

# HOW EMERGING MARKETS HAVE SNEAKED BACK IN VOGUE

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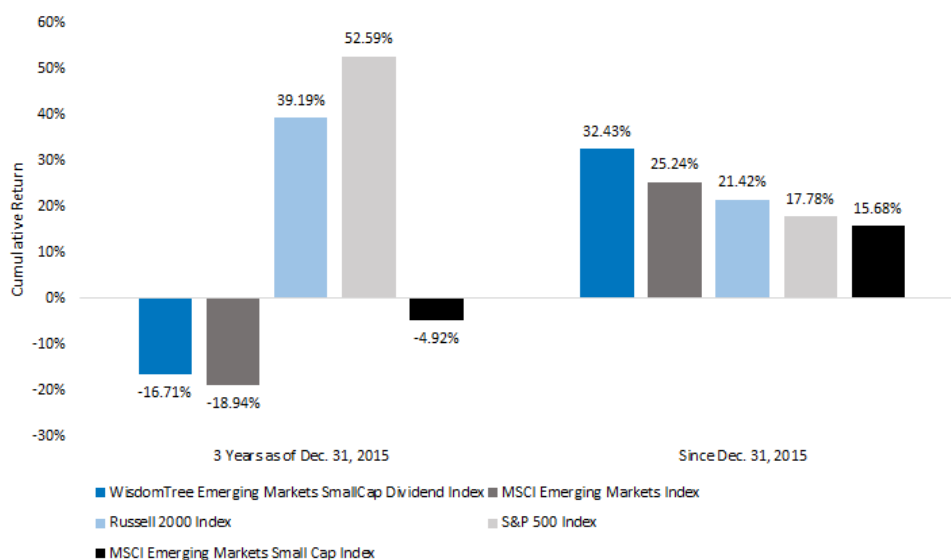
We remember speaking with clients in December 2015, and at that point:

- The price per barrel of West Texas Intermediate crude oil was between \$30 and \$40, trending downward.<sup>1</sup>
- The [Bloomberg Dollar Spot Index](#) was on its way to notching a 9% return for 2015, punctuated in part by a Brazilian real that would depreciate by nearly 33% versus the U.S. dollar.<sup>2</sup>
- The [FTSE China 50 Index](#) was on its way to delivering a return of -11.39% for 2015.<sup>3</sup>

Even if we could present compelling [valuations](#) compared to other global equity markets, there was simply too much carnage for many to see beyond. Also, after such drastic outperformance of U.S. equities, we remember hearing that many clients were no longer holding a position in emerging markets.

As has often been the case, the inflection point came when many were least expecting it.

## After Three Years of Dramatic Underperformance, Emerging Markets Have Fired Back Up



Sources: WisdomTree, Bloomberg. Three Years as of Dec. 31, 2015, from 12/31/12 to 12/31/15. Since Dec. 31, 2015, from 12/31/15 to 3/24/17. Past performance is not indicative of future results. You cannot invest directly in an index.

*For definitions of indexes in the chart, visit our [glossary](#).*

- **Three Years as of December 31, 2015:** We all know that was a very tough period for emerging markets. Looking at the [MSCI Emerging Markets Index](#), the currency headwind—in other words, the U.S. dollar's appreciation versus the collective emerging market currencies—of more than 21% canceled out any possibility of positive equity returns. Additionally, the [S&P GSCI Index](#) was down nearly 56% cumulatively over this period. There simply were not a lot of positive potential catalysts during that period.
- **Since December 31, 2015:** This period of emerging market equity outperformance sneaked up on many people. The U.S. [Federal Reserve \(Fed\)](#) had just moved the target for its [Federal Funds Rate](#) up,<sup>4</sup> causing many to build a consensus view for a stronger U.S. dollar—a headwind for emerging market equities. Additionally, there were many questions 1) concerning how low the price of a barrel of oil could go, and 2) concerning the possibility of risks to China's economic growth. Very few were itching to allocate to emerging markets, but what's clear is that since then, the MSCI Emerging Markets Index has outperformed the [S&P 500 Index](#).

### What about Emerging Market Small Caps?

Even more interesting is the fact that the [WisdomTree Emerging Markets SmallCap Dividend Index](#) delivered nearly twice the return of the S&P 500 Index over this period and did even better than the MSCI Emerging Markets Index, as well as the MSCI Emerging Markets Small Cap Index, which underperformed the S&P 500 Index over the same period.

