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Emerging Market Commentary

Glovista EM Perspectives

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A 30 Thousand Feet Level Account of EM Equity Cycles since Asset Class' Inception 3 Decades ago along with Asset Class Outlook: The Evolving Role of Macro and Market Structural Factors

Since the asset class' inception in the late 1980s, emerging market (EM) equities have undergone tectonic changes at the structural and macro levels. At the structural level, material changes have permeated EM index benchmarks' sector and country compositions, local markets' liquidity levels, investor participation, and governance. At the macro level, EM economies have become materially more closely integrated into the global economy and production chains, courtesy of globalization, urbanization, technological innovation and the energy revolution. Through the three decades that have lapsed since the EM asset class' inception, the role of macro factors has remained a constant lever against which cross-country and cross-sector relative valuation and earnings performance dynamics have unfolded. As we look ahead at the next ten years, we submit the relevance of country-level dynamics is bound to increase materially on the back of several secular trends, including the ascendancy of multi-polarity at the geopolitical level, the rise of anti-globalization forces and broadening effects of the ongoing energy and technological revolutions, including the internet of things and the 5G era.

EM Equities Asset Class' Metamorphosis from Fringe to Core Segment of Global Benchmarks: Genesis, Shifts in Investor Participation and the Role of the Country Factor

The EM equities' asset class finds its inception in the late 1980s, with the first meaningful index benchmark compiled by the World Bank's International Finance Corporation in 1986. A year later, in 1987, MSCI released its MSCI EM benchmark indices covering a wide spectrum of the nascent asset class. In the first few years of the asset class' history, the index benchmarks were dominated primarily by Latin American countries as the large continental economies of India, Russia and China were still in the midst of a political transition that would ultimately culminate in a period of political and economic openness to market-based activities as well as reforms including privatization, state-owned enterprise reforms, capital account and financial sector liberalization and trade reforms, among others.

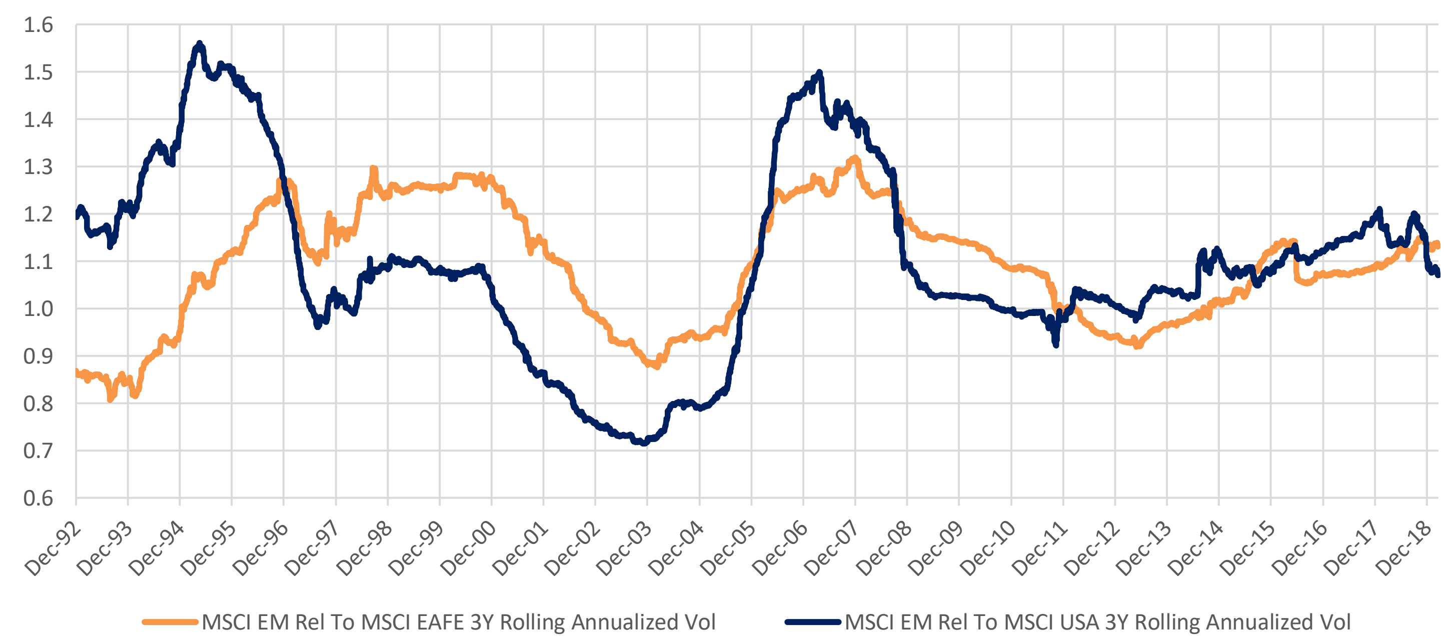
Such historical context, in which the asset class' early years were dominated by company constituents tied to commodity-exporting sectors - owing to the then heavy Latin America regional composition - along with the asset class' small role in global benchmarks, carried several implications for the asset class, including: exceedingly high cyclicality both in terms of earnings and price dynamics as sector earnings – tied to the commodities universe – are intrinsically volatile while elevated stock price volatility derived both from earnings volatility and the asset class' then fringe status vis-à-vis global investor participation. For example, in the late 1980s only 35 percent of US pension funds were invested internationally, compared to 90 percent today. Moreover, of those pension funds that were invested internationally, a large majority had exposure to EAFE and not to EM. Table 1 illustrates the material rise in EM equities' capitalization weighting in global equity index benchmarks, such as the MSCI ACW index, over the past 20 plus years.

