KEEL POINT

INVESTMENT BULLETIN

Volume III, No. 2
February 2014

8065 Leesburg Pike, Ste. 300
Vienna, VA 22182
www.keelpoint.com

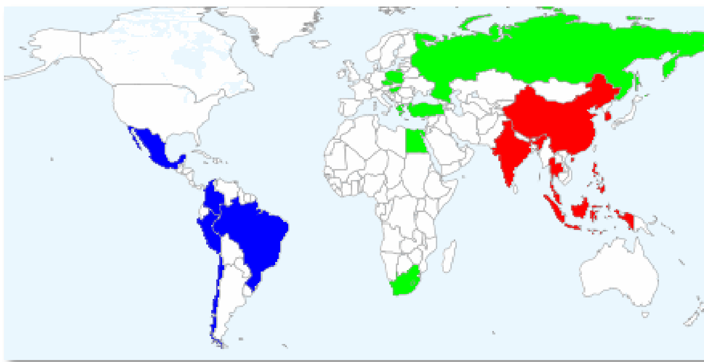
Unpacking the Emerging Markets Bucket

Rising tides are supposed to lift all boats. Last year was a historic flood year in the US and other developed equity markets, but the emerging markets ship managed to miss the tide entirely. The underperformance of an asset class always earns extra scrutiny from the Keel Point Investment Team. We completed our early year review of the asset class and will use this space to outline our updated opinion on emerging markets, specifically that unhedged broad exposure should be eschewed for Asia-only exposure.

The Emerging Market Bucket Today

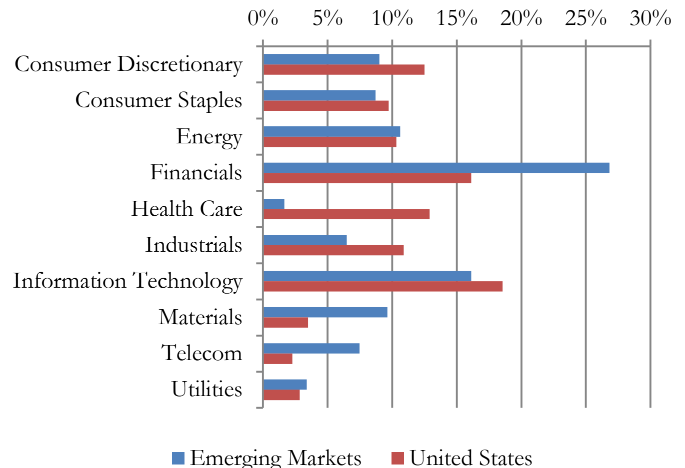
MSCI, the industry standard for classifying non-US stocks, determines whether an economy's stock market qualifies as an emerging market based on three criteria: economic development, stock size and liquidity requirements, and market accessibility. Any country with a per capita gross national income lower than $16,000 (this varies based on the World Bank's high income threshold) in any of the last three years, three companies worth more than $1 billion, and modest to significant market accessibility is classified as emerging. It's no surprise that the asset class ends up with a diverse group of economies.

The major regions of the world that meet MSCI's definition are Asia (specific countries are shaded in red below) and Latin America (blue). The index also includes countries from Africa, the Middle East and Eastern Europe (collectively green), but, combined, they only represent 17% of the market capitalization of the index[1]. Asia is the biggest component of the bucket at 62% and Latin America tallies to 21%.



The BRICs are a popular subcomponent of the emerging markets universe. While they certainly are the most populous and boast the largest GDPs in the emerging world, Brazil (11%), Russia (5%), India (6%), and China (15%) only account for just over a third of the market capitalization of the emerging world by MSCI's definition. The acronym omits such heavyweights as South Korea (16%), Taiwan (12%), South Africa (7%) and Mexico (5%).

Figure 1: Industry Group Comparison
Industry Components of Emerging Markets (EEM) vs. United States (SPY)
Source: Bloomberg



Analysis of the universe should not stop at country of domicile; there are some striking differences in industry concentration between the emerging world and the United States. See Figure 1 for a full comparison of the two markets. One clear takeaway is that the consumer sector in the emerging markets is underdeveloped: the two consumer categories plus health care total to 19% versus 35% in the US. An indexed emerging market investment also implies a heavy overweight to financials (27% vs. 16% in the US). We will return to these differences later in our discussion.

Why We Think it's Time to Unpack the Bucket

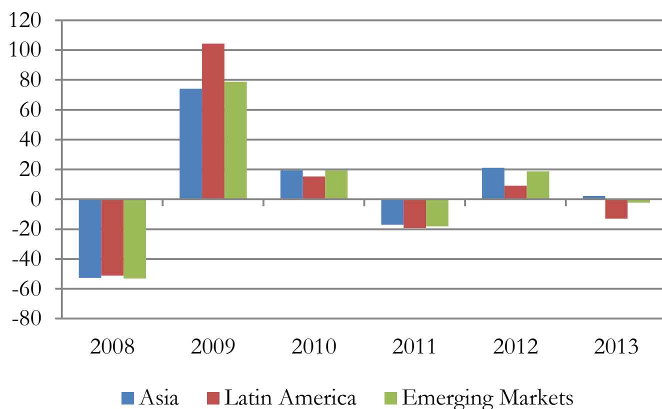
The coexistence of these disparate countries within a single asset class was more logical at the beginning of the century. The common thread in their economic stories was a reliance on exporting commodities, low value-add manufacturing, and/or services. This is a brilliant model when yours is a smaller economy and the global economy is humming. However, as the customers for these goods and services, the developed world nations, have limped out of the credit crisis, the suppliers are following different trajectories. This argues for a sub-asset class review of emerging markets.

