

Emerging Markets: Time to stay invested or pull back?

"If we want things to stay as they are, things will have to change."

Giuseppe Tomasi di Lampedusa, *The Leopard*¹

The recent turmoil in global financial markets was caused by a number of market events and systemic factors. A top contender is China, with its recent monetary adjustments and freefalling market values. But so too are Emerging Markets in general, due to their existing structural limitations. What follows is an attempt to separate what we already knew, what we didn't know, and what we should know about Emerging Markets economies and their outlook, as well as some insights on how quantitative strategies can effectively capture return dynamics in the current market environment.

Is there a crisis in Emerging Markets?

We believe the answer is clearly "no." One accepted set of criteria for an event to be considered a "crisis" is that severe disruptions in the workings of financial markets are present, and extraordinary intervention from governments is required to restore order and confidence.² We believe recent events do not qualify as a severe disruption, both because the current volatility has been within historical levels of what is considered normal, and because the volatility has been in response to monetary and regulatory actions taken by certain countries (like China) that are utilizing policy tools at their disposal in the pursuit of welfare-enhancing policies.

What is going on in Emerging Markets then if this is not a crisis?

We would make the case that instead of acute crisis, Emerging Markets are suffering from a number of well-known and documented chronic ailments. Simply put, most Emerging Markets are still in the process of introducing necessary (and

painful) structural reforms to continue growing at rates above those of their developed counterparts. Most Emerging Markets countries—such as China, Brazil, Mexico, Turkey, South Africa, Russia—have already reaped the initial benefits from opening their economies.

Next steps are more difficult because they typically involve strengthening local institutions and regulatory frameworks to provide stability and security to local and international investors. In certain cases, like Brazil, this important stage involves painful fiscal measures that the current government is unwilling or powerless to enact.

How could countries like China and Brazil go from success stories to cautionary tales in just a few years?

Let's look at Brazil because it embodies a lot of what investors are worried about. We believe Brazil's economy, which expanded at 7.6% in 2010, will contract by at least 2% in 2015. A trade surplus of \$20 billion in 2010 has become a deficit of \$40 billion in the 12 months ending July 2015. Job creation of 2 million in 2010 is now job destruction at a pace of approximately 150,000 each month.³

Many of these problems originated in housing and social programs undertaken in the second half of the 2000s that proved popular, but expensive. These programs were relatively easy to fund when the economy was growing above 5%, yet crippling at current growth rates. Growth rates for commodity-exporting countries like Brazil have decreased dramatically because the main customer for countries relying on export-driven models is China. Add a decrease in credit-fueled consumer demand to this reduced demand for commodities—and more recently an exodus of foreign capital—and you have a textbook recipe for currency depreciation. These facts are at the center of the reasoning of many analysts like the widely quoted Chief Economic Adviser at Allianz Asset Management Mohamed A. El-Erian who has recently claimed "the growth models are challenged overall and exhausted in some countries. It is not just that Emerging Market growth has slowed ... the weakness in Emerging Markets disrupts the economies of the west and makes its challenges harder to face."⁴

¹Translated by Archibald Colquhoun (London: Pantheon Books, 1960), p. 111.

²A 2013 IMF Working Paper by Stijn Claessens and M. Ayhan Kose defines financial crises as shocks that "can have domestic or external origins, and stem from private or public sectors. They come in different shapes and sizes, evolve over time into different forms, and can rapidly spread across borders. They often require immediate and comprehensive policy responses, call for major changes in financial sector and fiscal policies, and can necessitate global coordination of policies."

³Source: Brazil Labor Ministry; 2015.

⁴Kynge, James and Jonathan Wheatley, "Emerging Markets: Fixing a broken model," Financial Times; August 31, 2015.