Table 1. Emerging Markets Impact Within MSCI ACWI

Country	1987	1992	1997	2002	2007	2012	2018
USA	32.8%	40.4%	46.6%	54.0%	41.8%	45.5%	53.1%
Europe	21.1%	26.0%	30.0%	28.5%	30.2%	23.9%	21.2%
Japan	40.2%	22.7%	11.3%	8.4%	8.6%	7.4%	7.4%
Canada	2.4%	2.3%	2.3%	2.2%	3.7%	4.2%	3.0%
Developed Markets	**99.1%**	**95.4%**	**93.2%**	**96.0%**	**88.7%**	**86.4%**	**89.1%**
China	-	-	0.0%	0.3%	2.0%	2.5%	3.3%
South Korea	-	0.7%	0.2%	0.5%	1.2%	1.4%	1.2%
Brazil	0.2%	0.5%	1.0%	0.3%	1.6%	1.7%	0.9%
India	-	-	0.4%	0.2%	0.0%	0.9%	1.0%
Russia			0.4%	0.1%	1.2%	0.8%	0.4%
Taiwan		0.8%	1.2%	0.5%	1.2%	1.4%	1.2%
Argentina	0.0%	0.2%	0.3%	-	-	-	-
Malaysia	0.3%	0.8%	0.4%	0.2%	0.3%	0.5%	0.3%
Emerging Markets	**0.9%**	**4.6%**	**6.8%**	**4.0%**	**11.3%**	**13.6%**	**10.9%**

Source: MSCI

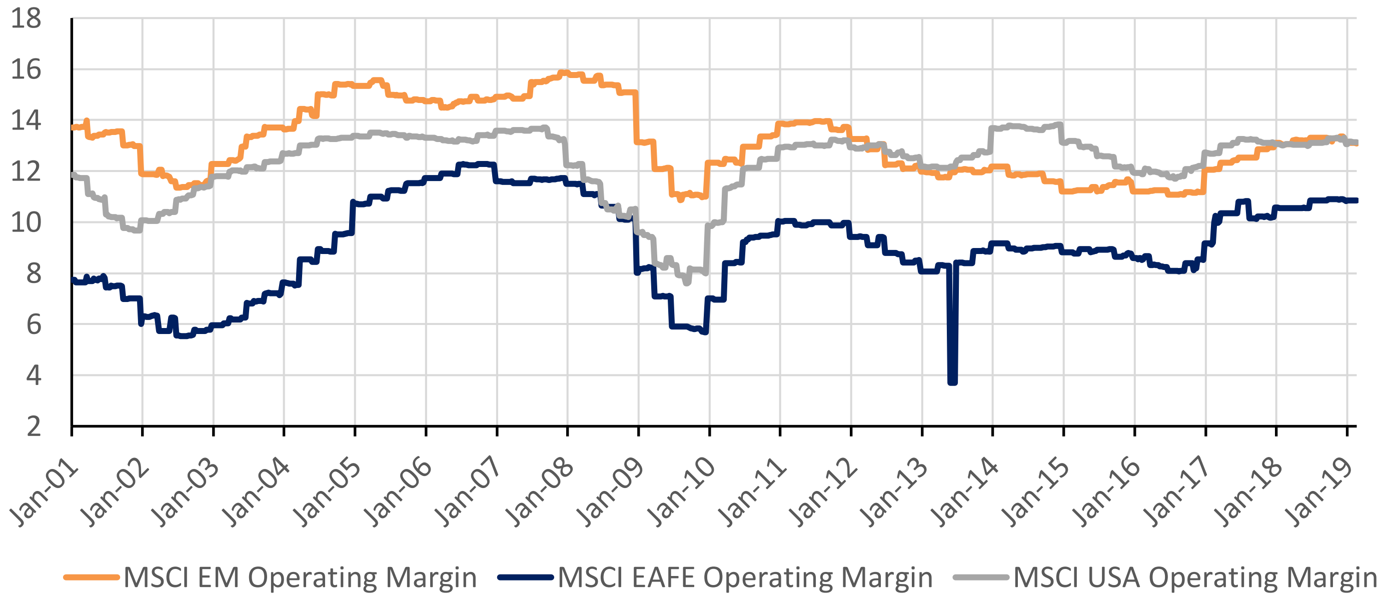
Figure 1. MSCI EM Historic Volatility Relative to MSCI EAFE and USA



Source: MSCI & Bloomberg

Figure 1 illustrates the secular decline over the past 30 years in the EM equities asset class' return volatility versus developed peers, discussed above. Such steady, secular decline in the EM asset class' relative return volatility reflects not only the asset class' no-longer fringe status – with emerging market equities currently representing 20 percent of the MSCI ACWI ex-USA universe – but also emerging market stocks' vastly diminished cyclical sector (especially commodities) representation, such as energy and commodities (Table 2). Besides EM stocks' significantly higher liquidity levels and diminished earnings cyclicality (Figure 2), EM equity returns' diminished relative volatility versus developed peers also reflects the EM asset class' stronger credit fundamentals (Figure 3).