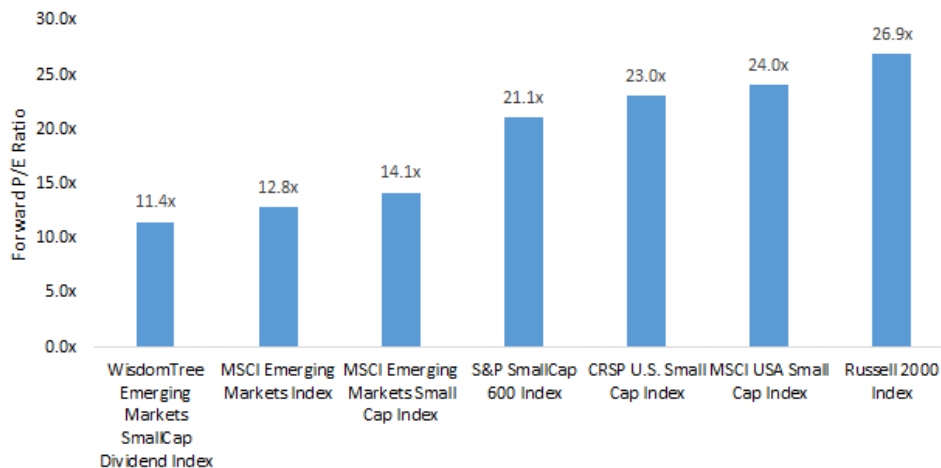
### After 15 Months of Outperformance, Has the Window Closed?

Market participants—after any period of outperformance—will typically ask whether the opportunity was missed. Since the future is always uncertain, answering that question in an absolute sense is impossible, but we always come back to relative valuation comparisons.

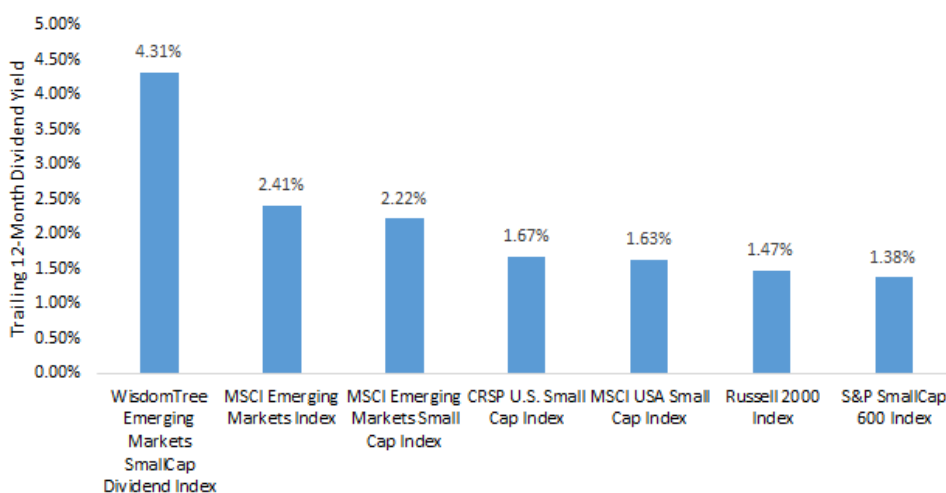
We specifically ask—knowing that the WisdomTree Emerging Markets SmallCap Dividend Index just underwent a period of outperformance—has it now become expensive compared to U.S. small-cap indexes? If it hasn't, we think there is 1) less of a chance that the opportunity was missed and 2) the potential for a diversifying effect if market participants forgo allocating the full percentage of their small-cap stocks to the U.S. and diversify some of that position in emerging markets.

### WisdomTree Emerging Markets SmallCap Dividend Index Still Indicates Significant Valuation Advantage

### Forward P/E Ratio Valuation



### Dividend Yield



Sources: WisdomTree, Bloomberg, with data as of 3/24/17. Past performance is not indicative of future results.