The other wedge splitting the emerging market world today is the Federal Reserve's tapering operations. Since May of last year, the yield offered by ten year treasury debt has improved by 1%. The marginal saved dollar that might have gone in search of yield in Asia

or Latin America is now more inclined to shelter in place in the United States.

Morgan Stanley issued a report in August of last year identifying a "Fragile Five" group of economies that are highly dependent on those marginal foreign dollars. The current accounts in the five countries – Brazil, India, Indonesia, South Africa, and Turkey – have deteriorated due to "subdued [developed market] growth, falling commodity prices, a slowing China and, importantly, deterioration in external competiveness related to elevated real exchange rates and high inflation." Our analysis is that this read is largely relevant six months later with the possible exception of an improvement in Indonesia. We think this is reinforced by recent actions taken by the central banks of India, South Africa, and Turkey to protect their currencies from capital flight.

Figure 2: Regional Em Mkts Returns
Asia = MSCI EM Asia Index
Latin America = MSCI EM Latin America Index
Emerging Markets = MSCI EM Index
Source: Bloomberg



This mosaic of information leads us to change our preference for Asian emerging market equities to a decision to weight 100% of unhedged emerging market exposure to Asia. For those curious as to how the major regions have performed, Figure 2 shows data for the last six years. We think recent Asian outperformance (2012 and 2013) will continue.

Why Asia?

The short answer is because that is where you will find a couple billion new consumers. Over time their export model of economic growth will morph into an organic growth story in the countries with the largest and wealthiest consumer base. Asian economies may not be as successful as the early 20th century US was in this regard, but wherever they fall short in wealth creation pace can be partially offset in consumer volume. Consider the trajectory of US food spending over the last 110 years. According to the Bureau of Labor Statistics, 40% of US consumer spending, measured by weight in the consumer price index, was earmarked for food in 1901. As the country grew wealthier, that number gradually came down to just over 10% in this century. Part of the 30% difference is naturally shifted to other consumer goods.

In practice, we are trying to capitalize on this expected trend in Asia by identifying managers who avoid the huge emerging market banks, exporters, and petro firms in favor of consumer companies. If you return to Figure 1 and buy into our assumption that Asian economies will have some success with consumption-led growth, you can trace the gap to be closed in the consumer sectors between the US and emerging markets. An index-only investor may get less of the growing consumer benefit.

Another reason to be pro-Asia is relative value. Average P/Es for Latin American stocks are running at 15.2 whereas Asia is slightly cheaper at 14.6 (although neither is significantly discounted relative to the S&P's 15.6 ratio). Our thought is that earnings growth in Asia will be faster so why not pay less for quicker growth.

We believe there are ingredients for Asian earnings growth beyond the consumption-fuelled model. The World Bank publishes an ease of doing business index which puts four Asian countries in the top 20 (Malaysia, South Korea, Taiwan, and Thailand). Despite its ignominious membership in the fragile five, India has a strong demographic advantage on the rest of the world as its working age population is expected to grow faster than its cohort of children and retirees. China is trickier, but recent reforms announced after their third plenary session last autumn indicated openness to more market-based and less centrally-planned activity – a positive for stocks. We can see a scenario in the future where it makes sense to own other regions unhedged, but at this time our emerging markets optimism is limited to the Asia region. □

[1] All references in this discussion to country and industry weights in the MSCI Emerging Markets Index are as of 12/31/13, proxied with the iShares MSCI Emerging Markets Index ETF (EEM), and sourced from Bloomberg. The comparison to the S&P 500 is proxied with the SPDR S&P 500 ETF (SPY).

This material is distributed for informational purposes only. The investment ideas and expressions of opinion may contain certain forward looking statements and should not be viewed as recommendations, personal investment advice or considered an offer to buy or sell specific securities. Data and statistics contained in this report are obtained from what we believe to be reliable sources including Bloomberg, the Bureau of Labor Statistics, Morgan Stanley, MSCI, and the World Bank but their accuracy, completeness or reliability cannot be guaranteed. An index is an unmanaged weighted basket of securities generally representative of a certain market or asset class. An investment cannot be made directly in an index. Our statements and opinions are subject to change without notice and should be considered only as part of a diversified portfolio. No conclusion should be drawn from any chart, graph or table that such illustration can, in and of itself, predict future outcomes. You may request a free copy of Keel Point's Form ADV Part 2, which describes, among other items, risk factors, strategies, affiliations, services offered and fees charged.

Past performance is not an indication of future returns.

Keel Point Advisors LLC is an independently owned registered investment advisor. Securities offered through WFG Investments Inc, Member FINRA and SIPC.