Figure 2. Firmer Operating Margins facing EM Universe versus Developed Peers



Source: MSCI & Bloomberg

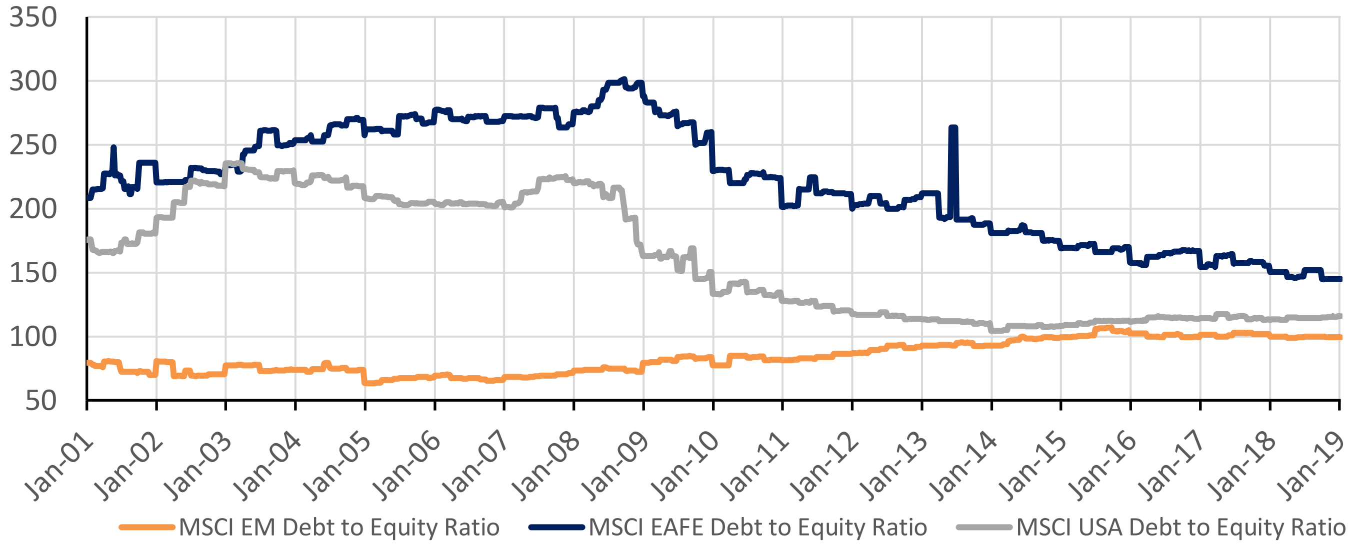
Table 2. EM Is No Longer Dominated By Commodity Exporters

Commodity Exporters	Index Weight	Neutral	Index Weight	Commodity Importers	Index Weight
Brazil	8.00%	Mexico	2.90%	India	9.40%
South Africa	6.10%	Poland	1.30%	China	30.00%
Peru	0.40%			Thailand	2.50%
Malaysia	2.40%			Turkey	0.60%
Indonesia	2.30%			Philippines	1.10%
Russia	3.80%			Hungary	0.30%
Colombia	0.40%			Korea	13.70%
Chile	1.10%			Taiwan	11.30%
UAE	0.80%			Czech Republic	0.2%
Qatar	1.10%			Greece	0.20%
				Egypt	0.10%
Total	**26.40%**	**Total**	**4.20%**	**Total**	**69.40%**

Source: MSCI and The Economist, Commodity Dependency, A Risky State, August 12, 2015

Along with the vast sector and institutional ownership changes impacting the EM asset class over the years, emerging market equities' credit fundamentals have strengthened materially during the period as reflected in Figure 3 which captures the strengthening in the MSCI EM index's underlying debt-to-equity ratio levels versus those of US and EAFE peers. Moreover, over the past several decades a growing number of EM economies have moved away from fixed or quasi-fixed exchange rate regimes, opening the setting of exchange rate levels to market forces.

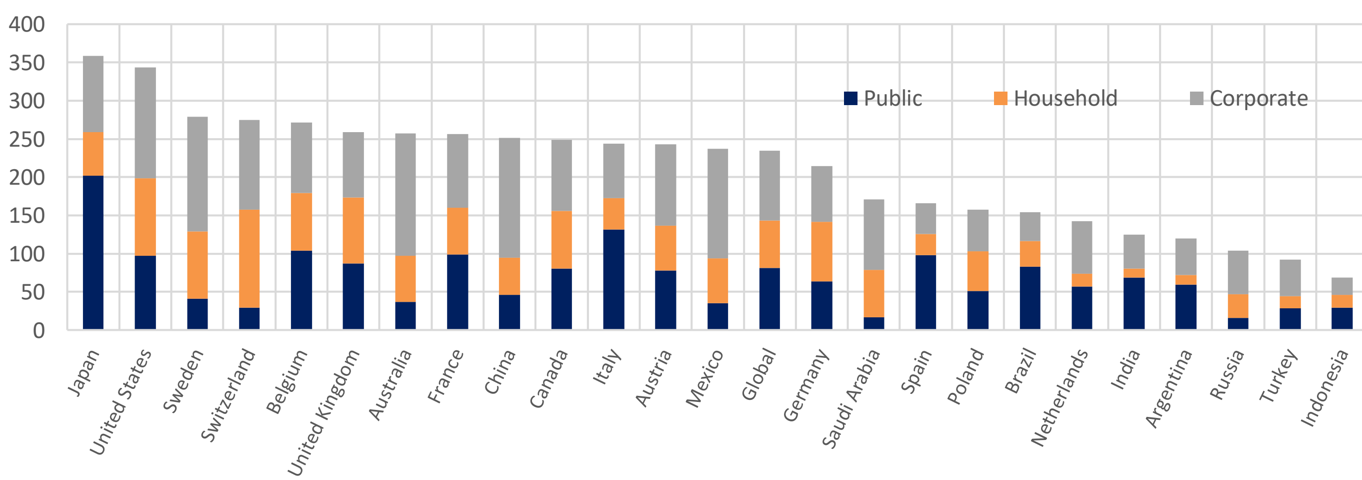
Figure 3. Strong Credit Fundamentals at Cheaper Valuations



Source: MSCI & Bloomberg

Beyond the broadening of market-oriented reforms, the vastly larger liquidity levels and stronger corporate credit fundamentals and diminished weightings of cyclical sectors in stock index benchmarks, at the macro level EM economies have strengthened materially versus developed peers, as illustrated in Figure 4. The figure captures the considerably smaller public sector indebtedness levels for a pool of large capitalization weighted EM economies when compared with some of the world's largest national economies.

