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The Forces Driving Emerging Markets are Evolving, Rapidly

BY CAROLYN MEKHAIL, SENIOR ANALYST, RESEARCH

The MSCI Emerging Markets Index ("MSCI EM") performance in 2017 was a perfect demonstration of how the underlying drivers of performance within this asset class have changed drastically over the years. The MSCI EM rose 37.3%[1] in US dollar terms by year-end, led by a series of variables including improving earnings growth, a weaker US dollar, and strong momentum. However, dissecting the index's performance for the year provides insight into longer term drivers of performance rather than possibly ephemeral impacts such as currency movements. The first major observation is that one sector in particular, Information Technology, was responsible for 38% of the total annual performance after rising an astonishing 60.6%.[1] The second observation is that one country's growth has been eclipsing competitors and is set to comprise an even larger portion of the index: China. It is essential for investors to understand how this increasingly relevant asset class is evolving, and its portfolio implications.

Not Just Commodities

As the old adage goes, "Emerging Market equities are driven by commodity prices." If that is still the case, then why did the MSCI EM Index rise 37.3% last year, while the Bloomberg Commodity Index only rose 0.75%?[1] Historically, the argument could be made that Emerging Market members' economies lived, or died, by the global demand

Hartland Leadership Series Event: Next Level Retirement Plan Governance

We hope you can attend the next Hartland Leadership Series event, titled ***Next Level Retirement Plan Governance***, on the morning of March 20, 2018.

Retirement plan sponsors struggle with balancing regulatory complexities, fiduciary responsibilities, and driving favorable participant outcomes. Hartland believes that consistent process and strong governance lead to optimal outcomes for both participants and fiduciaries.

Next Level Retirement Plan Governance will bring plan sponsors and industry professionals together for a discussion regarding fiduciary responsibilities, best practices, and achieving favorable participant outcomes.

The Union Club

Tuesday, March 20, 2018

8:00 am - 10:00 am

Please contact Sarah Parker,
Senior Managing Director,
for more information.

