SEPARATING GOOD FROM BAD EMERGING MARKET EXPOSURE

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As pioneers of Modern Alpha™ strategies and currency hedging, WisdomTree has been at the forefront of providing smarter exposure to investors. We have seen an uptick in interest in discussing different strategies for exposure to emerging markets. This comes at a time when emerging market currencies have been under immense pressure due to trade concerns, sanctions and a host of other global macro-related issues.

Should all emerging markets exposures be painted with the same brush? Is there a way to separate emerging markets with lower risk and better fundamentals from those with higher risk with worse fundamentals in the current environment?

Segregating emerging markets into its components

Most investors have treated emerging markets like a single asset class. However, individual countries do have higher and lower risks, just like in any other region. In the European Union, for example, there are fundamental differences between the German and Italian economies. Similarly, in emerging markets, there are fundamental differences between the Indian and Brazilian economies.

This is why when it comes to the single biggest threat facing emerging markets stocks right now—trade and geopolitics—we hear of certain countries like China and Turkey much more often than countries like India and South Korea.

When Washington looks into individual trade surpluses, they likely start with some version of the chart below, showing in Figure 1.

At a Chinese trade surplus of over $375 billion, Washington realizes that closing 10% of the total gap with China would be a much bigger victory than closing 100% of the gap with Malaysia, South Korea or especially India individually.[1]

Here I would clarify that not all Chinese equities face the brunt of a trade war in equal measure, but investors should focus on sectors and companies that tap into China's stellar internal growth, such as Information Technology, which is increasingly the focus of the new China economy, while staying away from traditional manufacturing and industrial companies.

Figure 1: 2017 trade deficit of the US for goods traded with large emerging markets trading partners

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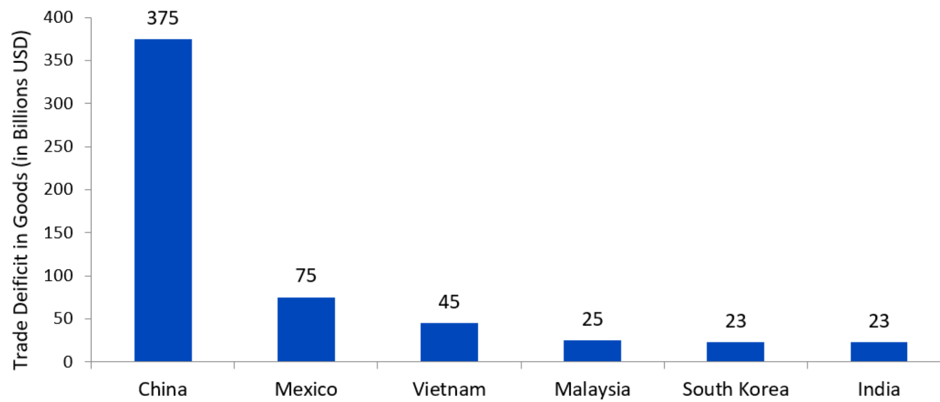


Source: US Census Bureau, as of 30 June 2018.