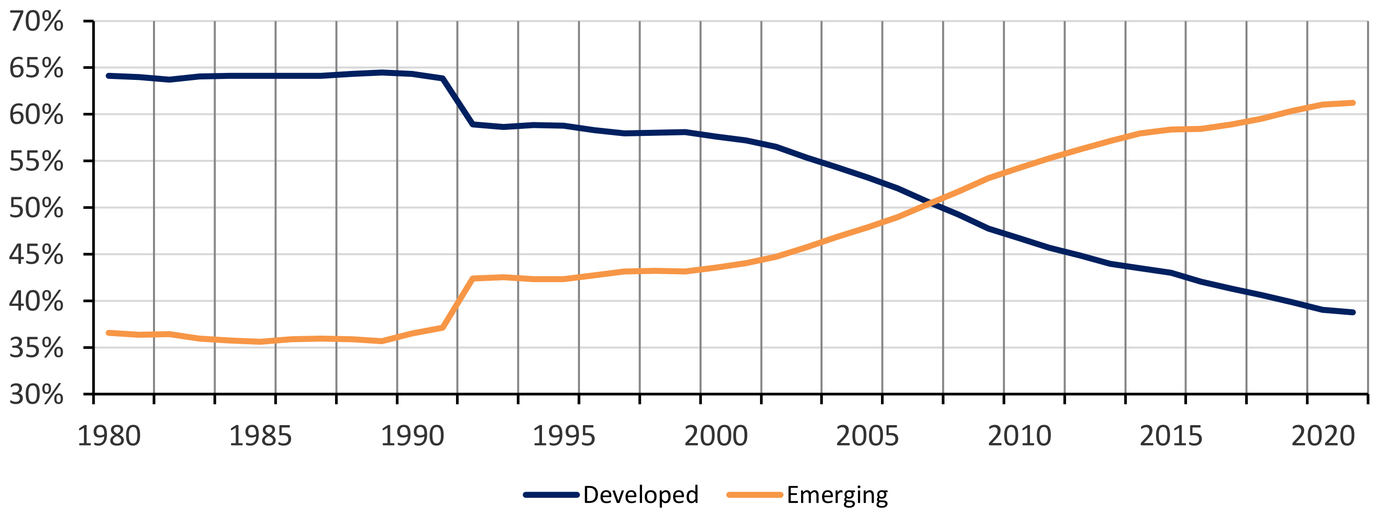
Figure 4. Non-Financial Sector Debt/GDP(%) in 2017



Source: Bank of International Settlements

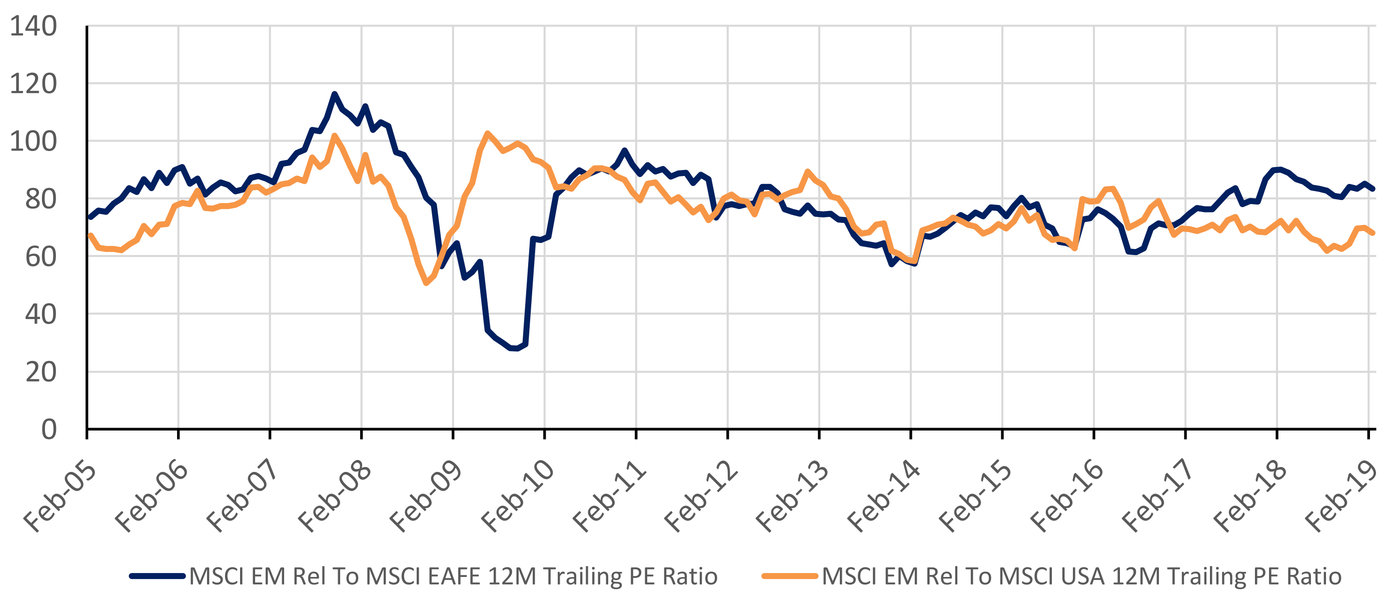
Figure 5 illustrates the marked rise in EM economies' world GDP share, from around 35 percent in the early 1980s to close to 65 percent today while Figure 6 highlights the asset class' attractive valuations versus developed peers on a historical basis, not even adjusting for varying cycle dynamics between the US (late cycle) and EM (early to mid-cycle).