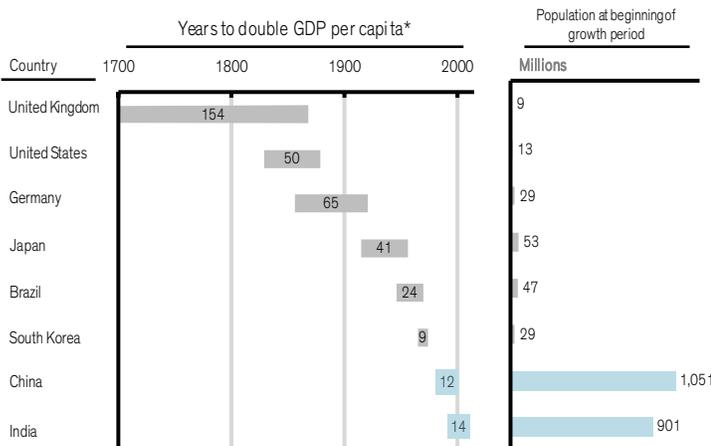
But, what is happening in China?

China has been flexing its policy muscles. The August decision to allow more flexibility in its currency is a positive one because it forced the recognition of multiple economic realities that have been chronicled in-depth already by most sell-side analysts. But China has much still going for it, as outlined in the following three points.

The first two points pertain to the economic potential that remains in China. Figure 1 illustrates the speed at which the Chinese economy has been growing recently. It took China just 12 years to double its GDP per capita from \$1,500 to \$3,000 a few years ago with a population of 1 billion. For comparison, that same achievement took the UK 154 years during the Industrial Revolution with a population of 9 million. Figure 2 shows the gap in GDP per capita (as a percentage of the US level) between developed European economies (UK), developed and quasi-developed Asian economies (Japan, South Korea), and up-and-coming economies like China and India, suggesting plenty of runway remains for further Chinese growth.

For the rapid pace of growth to continue in countries like India and China, certain conditions will have to be met. These conditions include, in the case of China, i) a smooth transition from investment to consumption-driven growth, ii) an orderly opening of their capital account via increased access to foreign capital as well as domestic capital being able to move abroad, iii) a soft landing of financial indicators like exchange rate and stock market values.

Figure 1.
CHINA'S FAST-TRACK GROWTH



*Time to increase GDP per capita based on purchasing power parity from \$1,500 to \$3,000.

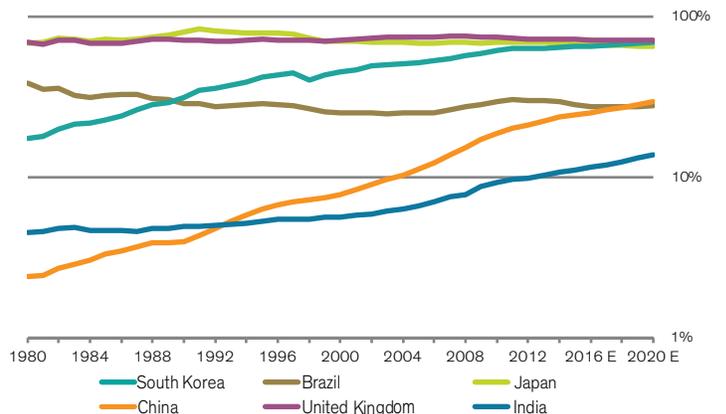
As of January 2013.

Source: The Maddison-Project,⁵ QMA. For informational purposes only.

Figure 2.

EMERGING MARKETS GROWTH STILL HAS A WAY TO GO

GDP per Capita Based on Purchasing Power Parity (As a % of US Level)



As of April 14, 2015.

Source: QMA, International Monetary Fund. For informational purposes only. There is no guarantee these forecasts will be achieved.

The third point focuses on the large pools of money outside China waiting to get in, as well as the money inside China waiting to get out. We believe the former will be good for asset prices, while the latter will be good for market efficiency and the internal allocation of resources. The inbound cross-border schemes as of the first half of 2015 stand at \$76 billion for the Qualified Foreign Institutional Investor (QFII) program, \$63 billion for Renminbi Qualified Foreign Institutional Investor (RQFII), and \$26 billion for the Connect program. By 2020, we believe these will likely grow to \$750 billion (QFII), \$620 billion (RQFII), and \$450 billion (the Connect program) – while access to Chinese markets will likely total \$2 trillion vs. about \$150 billion today. Another way to look at this potential is that more investment funds will likely move in and out of China in 2016 than in the previous six years combined as part of a well-orchestrated effort by Chinese authorities to gradually open their capital account.

