

Why the Timing Is Ripe for Emerging Market Equities

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The [S&P 500 Index](#) has continued a relentless climb upward, leaving most other markets in its dust. Putting the S&P's secular rally in context, it was touching 666 on March 6, 2009, and settling in the mid-2,300s as of mid-April 2017, more than eight years later.¹ That's a 241% cumulative return—304% with reinvested dividends.

Seeing data like this makes us all think about one thing: how we wish we'd have had the fortitude to put more money to work in U.S. equities in March 2009.

Emerging Markets—Where Many Investors Have Feared to Tread

After tough returns in the 2013, 2014 and 2015 calendar years, many clients abandoned emerging market equity exposure. This reminds us of the old maxim: money managers are compared to three benchmarks—the S&P 500, cash and the client's next door neighbor's returns—and you had better be beating whichever one is doing best when it comes time for the client meeting.

Catalyst One: Valuation Relative to Other Equity Markets

It isn't enough to simply say emerging markets are cheaper than the U.S. because by the very nature of their being more risky than U.S. equities they are supposed to appear less expensive. The real question is how much less expensive they need to be to pose a compelling opportunity

We noticed the following:

- As of March 31, 2017, the reciprocal of the 22.0 trailing price to earnings (P/E) ratio on the MSCI USA Index² is 4.54%, meaning the equity risk premium the market is demanding for U.S. stocks is only 215 basis points (bps) over and above the 2.39% yield on 10-Year Treasuries.
- To wit, the market capitalization-weighted MSCI Emerging Markets Index is offering an earnings yield of 6.45%, or 191 bps over and above that of the MSCI USA Index.

- How did this valuation gap happen? Woeful emerging markets performance caused it. In the 20 years to March 2017, the U.S. index returned 7.84% annually, over two percentage points more than the 5.73% gain for emerging markets. The contrast was even sharper over the 10-year horizon, with the MSCI USA Index returning 7.49% per year while the MSCI Emerging Markets Index was up just 3.03%.³
- Taking a step even further inside broad-based exposure to emerging market equities, there is a 9.39% earnings yield on the [WisdomTree Emerging Markets High Dividend Index](#), which tacks on another 294 bps to the 6.45% earnings yield of cap-weighted emerging markets.

Catalyst Two: Emerging Market Currency Valuations May Be Supportive

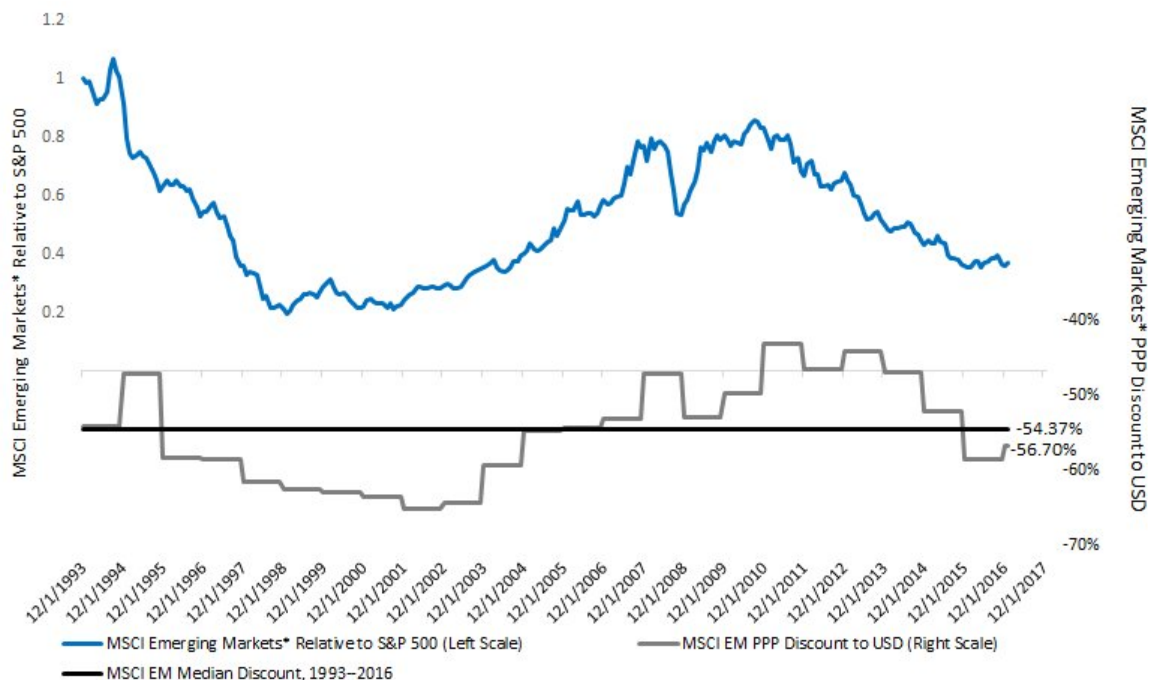
Unhedged equity investments outside of the U.S. involve two critical components of returns—the equities themselves, which are frequently the focus, and the currencies.

Currency depreciations of 6.04%, 7.36% and 9.16% in 2013, 2014 and 2015, respectively, for the MSCI Emerging Markets Index have burned into our collective memories that emerging market currency performance is not just important, it is critical.⁴

Purchasing power parity (PPP), which compares prices from country to country and can indicate if currencies are expensive or inexpensive, has been an important gauge of where currencies may be within their respective cycles.

