Investment Insights

Boosting Emerging Markets Exposure to Neutral on Improved Outlook

Holly MacDonald
Chief Investment Strategist

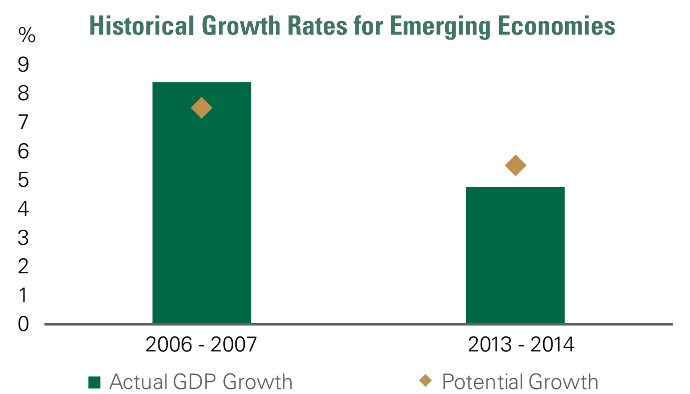
Highlights

- In recent weeks, the investment team has moved to close a longstanding underweight position in Emerging Markets (EM) and are now neutral in a Balanced Growth portfolio
- Our view of a brighter outlook for EM is based on a more stable U.S. dollar, improving trade prospects, more balanced sentiment towards China, and policy reform in certain countries
- Our portfolios are not moving to an overweight position mainly due to 2016-specific risks (U.S. elections, Brexit potential) and our belief that we are moving into the later stages of the economic cycle

Since 2013, Bessemer's Balanced Growth portfolio (reflecting a 70% global equity, 30% U.S. fixed income risk profile) has held an underweight allocation to Emerging Markets (EM) across equities, fixed income, and currencies. In recent weeks, the mandates have moved to close that underweight, and Balanced Growth now holds a neutral EM allocation across asset classes.

There were numerous drivers behind the decision to be underweight to Emerging Markets in recent years. A period of weaker commodity prices alongside slower economic growth in China put a dent in the growth prospects for many China-focused and/or commodity-exporting emerging markets countries. Indeed, both actual and potential emerging-market GDP slowed materially in recent years. According to the International Monetary Fund, potential growth in emerging economies declined from about 7.5% in the pre-crisis period (2006-2007) to about 5.5% during 2013-2014; actual GDP declined from 8.4% to only about 4.8% over the same period (Exhibit 1).

Exhibit 1: Emerging market economies ran below potential growth in recent years



Source: International Monetary Fund

Recent years have also seen a strengthening U.S. dollar (USD) translate into weakness for emerging-market currencies. Since April 2011, an EM currency basket[1] has weakened by 38% versus USD (through mid-March). For U.S. investors who view returns in dollar terms, this is a direct hit for EM equity and local debt holdings. (We would note that the strong dollar also hurts emerging debt even when denominated in U.S. dollars, given the mounting concerns about various countries' and companies' ability to pay back that debt with local currencies depreciating.)

[1]Represents the JP Morgan Emerging Market Currency Index (EMCI) live spot through March 25, 2016.

These external headwinds — commodity prices, China, and the dollar — have coincided with internal challenges as well. Brazil, for instance, has faced a massive corruption probe in the middle of its deepest recession in decades. Economic sanctions in Russia have complicated a weak commodity environment. Chinese policy makers have been experimenting with new economic and financial models against a more vulnerable growth backdrop. There has been better news from India, where new political and central-bank leadership has raised policy hopes, but the strong dollar has made it difficult for U.S. investors to capitalize on likely (or, in some cases, actual) structural reform.

In the *Quarterly Investment Perspectives* published in December 2015, we discussed emerging markets in detail, both as they pertain to our global macro views and as investment vehicles in and of themselves. In that report, we reiterated our underweight stance but detailed the factors that might make us change our view. Since then, we believe we have seen enough progress on at least a few key fronts to warrant closing the underweight to a neutral allocation. Below we discuss those "EM markers" in more detail and what has transpired this quarter.

