HAVE WE REACHED THE EM INFLECTION POINT?

Joseph Tenaglia – Director, Model Portfolios
11/15/2018

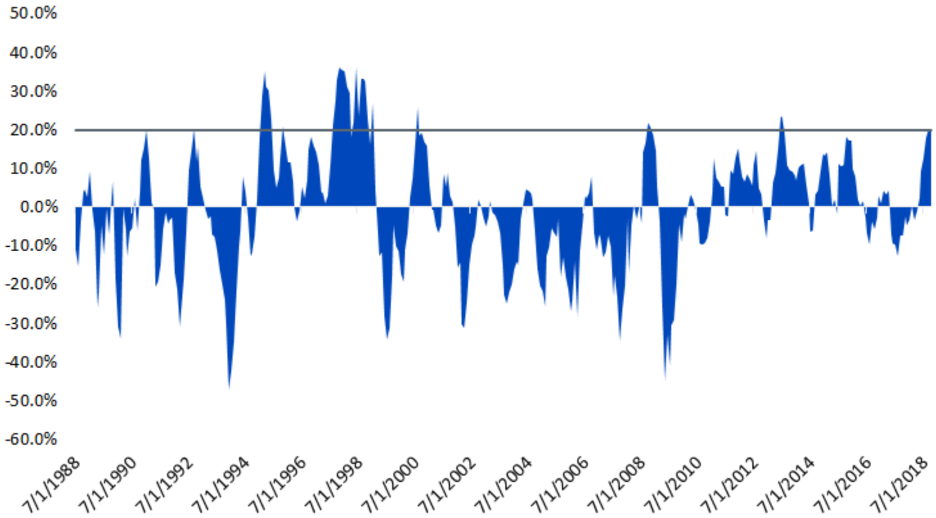
Following a long wait, 2017 was the year that being a globally diversified investor finally seemed to pay off. The MSCI ACWI ex USA Index beat the S&P 500 by more than 500 basis points (bps), outperforming for the first time since 2012. Many wondered if the baton was finally being passed to the international markets—after a decade of lagging the U.S.—to lead us into the next stage of the global equity rally.

Funny how quickly things can change.

It seems like a long time ago, but for the first four months of 2018, the U.S., the EAFE region (consisting of Europe, Australasia and the Far East) and emerging markets (EM) regions all performed almost exactly in line with each other. Since then, a massive gap has emerged. Over the last six months, the S&P has beaten the MSCI ACWI ex USA Index by more than 14.5%—a performance gap that falls into the top decile of history.

Looking at EM, the difference has been even more stark, with a nearly 20% gap between the two regions in just six months—in the 92nd percentile of history![1] Outside of the Asian debt crisis in the late 1990s, outperformance of this magnitude has not tended to last long; given the stark differences in fundamentals in the asset class between now and then, it seems reasonable to believe an eventual reversion to the mean will arrive.

S&P 500 – MSCI Emerging Markets Trailing Six-Month Performance



Sources: WisdomTree, Bloomberg. Data from 1/31/1988 to 10/31/2018, representing the earliest date of available data. Line represents current value. Past performance is not indicative of future results. You cannot invest directly in an index.

Was October 2018 an Inflection Point?

Even with the recent U.S. outperformance, there are some signs that the divergence momentum has slowed. The S&P 500 lost 6.8% in October, its worst month since September 2011. October seemed like an inflection point in the U.S. markets, with sentiment shifting away from what had previously done well:

- Technology and Consumer Discretionary, the main drivers of the market over the last few years and the two best-performing sectors year-to-date through September, both lagged on the downside.
- All FAANG stocks except for Apple underperformed
- The MSCI USA Momentum Index trailed the S&P by nearly 300 bps.

This contrasts with international markets, where, on a local currency basis, the MSCI ACWI ex USA Index performed exactly in line with the S&P. For most of the year, the escalating trade war had been priced into international equities but not the U.S. To many, it felt like October may have changed that.