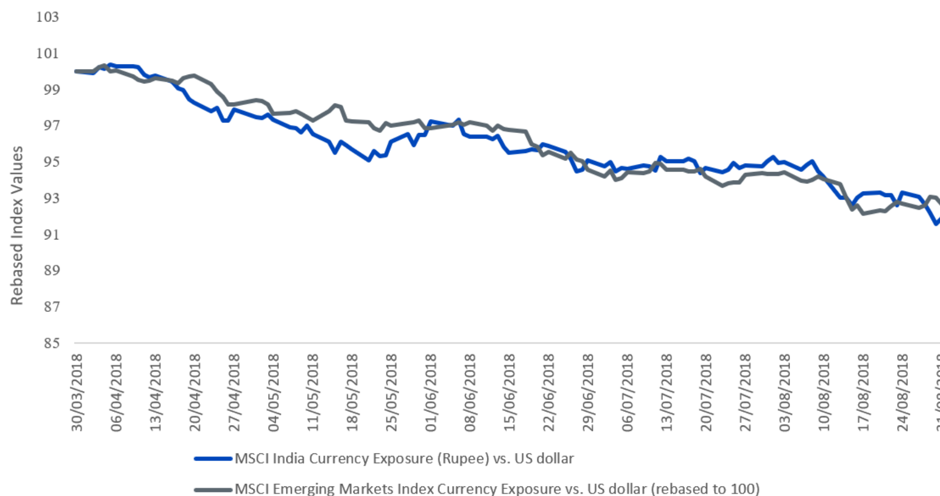
Currency Is Important

Whenever there is any negative sentiment about broad emerging markets, currencies, which are almost entirely driven by global appetite (and macro factors such as inflation and differences in interest rates), are usually the first to be impacted due to knee-jerk reactions from investors. In contrast, equities, which are in part driven by global risk appetite and in part by earnings and economic growth, can continue to do well.

Thus, emerging markets currencies tend to move in a flock, driven by global risk appetite, while stocks can continue to be differentiated from currencies and can offer alternative returns.

The chart shown in Figure 2 indicates how the India Rupee generally has been moving in lockstep with other emerging markets currencies over the last quarter (since trade war concerns started escalating). At the same time, Indian equities (i.e., MSCI India), shown in Figure 3, have demonstrated massive divergence from broad emerging markets equities (i.e., MSCI Emerging Markets Index). **Note that outperformance by Indian equities, shown in figure 3, is even more interesting when you consider that it is in US Dollar terms and includes the currency drag of Rupee depreciation over that period.**

Figure 2: Performance of MSCI Emerging Markets Index currency exposure & Indian Rupee versus the US Dollar



Average Annual Returns (as of 31 August 2018)				
Exposure	1-Year	3-Year	5-Year	10-Year
MSCI India Currency Exposure (Rupee) vs. US Dollar	-9.87%	-2.14%	-1.41%	-4.68%
MSCI Emerging Markets Index Currency Exposure vs. US Dollar	-4.79%	-0.50%	-3.10%	-2.80%

Sources: Bloomberg, MSCI. Period covered: 1 April 2018 to 31 August 2018. You cannot invest directly in an index.

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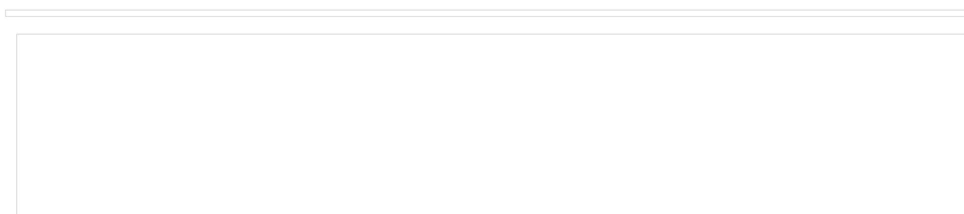
Figure 3: Performance of MSCI Emerging Markets Index versus performance of MSCI India Index



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So, what has surprised us in emerging markets equity performance this year?

First, we believe a plain market cap-weighted exposure to emerging markets does severe injustice to investor portfolios by exposing investors to the potential risk of higher equity valuations.

We (and others) have watched the price of a barrel of Brent crude oil go from about $66 to about $79 between end of December 2017 to end of August 2018, which has led to the energy sector within the MSCI Emerging Markets Index to be the top-performing sector in this index during 2018 thus far[2].

The WisdomTree Emerging Markets Equity Income Index—which focuses on stocks with some of the highest dividend yields within emerging markets—has mitigated a large amount of the downside risk that has been seen in 2018[3]:

- WisdomTree Emerging Markets Equity Income Index: -2.09%
- MSCI Emerging Markets Index: -7.18%

Emerging markets as an asset class often earns bad press due to its lower performance concentrated in select sectors, regions or currencies. In my opinion, investors who actively seek out good emerging markets exposure—and avoid bad emerging markets exposure —can capture the long-term growth rates that Emerging Markets has to offer.

Source

1 U.S. Census Bureau, as of 30 June 2018.

2 Bloomberg, period from 31 December 2017 to 31 August 2018.

3 Bloomberg, period from 31 December 2017 to 31 August 2018.

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