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- **Small-Cap Stocks at a [Forward Price-to-Earnings \(P/E\) Ratio](#) below 12.0x:** While this would clearly be difficult to find among the commonly followed U.S. small-cap equity indexes shown here (all of which trade over 21.0x), the WisdomTree Emerging Markets SmallCap Dividend Index offers such an opportunity. Again, this is after outperforming the [Russell 2000 Index](#) over the prior period of about 15 months.
- **771 Stocks & a [Dividend Yield](#) above 4.3%:** Many might ask WisdomTree how it's even possible to have an emerging market small-cap equity index comprised solely of dividend payers. As of March 24, 2017, there were 771 such stocks.<sup>5</sup> That's more than the 694 stocks in the WisdomTree SmallCap Dividend Index, which focuses on U.S. stocks.<sup>6</sup> The real benefit: a dividend yield of more than 4.3%, more than twice the dividend yield of the commonly followed U.S. [market capitalization-weighted](#) indexes.

### Looking Forward: Catalysts to Watch

Emerging market equities—like those in other markets—are all about the catalysts. First, the Fed has raised rates three times in the current [tightening](#) cycle, but the U.S. dollar has largely weakened in response, a positive outcome for emerging markets.<sup>7</sup> Second, the price of oil has been tending to fall<sup>8</sup> but a) isn't pushing the February 2016 lows, and b) small-cap emerging markets largely avoid the massive state-run energy firms most impacted by the price of oil and other commodities. Third, and most importantly, small-cap emerging markets are really an access play on the emerging

market consumer, as these companies derive the bulk of their revenue from inside their home markets. With the bulk of global population in emerging markets, many investors whom we speak with—even those nervous about emerging markets—recognize that the emerging market consumer will be an important force propelling global growth in the coming decades.

<sup>1</sup>Source: Bloomberg, with data as of 12/15.

<sup>2</sup>Source: Bloomberg, with data measured from 12/31/14 to 12/31/15.

<sup>3</sup>Source: Bloomberg, with data measured from 12/31/14 to 12/31/15.

<sup>4</sup>Source: Federal Reserve Open Market Committee Press Release, 12/16/15.

<sup>5</sup>Sources: WisdomTree, Standard & Poor's.

<sup>6</sup>Sources: WisdomTree, Bloomberg.

<sup>7</sup>Source: Bloomberg, with performance of the U.S. dollar measured against major emerging market and developed market currencies from 12/31/16 to 3/24/17.

<sup>8</sup>Source: Bloomberg, noting behavior of West Texas Intermediate Crude Oil price-per-barrel in March of 2017 up to 3/24/2017.

#### 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.

Investments focusing on certain sectors and/or smaller companies increase their vulnerability to any single economic or regulatory development. This may result in greater share price volatility.

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You cannot invest directly in an index.

## DEFINITIONS

**Bloomberg Dollar Spot Index (BBDXY)** : Tracks the performance of a basket of ten leading global currencies versus the U.S. dollar. Each currency in the basket and their weight is determined annually based on their share of international trade and FX liquidity.

**FTSE China 50 Index** : a market capitalization weighted index tracking the top 50 Chinese companies. Stocks are weighted by H or Red Chip share cap as appropriate.

**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 Emerging Markets Index** : a broad market cap-weighted Index showing performance of equities across 23 emerging market countries defined as "emerging markets" by MSCI.

**S&P GSCI Index** : leading measure of general commodity price movements and performance over time.

**Federal Reserve** : The Federal Reserve System is the central banking system of the United States.

**Federal Funds Rate** : The rate that banks that are members of the Federal Reserve system charge on overnight loans to one another. The Federal Open Market Committee sets this rate. Also referred to as the "policy rate" of the U.S. Federal Reserve.

**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.

**Forward P/E ratio** : Share price divided by compilation of analyst estimates for earnings-per-share over the coming 12-month period. These are estimates that may be subject to revision or prove to be incorrect over time.

**Russell 2000 Index** : Measures the performance of the small-cap segment of the U.S. equity universe. The Russell 2000 is a subset of the Russell 3000 Index representing approximately 10% of the total market capitalization of that index. It includes approximately 2000 of the smallest securities based on a combination of their market cap and current index membership.

**Dividend yield** : A financial ratio that shows how much a company pays out in dividends each year relative to its share price.

**Market capitalization-weighting** : Market cap = share prices x number of shares outstanding. Firms with the highest values receive the highest weights in approaches designed to weight firms by market cap.

**Tighten** : a decline in the amount of compensation bond holders require to lend to risky borrowers. When spreads tighten, the market is implying that borrowers pose less risk to lenders.