1. **A more-gradual-than-expected U.S. Fed and a weaker dollar, making emerging market equities, bonds and currencies more attractive.**

Market volatility so far this year, alongside mixed U.S. data, has triggered a more dovish tone from the Federal Reserve. The Fed's own median forecast has shifted to two interest-rate hikes by end-2016 versus four hikes predicated at the beginning of the year. Market expectations for U.S. yields have similarly eased. This shift in tone from the Fed suggests that real interest rates (which is what is most important from a currency perspective) are unlikely to meaningfully drive the dollar higher (please see our recent *Investment Insights: Coordinated Currency Policy is Back*, for more detail on our dollar view). A more stable U.S. dollar, all else equal, suggests less of a drag on emerging market performance. In light of the higher interest rates in emerging countries (5.7% on a GDP-weighted basis versus 0.3% for developed markets), investors actually pay a cost to be underweight EM currencies. In other words, in range-bound markets, there is a natural pull for investors to own emerging currencies to benefit from the higher interest rates.

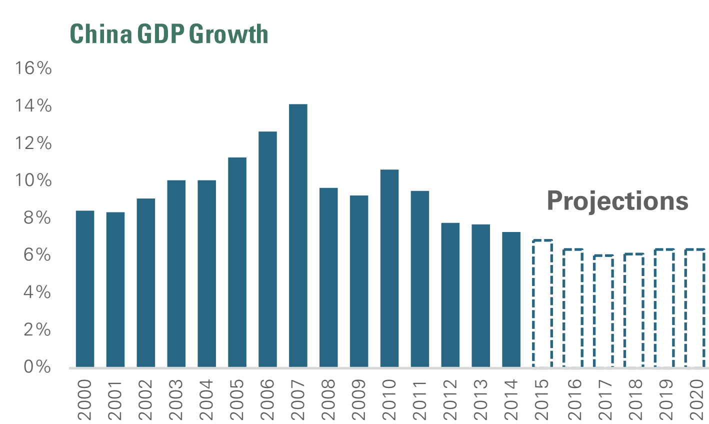
2. **Notably stronger growth from major developed markets that leads to greater export demand for EM producers.**

Developed-market (DM) growth still leaves much to be desired, but even now, EM is starting to get a modest trade lift, helped in particular by cheaper currencies that make exports more competitive. Specifically, a modest acceleration in EM export growth alongside a decline in import growth has added approximately 0.75% to GDP in the fourth quarter of 2015. This was the result of both an increase in DM income growth, as well as a depreciation of emerging market currencies, supporting DM imports from EM. Looking forward, we expect growth in Europe and the U.S. to hold steady or improve further (in the U.S. as manufacturing and energy headwinds begin to ease), suggesting improving prospects for EM growth via trade channels.

3. **A stronger-than-expected Chinese economy that helps commodity price sentiment and major trade partners.**

We acknowledge that Chinese economic growth is likely to continue to structurally slow (Exhibit 2). Important for our view here, though, is what appears to be a greater policymaker emphasis this year on managing the pace

Exhibit 2: Slowing Growth in China Likely to Continue



Dashed bars represent IMF staff projections.

Source: International Monetary Fund

of the slowdown to ensure social and political stability. China has taken a number of steps already this quarter to stimulate growth including interest rate cuts and fiscal stimulus. In addition, officials have repeatedly stated that they will avoid a potentially disruptive currency devaluation.

We continue to see meaningful two-way risk around China over the long term (we are frankly unsure if China can manage its economic and financial transitions without any major disruptions along the way; please see our *Quarterly Investment Perspective: China's Growing Pains* from October 2015 for more detail). However, at least over the coming quarters, we think China's slowing will occur in line with what is already discounted in market valuations. At the margin, we believe that relatively more stable sentiment towards China will remove a headwind from commodity prices, as well as emerging markets more broadly.

