Have we reached the Emerging Markets inflection point?

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Following a long wait, 2017 was the year it finally paid off to be a globally diversified investor. The MSCI ACWI ex-US index beat the S&P 500 by more than 500 basis points (bps), outperforming for the first time since 2012. After nearly a decade of lagging the US, many wondered if the baton was finally being passed to the international markets 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 now, but for the first four months of 2018, the US, Europe, Australasia and Far East regions (EAFE), and Emerging Market (EM) regions all performed almost exactly in line with each other. Since then, a massive gap has emerged. Over the last 6 months, the S&P has beaten the MSCI ACWI ex-US by more than 14.5% - a performance gap that falls into the top decile of history.

Looking at EM regions, the difference has been even more stark, with a nearly 20% gap from the US in just six months – in the 92nd percentile of history1! 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.

Figure 1: S&P 500 - MSCI Emerging Markets Index trailing 6-month performance

Source: WisdomTree, Bloomberg. Data from 31 January 1988 to 31 October 2018 and represents earliest date of available data. Line represents current value.

Historical performance is not an indication of future performance and any investments may go down in value.

Was October an inflection point?

Even with the recent US 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 US markets, with sentiment shifting away from what had previously done well:

- Tech and Discretionary (non-essential consumer goods), the main drivers of the market over the last few years and the two best performing sectors YTD through September, both lagged on the downside

- All FAANG (Facebook, Apple, Amazon, Netflix and Alphabet's Google) stocks except for Apple underperformed
- The MSCI USA Momentum Index trailed the S&P by nearly 300bps

This contrasts with international markets, where on a local currency basis, ACWI ex-US 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 US. To many, it felt like October may have changed that.

Valuations following performance

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

And speaking of which, EM now stands at a 39% discount to the US, 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 US 96% of time over the last five years, by an average of 16% annually2.

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 the month of October. The MSCI EM Index has typically had a standard deviation of 1.5x 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 US by less than 190bps (and less than 100bps on a local currency basis). This has often been the case in times when EM was cheap relative to the US – looking at some of the most inexpensive time periods over the asset class' 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.

Figure 2: S&P 500 and EM performance in 10 largest monthly Price to Earnings discounts

Source: WisdomTree, Bloomberg, Factset. Data from 31 December 2000 to 31 October 2018 and represents earliest date of available data. Discount calculated at start of respective month.

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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 US may help slow the upward trajectory of the dollar, we remain constructive and optimistic on the asset class.

1 WisdomTree, Bloomberg, as of 31 October 2018

2 WisdomTree, FactSet, Bloomberg, as of 31 October 2018

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