When Might Emerging Markets Outperform the S&P 500 Index? In the Years After Relative PPP Levels Carved Out a Bottom.

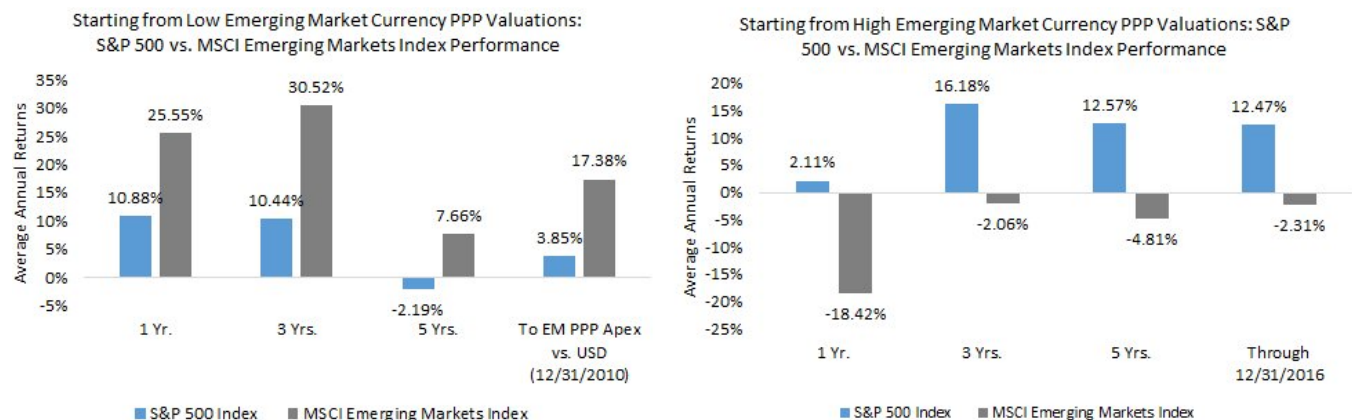
OCED Purchasing Power Parity for GDP



Sources: Zephyr StyleADVISOR, Bloomberg, WisdomTree, OECD. All non-eurozone nations currently in the MSCI Emerging Markets Index with reliable exchange rates to 12/31/93 included, with Russia added as of 12/31/95. Time series of emerging markets PPP discounts to the U.S. dollar calculated with current weighted average proportions in constant manner to 1993. *MSCI Emerging Markets Index through 12/31/00, MSCI Emerging Markets Index (net) thereafter. Past performance is not indicative of future results. You cannot invest directly in an index.

- In the chart above, the right axis measures our calculation of the MSCI Emerging Markets Index's aggregate PPP discount relative to the U.S. dollar, using countries that have nearly a quarter century of OECD PPP data.
- While emerging market currencies have traded at an extended discount to the dollar throughout the last 25 years (the median over the period is -54.37%), in 2003 there was a discount similar to what we are seeing today, while 2010 marked the most expensive level for emerging market currencies.
- As the emerging markets currency discount closed from 2003 to 2010, the MSCI Emerging Markets Index's performance relative to the S&P 500 Index (shown on the left axis above) was strong and generally relentless.

Examining the Most Recent Inflection Points in the MSCI Emerging Markets PPP Exchange Rate



- From 2003 to 2010, the MSCI Emerging Markets Index handily outperformed the S&P 500 across all measured periods. The annual return differential over the seven-year horizon was 1,353 bps (chart on the left, above).
- That was also a period in which the MSCI Emerging Markets Index more than tripled even though the S&P 500 was able to register a compound return of only 30.27%. The cumulative difference between the two for that seven-year horizon was 17,667 bps (or ~177 percentage points).
- In contrast, the situation since 2010 has been fundamentally different from the 2003–2010 era. The OECD PPP data for that year marked what we know in retrospect to be the most expensive emerging markets currency environment on record, based on the OECD's PPP calculations.
- During the six years since the point of peak emerging markets currency valuations, the MSCI Emerging Markets Index had a painful bout of cumulatively negative performance, despite the S&P 500 returning 12.47% annually (chart on the right, above).
- In fact, while the S&P 500 was in the process of doubling, emerging markets actually experienced a cumulative loss of 13.08%. The total performance differential between U.S. and emerging markets equities from 2010 to 2016 was 11,545 bps (or ~115 percentage points).

For investors who have come to the view that emerging market equities present a fundamental valuation opportunity relative to U.S. equities, we think that tying in that conclusion with the tandem element of thinking about PPP creates a further catalyst, a catalyst for engaging this once-darling asset class that is just now catching a bout of fortune.

1Source: Bloomberg. Data as of the first quarter of 2017.

2MSCI indexes sourced from Bloomberg.

3Source: Bloomberg. Twenty years and 10 years to 3/31/17, respectively.

4Sources: WisdomTree, Bloomberg, with data representing the difference in returns from 12/31/12 to 12/31/13 (2013), 12/31/13 to 12/31/14 (2014) and 12/31/14 to 12/31/15 (2015) for the MSCI Emerging Markets Index denominated in U.S. dollars and in local currency.

Important Risks Related to this Article

Investments in emerging, offshore or frontier markets are generally less liquid and less efficient than investments in developed markets and are subject to additional risks, such as risks of adverse governmental regulation and intervention or political developments.