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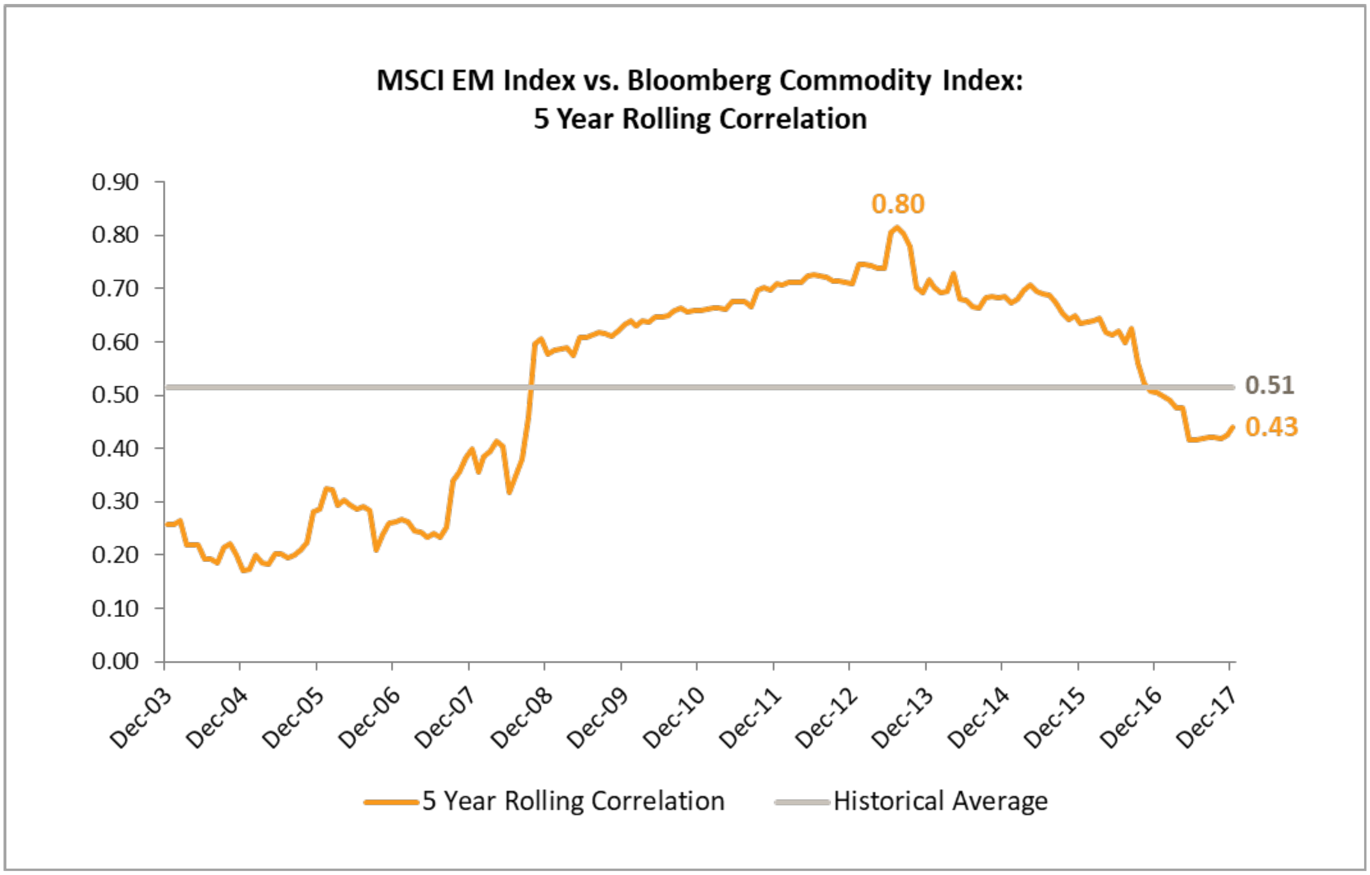
for commodities like oil and gas or precious metals (Latin America, for example). However, many of these nations have evolved and adapted to the increasingly globalized economy. The chart below illustrates the five-year rolling correlation of monthly returns comparing the MSCI EM Index to the Bloomberg Commodity Index:

FIGURE 1:



