improvements we expect can support a higher level of economic growth compared to developed markets. China specifically has been at the forefront of these changes, evolving from a heavy-industry and commodity-based economy to a consumer-driven source of global economic growth. We believe those market forces are just beginning to spring forward.

The universe of EM equities covers more than 80% of the world’s population across 24 countries; that is an incredible amount of “green shoots” potential from a large and growing middle class. Given the heterogeneous aspects of the EM universe, we prefer investments in actively managed solutions that can identify value-added pockets of opportunity.

Even though that mischievous Masha was continually creating problems for the Bear, it is imperative to understand they remained friends. We believe a strong EM makes for a stronger global economy and stronger long-term global equity market performance.

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Emerging from Hibernation: The Green Shoots of Emerging Markets

For definitions of indexes used in this publication, please refer to pnc.com/indexdefinitions.

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