Figure 5. Share of EM within Global GDP



Source: World Economic Outlook Database, International Monetary Fund, October 2018

Figure 6. EM Still Trading at Significant Valuation Discount



Source: MSCI & Bloomberg

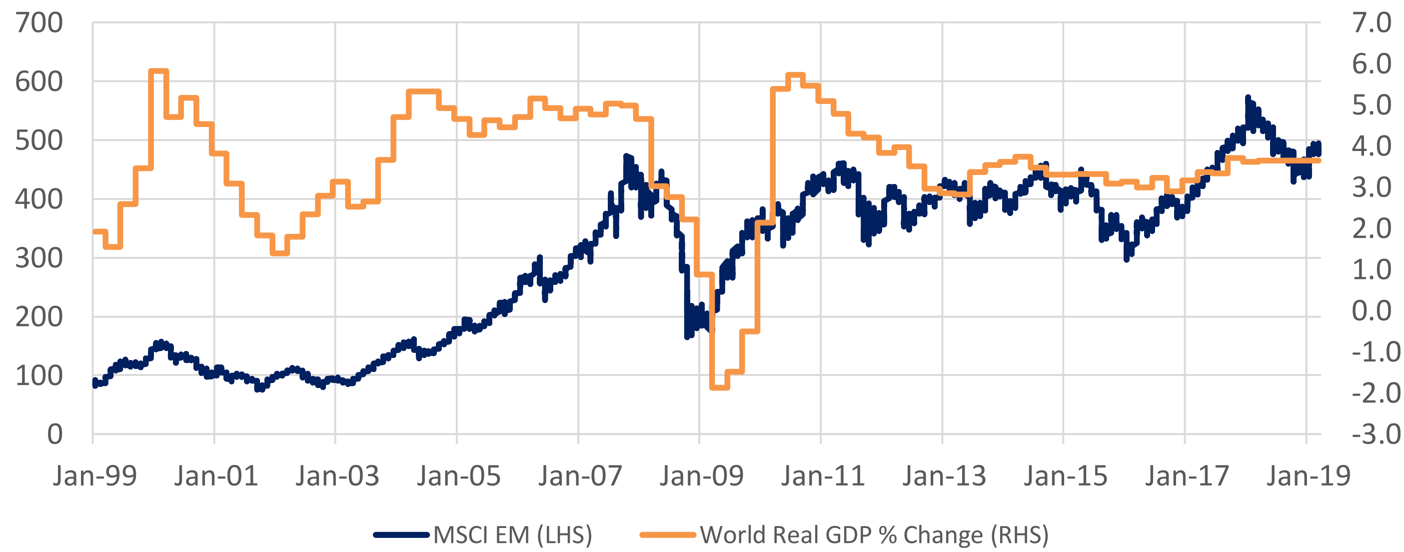
Prior to discussing in some detail the broad contours of our outlook for the asset class in the coming decade, we believe it is pertinent to address some of the main macro drivers (e.g. world economic growth, liquidity conditions, volatility, US Dollar cycle, among others) anchoring global investors' historical interest in the asset class along with the asset class' varying sensitivity to said pool of macro factors over the years. Following a brief outline of such factor list immediately below, we organize the remainder of this report by briefly summarizing some of the distinctive characteristics of the EM asset class' performance throughout each of the past three decades of its history, followed by a discussion of our outlook for the next decade.

Emerging Market Equities' Allure to Global Investors: Diversification, Growth Exposure

Historically, global investor interest towards the EM asset class has centered on a number of considerations, including two key ones: diversification (across the country domain, including exposure to a large pool of currencies tied to imperfectly synchronized domestic business cycle dynamics); and, exposure to growth dynamics distinct from those present in the developed world's domestic economies.

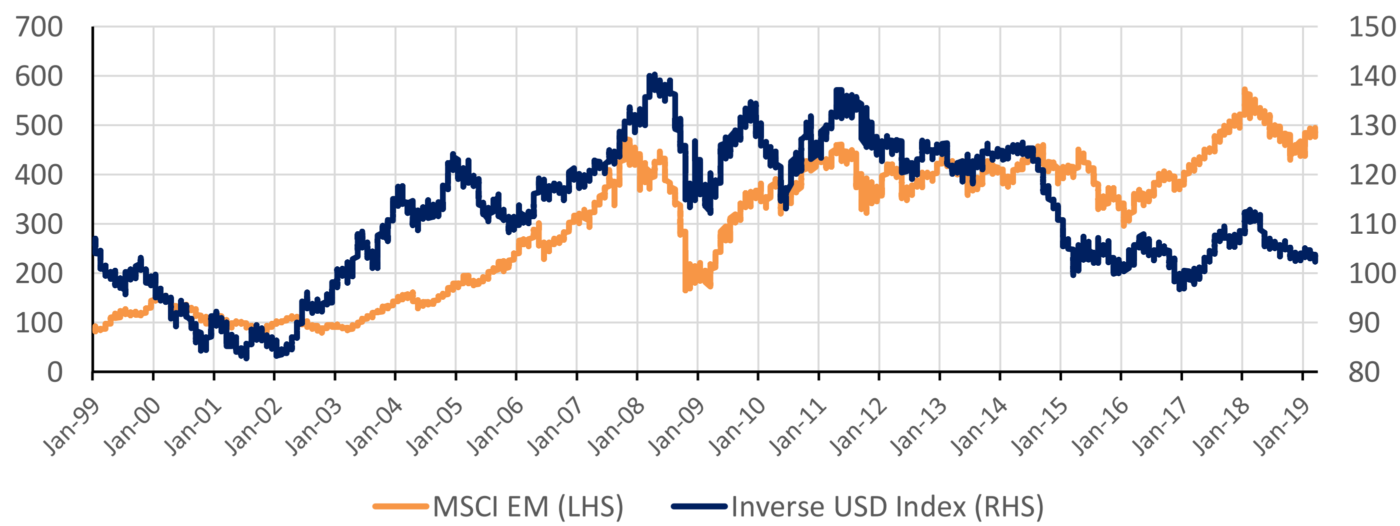
Figure 7 illustrates the close positive historical co-movement between world economic growth dynamics and EM equities' returns while Figure 8 highlights the inverse historical co-movement between the US Dollar index and the direction of EM equity prices.

