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Market Ethos

The latest market insights from the Richardson Wealth team

Continued warming to emerging markets

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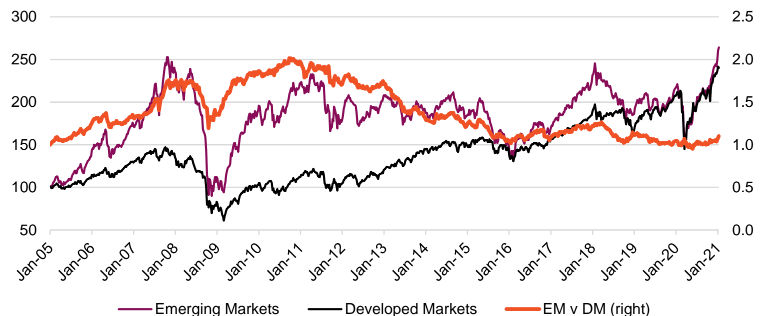
Over the past five months, we have become more constructive on emerging market (EM) exposure within portfolios. In our asset allocation service, we increased EM exposure in early September and again in early January. Now, for the record we are not alone in this opinion. Having read or at least perused many 2021 outlook reports, we note two of the most pervasive themes: the great rotation and EM. As natural-born contrarians, this certainly gives us pause, as does EM rising over the past few months to achieve all-time highs. So this Ethos is about EM, the basis for our positive view and why we are not worried about being among the herd.

Why we are more positive on EM

This pandemic-induced unique global recession, along with previously unimaginable stimulus, created a near perfect environment for growth stocks. Low yields helped as did the fact that these growth stocks were less economically sensitive. However, trees don't grow to the sky and there is a rotation afoot back to value that appears to have started in September. As the global economy continues to recover, thanks to the vaccine rollout and the economy simply adjusting to a pandemic mode, this perfect environment for growth appears to be ending and tilting more in favour of value.

You can find small pockets of value in the U.S. equity market. The pockets are bigger in Canada and Europe. But perhaps the biggest source of value is in EM. Combine this with a near decade of underperformance versus developed markets (DM), the mean reversion argument holds either on a style basis or an EM versus DM basis.

Chart 1: Both emerging markets (EM) and developed markets (DM) are at all time highs. But EM has underperformed for about a decade



Past reports

Lessons learned from 2020 Top 8 of 2020 Golden pause Who will pick up the tab Great Rotation Sweet Gridlock Earnings Dance Active vs Passive

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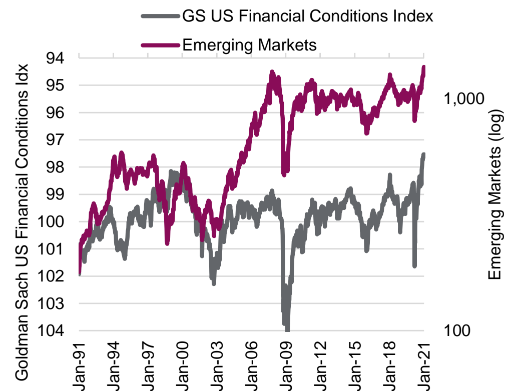
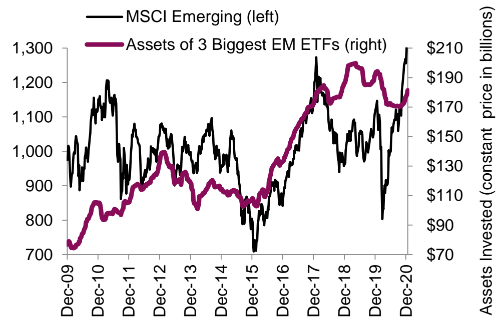
It seems everything is relative. Yes, EM have just reached an all-time high – the previous record was set in early 2008 – but DM have been hitting new highs for years. If a reversal back to favouring EM is coming, this too could last years. There is also a strong relative relationship between EM and U.S. financial conditions. When conditions are tight, there tends to be fewer financial inflow into EM. When conditions are good, or loose, money is easier to come by, including within EM. The Goldman Sachs U.S. Financial Conditions index has a long history of being negatively correlated to the price behaviour of EM. When the financial conditions index is rising (tighter), EM struggles. When conditions are easy, EM does well (**Chart 2** – note the financial conditions index is reversed). Based on comments by the U.S. Federal Reserve, among other central banks, financial conditions should remain rather easy for some time. This is positive for EM.

Chart 2: EM has a -0.7 correlation to U.S. Financial Conditions



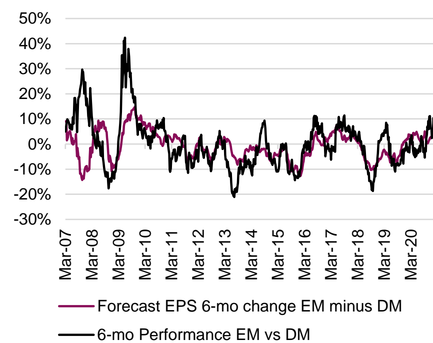
Despite increased exposure to EM being one of the most popular strategies outlined in 2021 outlook reports, flows into EM ETFs have barely budged (**Chart 3**). Measuring the three biggest EM ETFs, investor outflows were the norm in 2019 and 2020 and have only just started to reverse back to inflows. Given the price gains, we would expect flows to increase. The key with money flows into asset classes, sectors or anything really, is to be early, before the flows accelerate. Just like pumpkin futures, you have to sell before Halloween!

Chart 3: ETF flows have been negative for 2 years, but strong EM price gains will likely see flows coming back



If you agree that global growth is on the mend, this should lead to faster earnings growth in EM relative to DM. EM is simply more sensitive to the ebbs and flows of the global economy than DM. During periods that see EM earnings grow faster than DM, EM tends to perform better as well (**Chart 4**).

Chart 4: Relative earnings growth is correlated to relative performance in EM vs DM



Investment implications

We have not even touched on the secular arguments for EM such as better growth prospects, demographic advantages, etc. But after having limited or no exposure to EM for years, we have pivoted over the past few months to become more positive. The space certainly has challenges, not the least of which is that the global economy is struggling to come out of the recession and the path forward is certainly not clear. Still, with many of the historical drivers favouring emerging over developed markets, some EM exposure does seem prudent.

Source: Charts are sourced to Bloomberg L.P. and Richardson Wealth unless otherwise noted.

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