Emerging Markets in 2018: A Balancing Act

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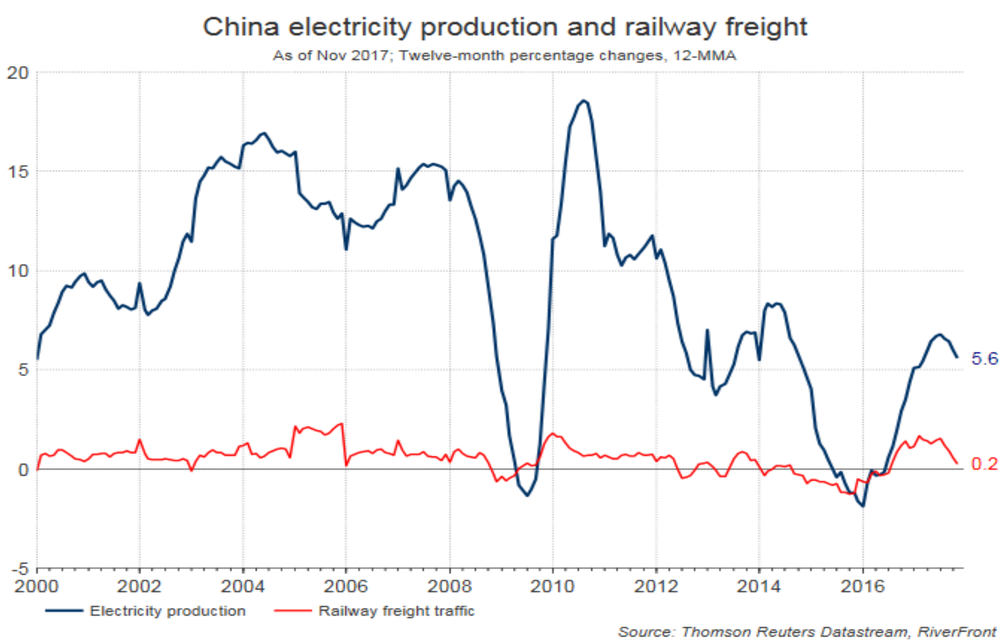
WE HEAD INTO 2018 WITH A 'NEUTRAL' WEIGHTING TO EMERGING MARKET EQUITIES RELATIVE TO OUR COMPOSITE BENCHMARKS: Our view on Emerging Markets equities (EM) is balanced by both the significant opportunities and risks the asset class presents. We view the long-term opportunity as attractive, but believe on a tactical basis that EM sentiment has gotten a bit ahead of the fundamentals after a red-hot 2017 (at the time of this writing, the MSCI Emerging Market price index is up over +30% in USD terms, not including dividends). We are also somewhat concerned about the tightening cycle starting in China. For these reasons we recently brought our emerging market (EM) equity weighting back to neutral from overweight relative to our composite benchmarks. Due to its long-term potential, in our view, we still believe investors with an investment horizon beyond 5 years should maintain exposure to EM.

AS GOES CHINA, SO GOES EM: With 24 countries comprising the MSCI Emerging Market Index it is always difficult to reduce our viewpoints into a single headline. However, given that China's 29% weighting is roughly twice the representation of the next largest country (South Korea); the economic prospects for the Middle Kingdom are an important contributor to our overall EM outlook. As the world's second largest economy China is also a customer and supplier to many other EM countries and its economic health can also have significant indirect effects on everything from export competition to commodity prices.

CHINA MONETARY TIGHTENING AND FED POLICY, RISKS WORTH MONITORING

Policymakers in China appear to be deliberately tightening monetary conditions, in preparation for a needed cooling-off of an unbalanced economy. President Xi Jinping, perhaps the most powerful Chinese leader in decades, has expressed concerns over excessive financial leverage and house price speculation in China. The coordinated efforts to cool the economy via interest rate hikes and increased lending restrictions appear to be having their effect, as can be seen in slowing house price inflation, electricity production and railway freight volumes. Xi's attempt at rebalancing the economy makes sense to us, but may lead to some market volatility in the first half of '18.