Valuations Following Performance

Meanwhile, mirroring this year's widening performance gaps between the U.S. and international markets have been widening valuation differentials. The MSCI EAFE Index, which has historically traded at an average 5% price/earnings (P/E) premium to the U.S. market, now stands at a 30% discount. Japan remains priced near developing world levels at a 38% discount to the U.S.

And speaking of which, EM now stands at a 39% discount to the U.S., around the widest it has been since 2003. Valuation tends to be one of the best predictors of forward performance, and that certainly has historically held true in EM. In fact, at today's valuation levels, EM has historically outperformed the U.S. 96% of time over the next five years, by an average of 16% annually.[2]

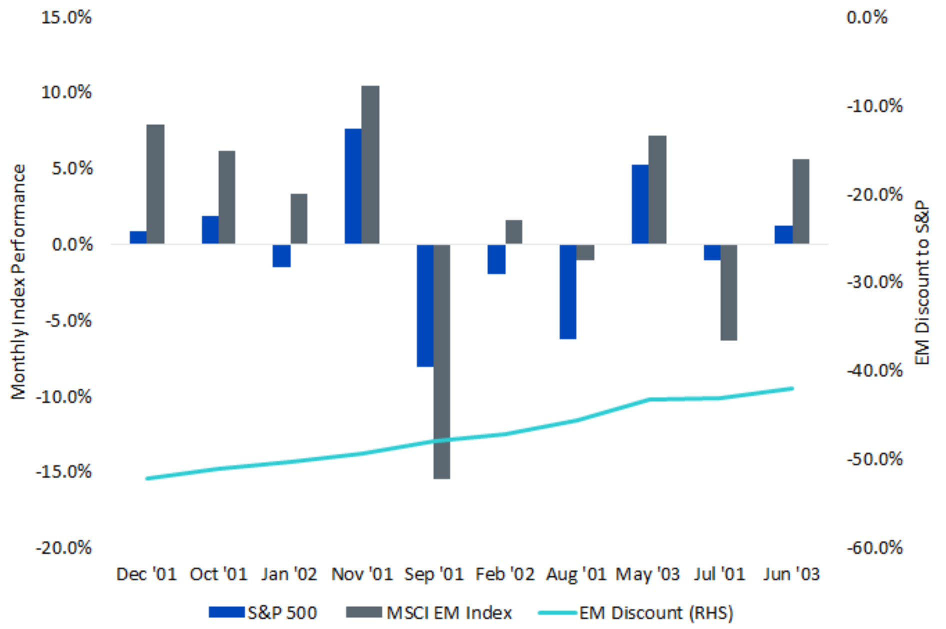
Valuation's Impact on Returns

In addition to helping improve forward return probabilities, managing risk and presenting attractive entry points, we think reduced valuations are important for another, less recognized reason: volatility. Beta is a crucial concept, but valuation impacts beta. That is, when an asset is more richly priced, it will tend to have a higher relative volatility than normally expected (and vice versa).

For a real-time case study of this concept, consider October. The MSCI Emerging Markets Index has typically had a standard deviation of 1.5x that of the S&P 500, and one might expect that relationship to hold in such a violent month. However, instead of the implied double-digit loss, EM lagged the U.S. by less than 190 bps (and less than 100 bps on a local currency basis). Admittedly, this is a small victory in an even smaller sample size, but it echoes what has often been the case in times when EM was less expensive relative to the U.S.: Looking at some of the most inexpensive time periods over the asset class's history, even the short-term returns have tended to favor EM.

Given how the international markets in general and EM specifically have been beaten down so badly over the past few months, it is possible that going forward, the risks are more skewed to the upside.

S&P 500 and EM Performance in 10 Largest Monthly P/E Discounts



	Dec-01	Oct-01	Jan-02	Nov-01	Sep-01	Feb-02	Aug-01	May-03	Jul-01	Jun-03
EM Discount to U.S.	-52.09%	-50.98%	-50.19%	-49.31%	-47.84%	-47.20%	-45.58%	-43.18%	-43.05%	-41.95%
S&P 500	0.88%	1.91%	-1.46%	7.67%	-8.08%	-1.93%	-6.26%	5.27%	-0.98%	1.28%
MSCI EM Index	7.93%	6.20%	3.37%	10.43%	-15.49%	1.62%	-1.00%	7.15%	-6.36%	5.67%

Sources: WisdomTree, Bloomberg, FactSet. Data from 12/31/00 to 10/31/18, representing earliest date of available data. Discount calculated at start of respective month. Past performance is not indicative of future results. You cannot invest directly in an index.