Figure 7. MSCI EM Index and World Real GDP Growth YoY (%)



Source: MSCI & Bloomberg

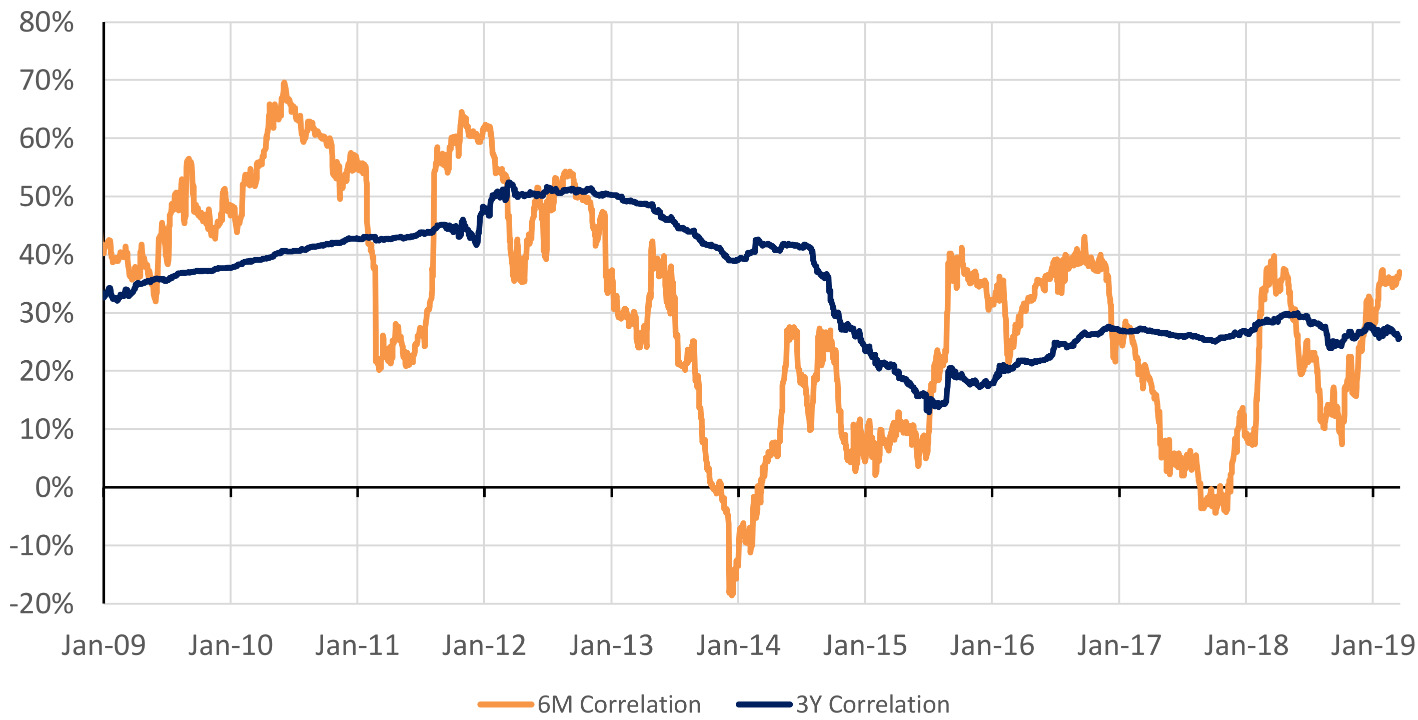
Figure 8. EM Still Correlated to US Dollar Strength



Source: MSCI & Bloomberg

Over the years, EM equities' sensitivity to commodity prices and global interest rates has diminished (as illustrated in Figure 9) owing to several considerations, including a growing participation of local investors, strengthened macro credit conditions, flexible exchange rate systems and EM equity index benchmarks' reduced cyclicality at the sector level, as discussed above.

Figure 9. EM's Correlation to Crude Prices Has Been Declining Since 2012



Source: MSCI & Bloomberg

A 30 Thousand Feet Level Account of the Past Three Decades for the EM Equities Asset Class

The 1990s Decade: A Cross-over, Discretionary Asset Class

Index benchmarks were dominated by Latin American issuers as a large share of emerging Asia regional economies were still managed under communism, socialism or heavy state-sector participation. The Latin America region was the first to implement large scale privatization reforms that resulted in a number of stock market listings (e.g. Mexico, Argentina and Brazil), including in the telecom, energy and banking sectors.

Market liquidity was exceedingly low, lending the asset class a 'frontier', cross-over, discretionary market status. Moreover, the decade marked the beginning of the modern era of financial globalization following a more than 100 year hiatus since the late 1890s period. During this decade, EM equities displayed a high level of cyclicality owing to Latin American currencies' cyclical status, derived from those economies' heavy reliance on energy and industrial metal commodity exports, as well as Latin American countries' fragile macroeconomic balance sheets.