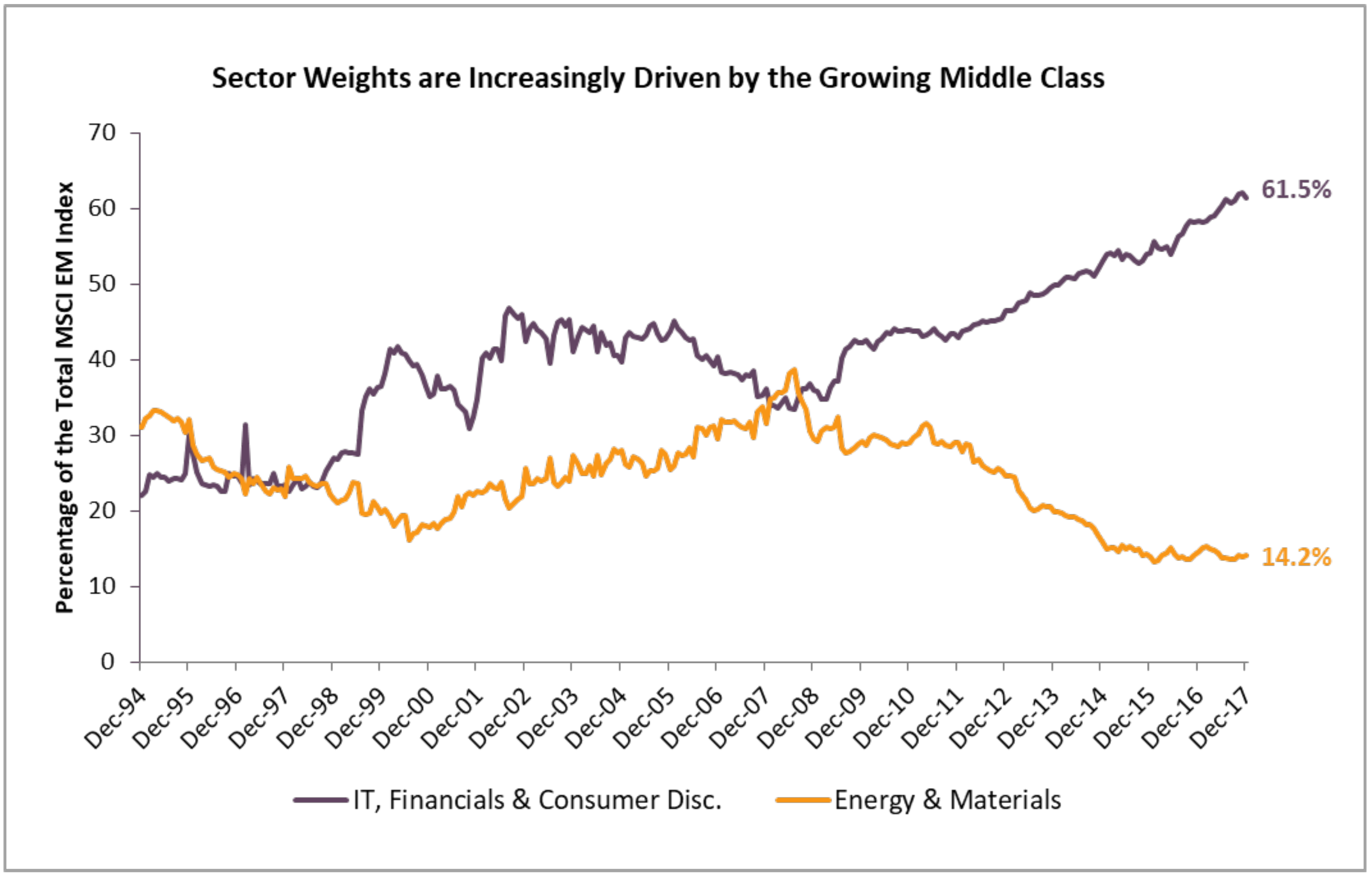
Source: Morningstar. Data as of 12/31/17.

The correlation between the MSCI EM Index and commodities peaked at 0.80 in 2013, meaning the equity and commodity prices had a strong positive relationship with one another over the previous five years of performance. By year-end 2017, the relationship has weakened to 0.43, indicating forces other than commodity prices have had greater influence on the movement of EM equity prices.

Information Technology

Many emerging nations have leapfrogged technological advances, taking full advantage of innovations at a rapid clip. The result has been a surge in major competitors within the Information Technology sector, including behemoths like Alibaba and Tencent in China. The rise of the middle class and rapid adoption of these technologies is reflected by the composition of the index, as seen on the next page:

FIGURE 2:



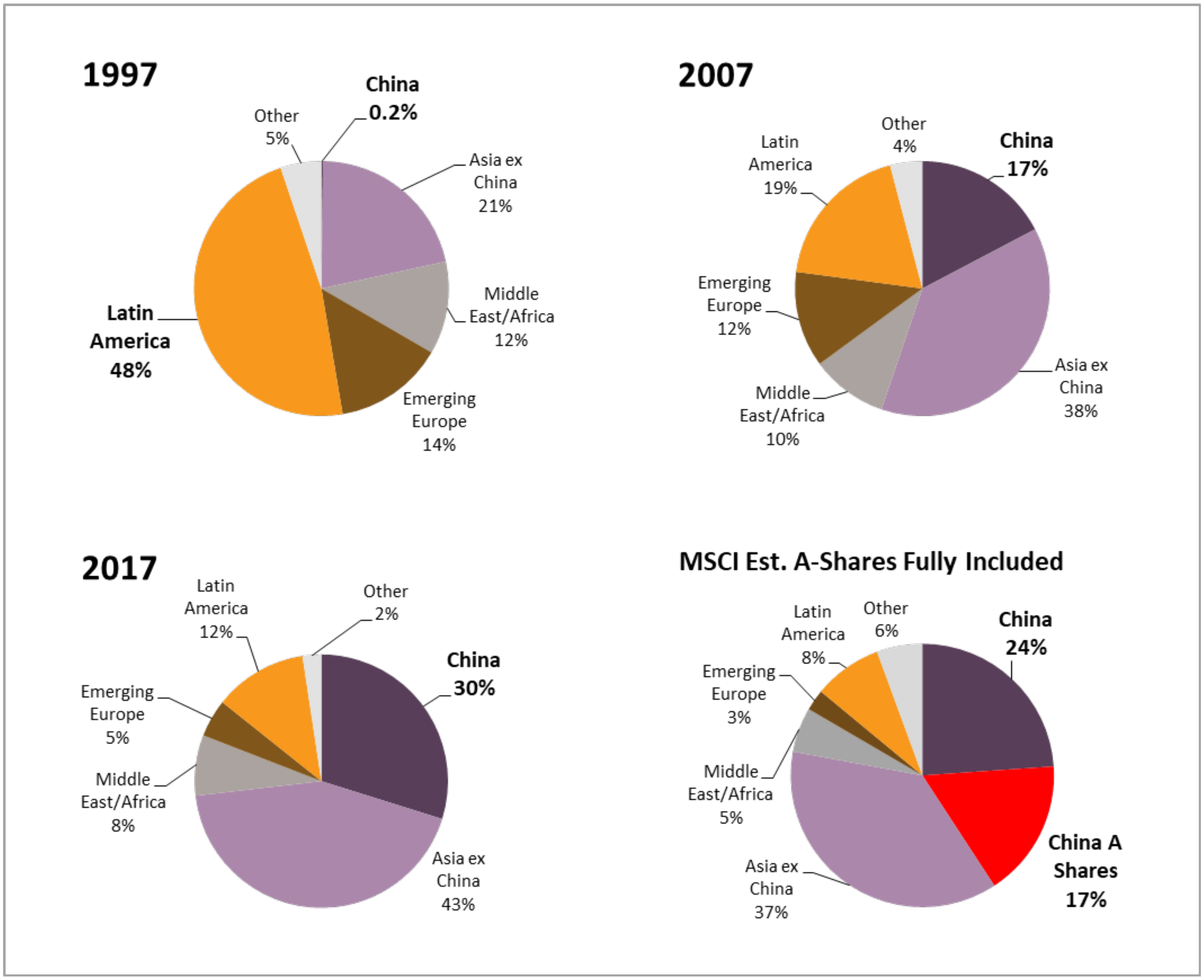
Source: Morningstar. Data as of 12/31/17.

The Energy and Materials sector exposure peaked in 2008 at 39% of the index, but has since fallen to 14%. This change is mirrored by the steady growth of the Information Technology, Financials, and Consumer Discretionary sectors. As these economies become more developed and their populations accumulate more wealth, the underlying drivers of economic growth have evolved. The demands of a growing middle class require investment and development in technology, a wide range of financial services to meet the demands of this new accumulation of wealth, and a push towards consumerism, whether that be organically or driven by government initiatives. Commodities are still hugely relevant to certain emerging nations, especially those that are major exporters of these goods, but the Emerging Markets of the contemporary world are much more dynamic than their histories suggest.

China and Asia

By dissecting the index from a different perspective, we are able to gain further insight into just how drastically the emerging markets have changed. The charts on the following page demonstrate the geographic exposures across a 20-year period, beginning in 1997 and ending with 2017.

FIGURE 3:



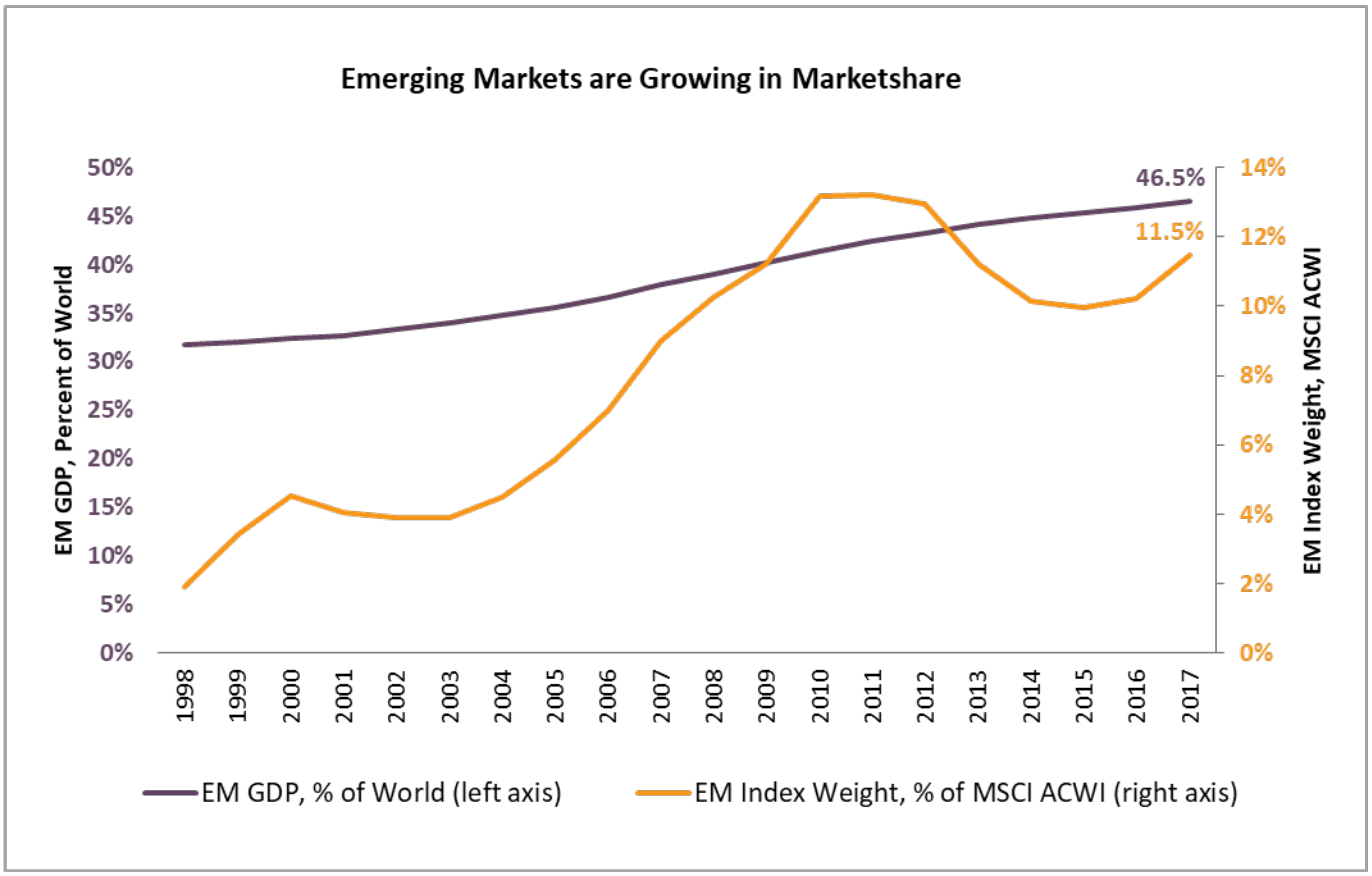
Source: Morningstar & MSCI. Chia, Chin Ping & Zhen Wei. "Are you ready for China A-Shares?" MSCI, June 2017.
Data as of 12/31/17, MSCI A-Share Estimates as of 06/19/17.

In the late 90s, Latin American nations represented close to half of the MSCI EM equity exposure, but the index shifted toward Asian economies over the following decade. By 2007, Latin American stocks fell to just under one fifth of the index, while China grew from 0.2% of the index in 1997 to 17% over the next ten years. The top two holdings in 2007 were representations of the old guard and the new: Brazilian oil giant PetroBras and China Mobil.[2] Jumping forward another 10 years, Asian domiciled companies comprise almost three quarters of the index in 2017, with China alone making up almost 30%. Commodity-sensitive names no longer make the top of the list, with Tencent, Samsung Electronics, and Alibaba holding the top spots.