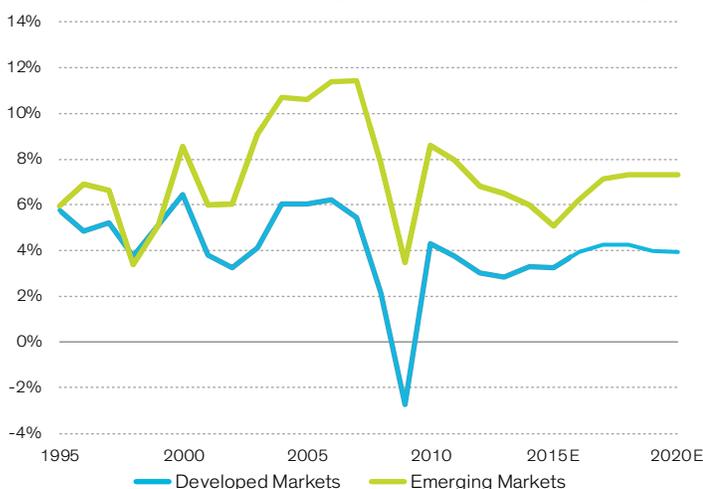
Should we pull back from Emerging Markets?

Quick answer: No. Even at a reduced target of 5% GDP growth among Emerging Markets, this is above the target growth of developed economies by over 2%, as shown in Figure 3. But moving forward, *we believe differentiation will become increasingly the focus among emerging economies*. Simply put, the Emerging Markets label, while convenient to group these countries, may no longer define large commonalities among them. Because of this newly improved opportunity set, we recommend a sector-based approach to capture the opportunities generated by increased differentiation.

To illustrate the need for differentiation among Emerging Markets, Figure 4 shows the breakdown in GDP growth between manufacturing and commodity-oriented emerging economies from 1995 through 2015 estimate. Commodity producers suffered the largest drop in growth, and their currencies depreciated the most against the US dollar. As we can see, not all emerging economies are equal and we believe investors can be rewarded by doing their homework.

⁵ The Maddison-Project (<http://www.ggd.net/maddison/maddison-project/home.htm>), 2013 version.

Figure 3.
EMERGING GROWTH CONTINUES TO OUTPACE DEVELOPED
GDP Growth Based on Purchasing Power Parity (Annual % Change)



As of April 14, 2015.
Source: QMA, International Monetary Fund. For informational purposes only.
There is no guarantee these forecasts will be achieved.

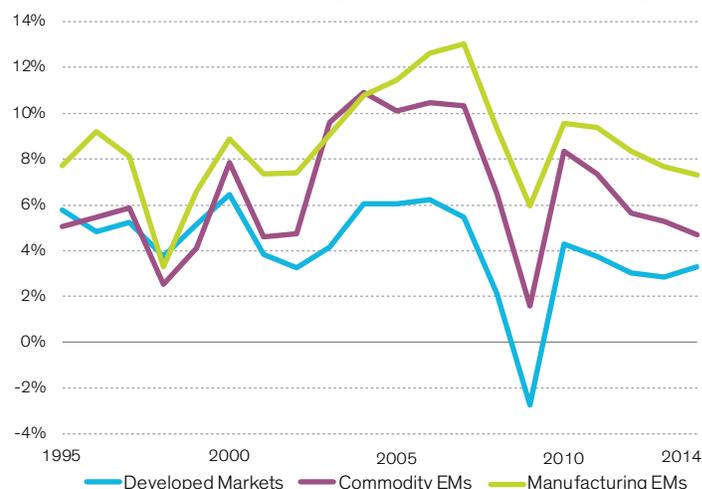
What does this mean for quant equity investors in Emerging Markets?

We believe the new regime represents a great opportunity for quant investors, and those with sector-based approaches should benefit in particular from the differentiation across countries. To understand why, remember that there are ten GICS® sectors and 23 countries in the MSCI Emerging Markets Index and thus the average sector bucket contains more stocks than the average country bucket. Add to these bigger sector buckets the greater dispersion in country returns resulting from greater differentiation and the results are sectors buckets with more constituents (we believe higher breadth is always good for quant investors). Further, greater cross-sectional dispersion of returns provide a richer opportunity set for a bottom-up stock selection approach focused on generating alpha from within country, within sector, and within country-sector stock selection bets.

