Tough times in emerging markets: ETF investors beware

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As Australian investors continue to extend their offshore investments beyond the ASX, there has been a parallel move into emerging markets.

Yet while emerging markets has been a brilliant asset class in the past, looking at recent performance, annualised on a three-year basis, the index has traded in line with Australia in Australian dollar terms and lagged developed markets (as has Australia) by about 1.2 per cent. Further, the asset class has underperformed developed markets and Australia by about 5 per cent on an index basis over the last year to June 30.

What has created this lacklustre performance?

To put this in context, International Monetary Fund estimates show that between 2017 and 2019, half of global economic growth originated in Asia, with China and

India comprising 35.2 per cent and 8.6 per cent, respectively. Many pundits are projecting that up to 70 per cent of global growth will come from Asia over the next 20 years.

Separately, while the US has been one of the leading equity markets over the past year, the trade war initiated with China has affected Asian markets, led by China. That has seen a downward impact on emerging markets.

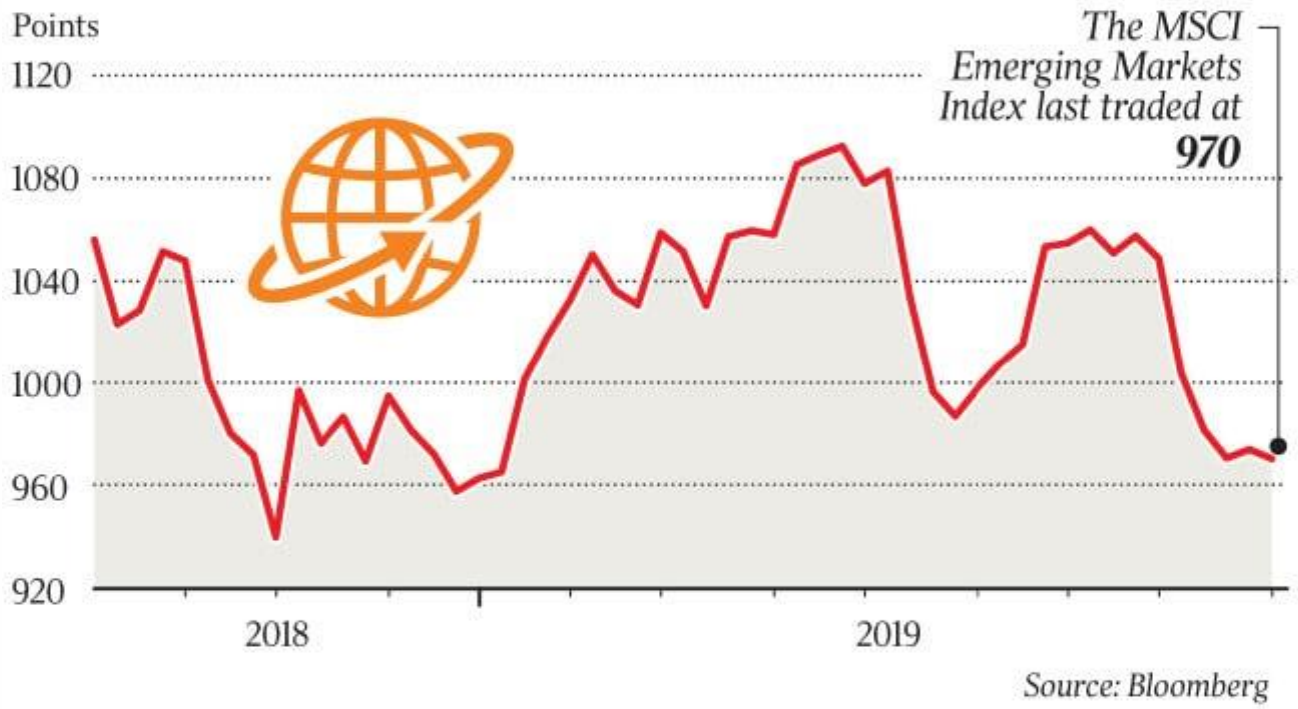
China presently has a weighting in the MSCI Emerging Markets index of 31.3 per cent, with Chinese domestic A-Shares given a weighting of 5 per cent. A-Shares are rising in November this year to 20 per cent.

Interestingly, Capital Economics in London estimates the trade war has decreased Chinese GDP by 0.5 per cent over the past year. China has nevertheless held its growth levels through the property sector offsetting the decrease in exports.

The remaining tariffs the US has announced will hurt the US more than China, through increasing the prices the US consumer will pay. Indeed, the latest tariffs have concentrated on areas where China is the dominant supplier to both the US and globally.

And so, the tariff war is having a negative flow-through effect on Asia even though, pound for pound, for every new round of tariffs the effect is diminishing.

In Asia, the market sees the chances of a deal between China and the US as ever diminishing. Even though Donald Trump needs the trade war as he heads into an election (and can thus announce a “great big deal”), he won’t be able to back down. Many in the market believe Chinese will not give up much ground from here if any. Given this scenario, we have recently moved “underweight” Emerging Markets. While recent selldowns precipitated by the trade wars and the Hong Kong protests are providing opportunities for fund managers to buy, markets dislike uncertainty and that is what the trade wars are providing, along with increased volatility.



So, what are emerging markets in reality? Stonehorn Global Partners in Hong Kong discusses this anomaly in a recently published white paper.

Stonehorn makes the point that the term emerging markets originated in 1981 with the goal of boosting investment to what were then referred to as "third world" countries.

They conclude — and I agree — that today the term is confusing, misleading, and the definition is not universal — the IMF classifies 23 countries as emerging markets and the MSCI EM index includes 26 countries.

When the emerging markets term was first used, China's share of world GDP was just 2.39 per cent. This is very low against the 35.2 per cent of the MSCI EM index it represents today.

Stonehorn notes what we know as Emerging Markets has performed poorly versus an Asian allocation. Since the beginning of 2010, total returns for Asian markets (MSCI AC Asia ex-Japan index) increased by 52 per cent, an annual equivalent rate of 4.76 per cent. Non-Asian emerging markets (MSCI EM ex-Asia index) like Brazil and Russia have seen total returns of -10.72 per cent, an annual equivalent rate of -1.25 per cent. The Brazilian and Russian economies are heavily commodity-oriented. Their markets therefore react negatively to incidents such as the 2014 oil price collapse.

As I have often said, investing in equities is about gaining exposure to growth. Asia will lead in this growth in the next 20 years through the continued maturity of its population, and personal consumption drives these economies to superior GDP growth.

The question is how does an investor best gain exposure?

This is an asset class where I think an index or exchange traded fund approach is fraught with danger. You will gain exposure to markets, economies and stocks you might prefer to avoid.

There are managers that manage within the wider emerging markets basket taking a strong disciplined approach to sovereign risk and macro factors linking that with strong bottom-up stock selection. Conversely, there are managers looking purely at Asia and a focus on the value of Asian growth while maintaining strong bottom-up stock pick disciplines.

The key take-out for investors is the need to look at opportunities the trade wars will provide with respect to valuations and use this as an opportunity to gain exposure. Seek the places that offer not only superior growth but opportunities in the region that are driving global growth. This approach is not just for now but also for the next couple of decades.

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