4. **Political and/or policy reform within emerging countries that, alongside valuations, boosts sentiment around growth prospects (as could prove the case during the coming months in Argentina).**

There have been important improvements within the emerging market complex this year. Argentina and Mexico are clear examples: Argentine President Mauricio Macri has followed through with market-friendly reforms (most notably settling claims with holdouts after a 15-year dispute over local government debt, but also devaluing the currency, reporting accurate economic statistics, and hiring credible policy makers). Mexico, meanwhile, has come through with more credible fiscal-, currency-, and monetary-policy plans. India, Indonesia, and other EM Asian countries have generally remained clean stories as well: through a combination of fiscal discipline and lower oil prices, India has shrunk its "twin deficits" (current account and trade balances), providing leeway for more supportive monetary policy, while Indonesian President Jokowi has led a more pro-business policy shift that has opened the economy to foreign investment and trade and helped stabilize the country's capital account. Brazil remains complicated, with political turmoil and recessionary conditions ongoing, but a change in government appears increasingly likely this year, which could set the stage for a period of relative outperformance. There still are challenges at the country level, as there likely will always be, but we see improvement consistent with a shift to a neutral EM allocation.

At this stage, emerging markets have underperformed for four of the last five years and look relatively more attractive on a number of metrics. For example, EM equity valuations have been running below their 10-year averages on a price-to-equity, price-to-book, and price-to-cash-flow basis, and emerging market currencies in aggregate are still trading around the lowest levels in six years. Valuation, alongside improving trends in the factors noted above, give us confidence that a neutral EM allocation will benefit portfolios in the quarters ahead.

Why not overweight? Two main reasons, one tactical and one longer-term. We are cognizant that 2016 faces some large potential risk events, such as the U.S. election and the U.K. vote on European Union membership (known as "Brexit"). Both could impact emerging markets indirectly, via a possibly stronger dollar and a deterioration in risk appetite. Looking further out, we believe we are in the later stages of the U.S. economic cycle, which in our view warrants a relatively more careful approach to risk. Historically, the later stages of the economic cycle have seen somewhat higher inflation and commodity prices, which often benefit emerging markets. At the same time, the later stages of expansion also often bring more volatility. With all these issues in mind, the investment team would be reluctant to be overweight emerging markets and prefer to hold EM exposure mainly via large-capitalization equities, which we expect to be more stable than smaller-cap equities.

We also believe that emerging markets should be approached not as a homogeneous group but rather as country- and security-specific opportunities. The Large Cap Strategies equity mandate uses Harding Loevner to actively invest in large-cap emerging stocks for client portfolios.

Following this shift, a 70/30 portfolio maintains an overweight to the U.S. but is now neutral Japan and Europe (from overweight earlier this year). We are continually monitoring global developments and will keep clients apprised of future developments and portfolio shifts.

Our Recent Insights

Coordinated Currency Policy is Back — Investment Insights (March 2016)

Will Negative Interest Rates Come to the U.S.? (March 2016, **Video Available**)

A Briefing on Brexit — Evaluating the Risks of the U.K. Leaving the EU — A Closer Look (March 2016)

Thinking About Corrections — Investment Insights (February 2016, **Video Available**)

Navigating Underfunded Pensions — Investment Insights (February 2016)

Addressing Recent Market Weakness — Investment Insights (January 2016, Video Available)

Inflation Checkpoint — Investment Insights (January 2016)

Managed Volatility Equities — Q&A — Investment Insights (January 2016)

To view these and other recent insights, please visit www.bessemer.com.

About Bessemer Trust

Privately owned and independent, Bessemer Trust is a multifamily office that has served individuals and families of substantial wealth for more than 100 years. Through comprehensive investment management, wealth planning, and family office services, we help clients achieve peace of mind for generations.