Emerging markets are cheap

Hilliard MacBeth

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Emerging markets equities have underperformed global markets in 2018 and over the last decade. Especially compared to U.S. markets, emerging markets look relatively attractive on a valuation basis.

Emerging markets are going to outperform developed markets like the U.S. at some point.

Is it time to dip a toe into the murky waters of emerging market equities?

The U.S. stock market continues to outperform and represents more than 50% of the value of all listed stock market companies on the planet. But the U.S. population is only about 5% of the world total and U.S. GDP is about 20% of world economic activity.

Relative to emerging markets, U.S. companies are more expensive than emerging market equities. This is probably because investors feel that U.S. markets are safer than other markets and due to a desire to hold U.S. dollars.

So, if it can be shown that an unusually high level of fear has depressed emerging markets to an extreme, it could be a good time to invest in emerging markets.

However, in times of crisis, most investors run for cover by returning to their home base. They also look for safety in U.S. dollar markets. A crisis can trigger a massive sell-off in emerging market equities as in the Asian crisis of 1997 when the Thailand baht collapsed overnight. Foreign debts were too large for many Asian countries when foreign investors tried to remove their investments. Emerging market countries learned a lesson from that crisis and now maintain much higher reserves to prevent such a panic.

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MSCI Emerging Markets: 1994-2018

Market Environment	Dates	Drawdown
Bear	Sept 1994 - Mar 1995	-32.6%
Correction	Jul 1995 - Nov 1995	-14.3%
Bear	July 1997 - Jan 1998	-38.2%
Bear	Mar 1998 - Sept 1998	-46.4%
Bear	Mar 2000 - Sept 2001	-53.7%
Bear	April 2002 - Oct 2002	-30.0%
Correction	Jan 2003 - Mar 2003	-12.4%
Bear	April 2004 - May 2004	-20.4%
Correction	Feb 2005 - April 2005	-10.6%
Bear	May 2006 - June 2006	-24.5%
Correction	Feb 2007 - March 2007	-10.6%
Correction	July 2007 - August 2007	-17.7%
Bear	Oct 2007 - Oct 2008	-66.1%
Bear	Nov 2008	-23.0%
Bear	Jan 2009 - Mar 2009	-21.8%
Correction	April 2010 - May 2010	-18.3%
Bear	May 2011 - Oct 2011	-31.1%
Correction	Oct 2011 - Nov 2011	-13.1%
Correction	Mar 2012 - June 2012	-18.3%
Correction	Jan 2013 - June 2013	-18.4%
Correction	Oct 2013 - Feb 2014	-12.3%
Correction	Sept 2014 - Dec 2014	-17.3%
Bear	April 2015 - Jan 2016	-35.5%
Bear	Jan 2018 - Aug 2018	-19.7%

Bear Markets defined as 20% peak-to-trough losses

Corrections defined as double digit losses not exceeding 20%

Price index only; no dividends included

Sources: MSCI via Ben Carlson

Fund manager Blackrock offers an ETF called iShares MSCI Emerging Markets ETF (symbol EEM) that holds a basket of many companies and countries. The price of this ETF (US dollars) is used as an indicator of emerging markets, and is trading this week at $43, less than double the low in 2009 of about $25.

The top four holdings in EEM are Tencent, Alibaba, Samsung and Taiwan Semiconductor. Of the ten largest, China-based companies hold six spots.

EEM is trading at relatively inexpensive valuations today, probably due to uncertainty over global trade.

When uncertainty over global trade increases, emerging markets are among the first to get hit. The largest emerging markets are dependent on exports. Trade represents about 10% of U.S. economic activity while China's trade is 37% of GDP.

China, Korea and Taiwan make up more than 55% of the EEM fund. The standard deviation of returns (a measure of volatility) on EEM is 16% while the S&P 500 is 10%. The ten-year average annual return of the S&P 500 is above 5% while the EEM is a paltry 1.58%.

The price-to-earnings ratio of EEM is about 12.67 compared to 23.66 for the S&P 500.

Emerging markets are much cheaper than U.S. markets but is it a good time to buy?

Trade war anxieties are the most important factor for the short term in deciding to buy emerging markets. The trade war is driven by U.S. actions and a U.S. President who believes that winning trade wars is easy. But, if the U.S. abandons its trade war efforts at some point, we might look back on this as a wonderful time to buy.

But what about the timing of the next recession? The time since the last recession is very long and the consensus is that the U.S. economy will endure a recession in 2019 or 2020. Recessions and bear markets often go together.

How would emerging markets perform in the next bear market? It would be normal for emerging markets to do worse than U.S. markets, but the wide valuation gap in favour of emerging markets could make for an exception.

Given the superior growth outlook for emerging market countries and the much cheaper valuations it might be worth buying now. Or, for those who want to time it perfectly, waiting for the next bear market could pay off.

Since market timing is so difficult it could be sensible to dip a toe into the emerging markets now with the plan of adding exposure when the markets correct.

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