International investors taking exposure to the asset class did so for diversification gains as well as exposure to commodities market along with a 'call option-like' exposure to economic growth potential in such economies. From a sector composition, EM equity index benchmarks displayed a heavy value tilt owing to energy and industrial commodity producers' heavy participation.

The decade brought about important 'growing pains'-like events for the asset class resulting both from the significant growth in index constituents as the rising wave of privatization and new issuance activity permeated various emerging market regions around the world. In addition, the fixation of multiple countries to fixed or managed exchange rate regimes was subjected to important 'stress-test'-like experiences in the form of the reversal of foreign portfolio capital flows from countries that had experienced large domestic credit-led growth, such as Mexico (triggered by the US Fed rate hike cycle of 1994). In the process, fixed exchange rate regimes collapsed across a number of countries in Latin America and Asia. Such regimes were replaced by either free-floating or quasi-floating exchange rate regimes, better equipped to withstand the ebb and flow of foreign capital inflows.

More generally, as a result of the significant pain inflicted by the Mexican peso (1994) and Asian financial crisis (1997-98), both of which shared fixed exchange rate regimes as common factor, a number of countries found themselves in the need to sponsor broader market liberalization and openness measures following the crises' onsets. The subsequent Argentina peso crisis (2002) also shared the similar seed factor of those found in the Mexican peso crisis of 1994: the straightjacket-like effects stemming from fixed exchange rate regimes along with the excesses in the domestic credit system that build up under such fixed price systems. The Russia (1998) crisis was fueled by the significant energy price declines set off by the Asian crisis. The Russian public sector's excessive reliance on the energy sector to balance its fiscal accounts helped set off the confidence crisis that escalated into a full-fledged financial crisis that enveloped Russia during that time, exacerbated by the authorities' arguably misguided decision to default on local public debt. In the years that followed the crisis, Russian authorities have implemented legislative reforms broadening the Russian economy's tax revenue base, thus lessening the public sector's reliance on the energy sector.

In short, the EM asset class' first decade was one characterized by the asset class' growing complexity associated with a heavily active new issuance market activity, propelled by privatization and marketization efforts that enveloped the EM economies during the modern globalization era's first decade. At the decade's end, a number of national financial crises were set off by the unsustainability of the macro financial regimes and policy backdrop embraced earlier in the decade, particularly fixed exchange rate regimes and excessive reliance on commodity sectors to balance fiscal accounts. The strong US Dollar cycle that defined that decade helped unveil many of said domestic imbalances across a number of EM countries. Towards the late 1990s and early 2000s a large number of EM countries embraced corrective reform measures that planted the seeds for the EM asset class' golden decade of 2000-2010.

The 2000s Decade: A Globalization, Commodity, Diversification Play

It is no exaggeration to express that the 2000s can be defined as the golden decade of the EM asset class. Several cyclical trends came into place so as to fuel the asset class' exceedingly strong performance during that period, both in absolute as well as relative terms versus developed peers. Some of those cyclical trends included: the declining US Dollar cycle, the end of the US economic growth exceptionalism era of the 1990s as the US mortgage crisis set off a vicious unwinding of the excesses built up through the years via a sustained rise in private sector indebtedness, and the cyclical upturn of the EM economies following the sharp crises experienced in the late 1990s that planted the seeds of a new wave of economic reforms implemented in the late 1990s and early 2000s.

During the decade, EM earnings outperformance massively outpaced those of the developed world, along with strengthening EM currencies and stronger terms of trade. In that context, EM valuation multiples re-rated versus developed peers. Other factors supporting the asset class during the decade included China's entry into the World Trade Organization (WTO) and the broadening wave of economic reforms across a number of emerging market countries.

Notwithstanding the EM asset class' stellar return performance during this decade, including the asset class' strong return outperformance versus developed peers in the aftermath of the 2007-2009 crisis, it is clear that the 2007-2009 crisis helped plant the seeds for the EM asset class' underwhelming performance in the decade that followed.

The 2010s Decade: Strong US Dollar and China Deleveraging Underpin Asset Class' "Lost Decade"

The EM equities asset class formed a major multi-year top versus developed market equities in the 2010-2011 period. Over the ensuing years, EM equities steadily underperformed developed market peers fueled by multiple reinforcing macro dynamics adverse to the asset class including the following:

- The beginning of a multi-year long US Dollar bull cycle versus both developed and EM currencies;
- End of super-cycle in commodities space as the Chinese economy embarked on a secular transition from a commodities intensive goods-sector to a commodities-light service-sector growth model following decades of supercharged goods sector-oriented growth;
- Beginning of multi-year long Chinese economic growth deceleration anchored on both the corresponding decline in productivity growth derived from the embrace of a service sector oriented growth model as well as the effects from the economy's financial deleveraging efforts following the unprecedented domestic credit growth recorded during the 2000s decade;
- Unwinding of macroeconomic excesses across a number of EM economies whose domestic sectors had grown above trend towards the tail end of the 2000s, fueled by the well above nominal GDP growth rate in domestic credit accommodated by central bank institutions in those countries when faced with large foreign capital inflows. Such imbalances manifested themselves via large current account and budget deficits, as was evidenced in Brazil and India, for example.

The above-mentioned dynamics impacted most adversely commodity export-oriented emerging market countries during the decade. As a result, the 2010s has been a decade in which north Asian markets have outperformed the MSCI EM index the most. Moreover, in 2015, the Chinese market underwent a massive weighting increase within the MSCI EM index benchmark as several behemoth companies, including Tencent, Alibaba and Baidu, entered the benchmarks. Such development helped fuel a sustained foreign investor interest in the Chinese market. Furthermore, the 2010s decade – one characterized by unprecedented benign global liquidity conditions courtesy of the quantitative easing policies implemented by the world's major central banks – proved unusually supportive of growth stocks globally, fueled by unusually low inflation adjusted long term interest rates.