Solutions for Getting Back In

The fact that EM earnings have remained resilient (with double-digit earnings growth this year, unaided by corporate tax cuts) and that the newly split Congress in the U.S. may help slow the upward trajectory of the dollar, we remain constructive and opportunistic on the asset class.

For investors thinking about dipping back into the EM water, we think having a view on currencies is key. In the 2018 EM sell-off, currencies have represented one-third of the negative total return (-5.3% of -15.7%[3]). This compares with the 22% average contribution from currencies in previous EM corrections,[4] meaning that currency losses have been more of a drag on performance than normal.

While strategically hedging EM currency exposure is far too expensive in many countries, we think that tactically it can add value, particularly in today's environment. Our recently launched WisdomTree Emerging Markets Multifactor Fund (EMMF) can dynamically hedge individual EM currencies based off momentum signals (and currently sits at about 85% hedged to the dollar[5]). This ability to hedge in market downturns has already paid off nicely as it beat the MSCI Emerging Markets Index by 1.4% in October's volatility.

If investors are ready to take the full dive back into the asset class on an unhedged basis, we believe the WisdomTree Emerging Markets ex-State-Owned Enterprises Fund (XSOE) is a superior core allocation to traditional cap-weighted options.

If the upward trend that we think may be right around the corner does arrive, we believe both the alpha-seeking potential of EMMF or the better beta solution of XSOE should be well positioned to take advantage.

Unless otherwise indicated, all data is as of Bloomberg as of 10/31/2018.

[1]WisdomTree, Bloomberg, as of 10/31/18.

[2]WisdomTree, FactSet, Bloomberg, as of 10/31/18.

[3]Bloomberg, as of 10/31/2018.

[4]UBS Global Research, 7/10/2018.

[5]As of 11/6/2018.

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You cannot invest directly in an index.

DEFINITIONS

MSCI AC World ex-US Index : Measures the performance of companies incorporated in both emerging markets and developed markets, excluding the United States. Index weighting is by market cap.

S&P 500 Index : Market capitalization-weighted benchmark of 500 stocks selected by the Standard and Poor's Index Committee designed to represent the performance of the leading industries in the United States economy.

Basis point : 1/100th of 1 percent.

Fundamentals : Attributes related to a company's actual operations and production as opposed to changes in share price.

MSCI Emerging Market Index : The MSCI Em (Emerging Markets) Index is a free-float weighted equity index that captures large and mid cap representation across Emerging Markets (EM) countries.

MSCI Momentum Index : designed to embody the performance of an equity momentum strategy by to emphasizing stocks with high price momentum, while also maintaining reasonably high trading liquidity, investment capacity and moderate investment turnover.

Valuation : Refers to metrics that relate financial statistics for equities to their price levels to determine if certain attributes, such as earnings or dividends, are cheap or expensive.

MSCI EAFE Index : is a market cap-weighted index composed of companies representative of the developed market structure of developed countries in Europe, Australasia and Japan.

Volatility : A measure of the dispersion of actual returns around a particular average level. .

Beta : A measure of the volatility of a security or a portfolio in comparison to a benchmark. In general, a beta less than 1 indicates that the investment is less volatile than the benchmark, while a beta more than 1 indicates that the investment is more volatile than the benchmark.

Standard deviation : measure of how widely an investment or investment strategy's returns move relative to its average returns for an observed period. A higher value implies more "risk", in that there is more of a chance the actual return observed is farther away from the average return.

Alpha : Can be discussed as both risk-adjusted excess return relative to a specific benchmark, or absolute excess return relative to a benchmark. It is sometimes more generally referred to as excess returns in general.