Another way to look at the current environment and why it is potentially good for quants is by looking at the fundamental law of active management. The fundamental law of active management states that performance is a function of skill and breadth. The divergence and diversification mentioned earlier in this text can help increase the Information Coefficient—or skill of quant investors. Applying this skill across the large number of independent bets available in Emerging Markets (over 800 stocks in large cap, or over 2,600 in all cap) translates into higher risk-adjusted returns, or Information Ratio.

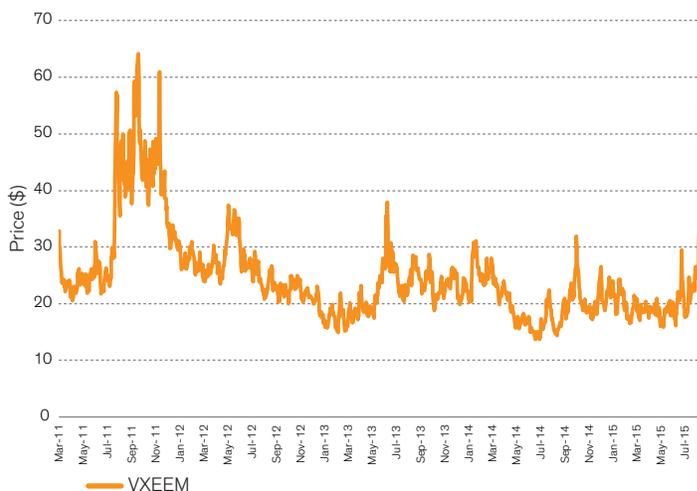
The second positive tailwind for quant strategies is based on mean-reverting properties of aggregate market sentiment measured by indices like the VIX.® We believe quant strategies can benefit greatly from regimes where the “dust is settling,” i.e., when trends are being reestablished, ideally after volatility spikes, as shown with the recent spike in the Emerging Markets VIX® Index in Figure 5.

Figure 4.
EMERGING MARKETS MANUFACTURERS LEAD THE WAY
GDP Growth Based on Purchasing Power Parity (Annual % Change)



As of April 14, 2015.
Source: QMA, International Monetary Fund. For informational purposes only.

Figure 5.
DAILY EMERGING MARKETS VOLATILITY



VXEEM represents the CBOE Emerging Markets ETF Volatility Index.
Data from March 16, 2011 to August 31, 2015.
Source: QMA, Bloomberg. For informational purposes only.

In Closing

We don't think it's time to give up on Emerging Markets. Yes, they have changed, they have evolved, and they have slowed down, but they remain the engine of growth for the world, with 80% of the population, 70% of the energy resources, and about 40% of the world's purchase parity adjusted GDP and 70% contribution to global GDP growth.⁶ They have well-known financial, monetary, and fiscal challenges, but many are actively responding by utilizing policy instruments that rely on the credibility earned through recent years of fiscal discipline.

To be able to capture this long term potential, investors should look through the noise created by negative retail flows and sensational reports in the news that see contagion and crises around every corner.

⁶International Monetary Fund World Economic Outlook, October 2014.

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VIX® is a trademarked ticker symbol for the Chicago Board Options Exchange (CBOE) Volatility Index®. This index is a key measure of market expectations of near-term volatility conveyed by S&P 500 stock index option prices. Since its introduction in 1993, VIX has been considered by many to be the world's premier barometer of investor sentiment and market volatility.

VXEEM is the ticker for the CBOE Emerging Markets ETF Volatility Index, which reflects the implied volatility of the EEM ETF, the iShares MSCI Emerging Markets Index.

Gross Domestic Product (GDP) is the broadest quantitative measure of a nation's total economic activity. More specifically, GDP represents the monetary value of all finished goods and services produced within a nation's geographic borders over a specified period of time.

Global Industry Classification Standard (GICS)® is a four-tiered, hierarchical industry classification system. It consists of 10 sectors, 24 industry groups, 67 industries and 156 sub-industries. Companies are classified quantitatively and qualitatively. Each company is assigned a single GICS classification at the sub-industry level according to its principal business activity. MSCI and Standard & Poor's use revenues as a key factor in determining a firm's principal business activity.

Purchasing Power Parity is an economic theory that estimates the amount of adjustment needed on the exchange rate between countries in order for the exchange to be equivalent to each currency's purchasing power.

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