China's equity weight has steadily grown since entering the World Trade Organization on December 11th, 2001, and its relevance to investors is set to rise even more as MSCI will begin adding Chinese A-share stocks to the index beginning in June 2018. Adam Blake, a Hartland partner, wrote an excellent piece explaining this unique equity market in August 2015 (after a particularly rough bout of volatility). The main idea is that the China A-shares represents the Chinese domestic equity market, which is largely driven by retail investors. The Chinese government has been working toward opening up its equity market to foreign investment, in part at the insistence of MSCI, and also as another step towards becoming a dominant player in the global marketplace. The index provider's first consultation of the China A-shares market was issued back in 2013, and MSCI is finally ready to begin adding exposure to these names in just a few months. It is important to note that the initial implementation will only result in 0.7% exposure to A-shares, though the potential for greater inclusion exists as long as China continues to liberalize its equity markets. The final chart illustrated in Figure 3 is based on MSCI's calculations of what the MSCI EM Index would look like assuming full inclusion of the China A-shares market. Currently, we are nowhere near this point, but it is important for portfolio managers and investors alike to understand how the Emerging Markets landscape is evolving, and in what direction it may be headed.

It is essential for investors to understand this asset class' underlying drivers of performance, especially considering its rising influence on the global economy. The chart below shows a comparison of the Emerging Markets' percentage of global GDP as well as their share of the MSCI All Country World Index.

FIGURE 4:



Source: Morningstar & IMF. International Monetary Fund, GDP based on PPP, share of world. Data as of October 2017.
Data as of 12/31/17.

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EM's Increasing Share

Over the past two decades, the EM GDP has grown from 32% of the world's economy to 47% in 2017, and the IMF is predicting the 50% threshold will be breached by 2022. Simultaneously, the EM equity weight in the index has risen from 1.9% to 11.5%, and should continue its ascent as more investors embrace the potential of these developing nations over the long term. Active portfolio managers must contend with an ever-changing universe of stocks within EM, and must decide what exposures will be best rewarded in the marketplace. The inclusion of A-shares will present an additional challenge, since this is a fairly unknown landscape of stocks largely uncovered by analysts. The decision of whether or not resources should be allocated towards finding opportunities in Chinese A-shares must align with a portfolio manager's long-term expectations of these names being represented in the index. Within the Morningstar category, Diversified Emerging Markets, 89% of all products listed use an MSCI Emerging Markets Index as their benchmark; the implication being that changes to the index have a major impact on the relative performance of managers within this asset class. Every active manager, whether they be fundamental research-driven or quantitatively inclined, must be able to defend active positions taken against the index. Therefore, investors must understand the drivers of the strategy's benchmark to evaluate the results of Emerging Market equity strategies. Though this continues to be a volatile asset class, Emerging Markets will soon make up the majority of the global economy (supported by favorable demographics, improving profitability of firms, and financial reforms) and therefore deserve a greater representation within client portfolios.

Sources:

(1) Morningstar.

(2) Bloomberg.

MARKET BENCHMARK RETURNS

February 28, 2018		1M	3M	12M	YTD
US Large Cap	S&P 500	-3.7%	3.0%	17.1%	1.8%
US Small Cap	Russell 2000	-3.9%	-1.8%	10.5%	-1.4%
Developed Intl	MSCI EAFE	-4.5%	1.9%	20.1%	0.3%
Emerging Intl	MSCI Em Mkt	-4.6%	7.0%	30.5%	3.3%
Real Estate	NAREIT	-7.0%	-10.1%	-5.8%	-10.0%
Core Fixed	BarCap Agg	-0.9%	-1.6%	0.5%	-2.1%
Short Fixed	BarCap 1-3Yr	-0.1%	-0.3%	0.1%	-0.4%
Long Fixed	BarCap LT G/C	-3.2%	-3.4%	2.8%	-5.1%
Corp Debt	BarCap Corp	-1.5%	-1.7%	2.1%	-2.4%

Source: Bloomberg

The performance data shown represent past performance. Past performance is not indicative of future results. Current performance data may be lower or higher than the performance data presented.