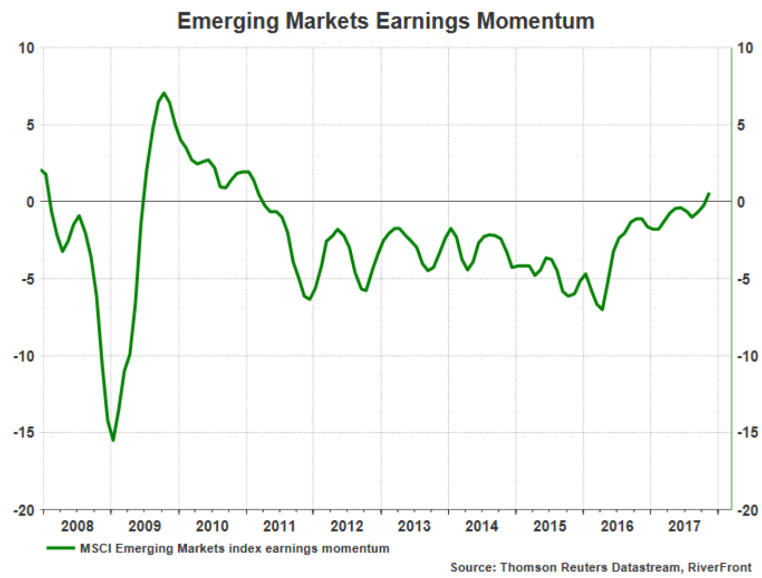


Policy normalization at the US Federal Reserve could also be a temporary concern for EM in 2018. We do not take the consensus view that higher real US bond yields are universally 'bad' for EM stocks. Instead, we believe that the trajectory and degree of interest rate hikes is far more important. Concerns about higher rates may only be warranted if rates rise quickly and dramatically. However, if the rate and magnitude of hikes are measured, as we expect them to be from a Jerome 'Jay' Powell-led Fed, then we see positive economic growth outweighing the negatives for EM...but not perhaps before some volatility in EM assets, as the market wrestles with this controversy.

LONGER TERM OPPORTUNITIES IN EM: STILL EARLY IN THE POSITIVE EARNINGS CYCLE, IN OUR OPINION

After lackluster growth from 2011 through 2015, EM corporate earnings growth turned definitively positive in mid-2016. This earnings rebound has been significant in both strength and breadth. From a strength perspective, we see aggregate earning's growth likely tallying over 20% in 2017. With regards to breadth, virtually all of the emerging market countries we track are expected to book positive earnings growth this year. Underpinning the optimistic earnings case, the number of net positive earnings revisions for 2018 has risen above zero for the first time since 2010 (see chart below). Consensus analyst estimates suggest a still-healthy +12% growth for 2018 (source: IBES/Datastream).

The major catalyst for this improved earnings cycle has been a resurgence in synchronized global economic momentum, fueled by monetary stimulus and low interest rates (see our *Weekly View* from 9/5/17 for more on this). For example, the JP Morgan Global Manufacturing PMI survey, which bottomed in mid-2016 at barely expansionary levels, maintained its multi-year high of 54.0 in November, suggesting business managers worldwide continue to be optimistic about prospects going forward.



EM VALUATION: STILL REASONABLE, BUT SENTIMENT HEIGHTENED IN SOME AREAS

We don't view EM valuation as a major impediment yet to further stock market gains. The MSCI EM index trades at a 12x multiple on next years' expected earnings, which is still a large discount to the US even after taking sector differences into account. However, we must acknowledge that valuation multiple expansion in areas such as China, Taiwan, India, South Africa and parts of Southeast Asia has been meaningful this year suggesting heightened investor expectations – which can create disappointment. We would also be remiss if we didn't mention the outsized impact of Asian tech stocks on the overall emerging market returns in 2017. Analogous to a higher-wattage version of the US's "FAANG' stocks, the largest tech and internet holdings in MSCI China were up in some cases close to +100% in 2017. While this isn't a market negative per se, it makes us a little nervous to see so much contribution from a relatively narrow part of the market.

CONCLUSION: EM EXPOSURE SHOULD DEPEND ON INVESTMENT RISK TOLERANCE AND TIME HORIZON

We head into 2018 with a 'neutral' weighting to Emerging Market equities. For risk-tolerant investors, we believe that emerging markets' positives of leverage to a strong global economy, early cycle earnings growth and non-demanding absolute valuation outweigh the potential near-term risks of Chinese and US central bank policy normalization. However, for less risk-tolerant investors, we expect EM assets to be potentially volatile in '18, and see better risk-reward in developed international (DM) markets such as Eurozone and Japan. Within EM we continue to maintain a tilt towards emerging Asia, where we view fundamental improvement as more pronounced than in broad emerging markets.

Source: Thomson Reuters Datastream, Riverfront, as of 12/17/17

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You cannot invest directly in an index. Past Performance is no guarantee of future results.

***MSCI Emerging Markets Index** measures equity market performance of emerging markets. The index consists of 23 countries representing 10% of world market capitalization.*

(2017.319)