As we look ahead to the next decade, as discussed immediately below, we expect the unwinding of some of the macro trends that have defined the 2010s decade. We turn to the outlook in the next section.

Emerging Market Equities: The Next Decade

As we look ahead at the next decade, directionally, we expect EM equities to post solid absolute (at least 7 percent average annual US Dollar return performance) and also solid return outperformance versus developed peers. We hold such expectations on the back of:

- the EM asset class' beneficiary status from current depressed absolute and relative, cycle-adjusted, valuations;
- asset class' beneficiary status from a turn (lower) in the US Dollar cycle following the turn of the 10 year average cycle length recorded in the past several decades;
- asset class' under-owned status on the part of global investors;
- EM economies' solid macro and corporate credit fundamentals versus developed peers;

- EM equity index benchmark's vastly larger exposure to non-tradable, domestic (consumer and investment) sectors as opposed to yesteryear's heavy tradable, commodities-oriented sectors;

- EM (domestic) sector stocks' beneficiary status from strengthening EM currency valuations, on the back of our weaker US Dollar cycle thesis for the coming decade as well as the EM currency valuation support stemming from strong balance of payments positions as well as prevailing above historical average real interest rate differentials with the US Dollar, Euro and Yen.

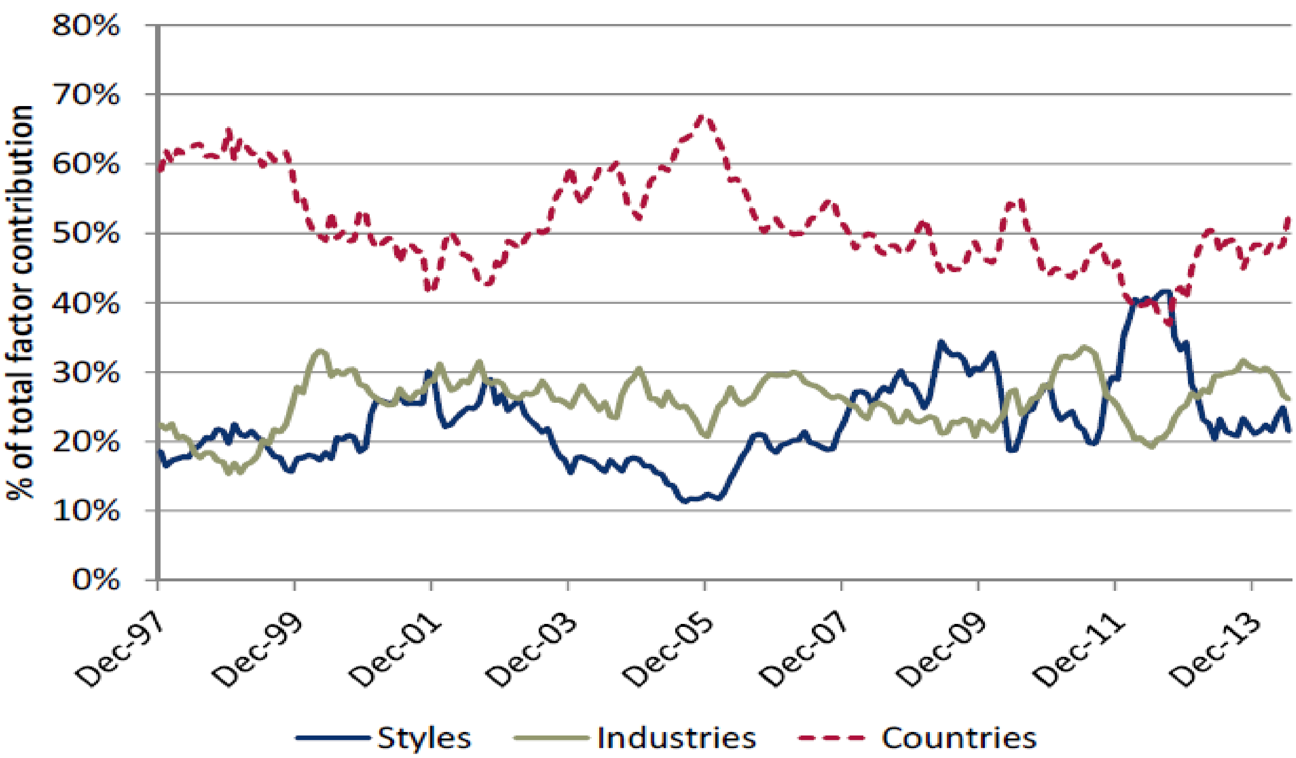
As for the most likely venues through which to generate excess returns (alpha) in an emerging markets-only equities portfolio in the coming ten years, we firmly believe investors ought to focus not mainly on the value-growth style divide but rather on the country factor. We hold such strong conviction view given several considerations, including the following:

- The increased prevalence of anti-globalization forces, including nationalism - along with the likely normalization of bond term premium levels in the developed world and the end of quantitative easing – are likely to lift the unusually growth stock friendly environment of the past 10 years in which it was 'easy' to simply be overweight growth over value;

- The broadening and deepening effects of the energy and IT revolution (including the internet of things and 5G) are likely to set off an explosion of local economy activity (service sectors primarily, cutting across the growth-value style divides). Such plays are likely in our view to be the main beneficiaries of economic value-added generated from such tectonic changes in the global economy's structure;

- The past decade, as discussed in the section above, proved unusually uneven in terms of the small number of countries accounting for much of the return outperformance versus the index benchmark (e.g. performance driven by a small number of large capitalization countries).

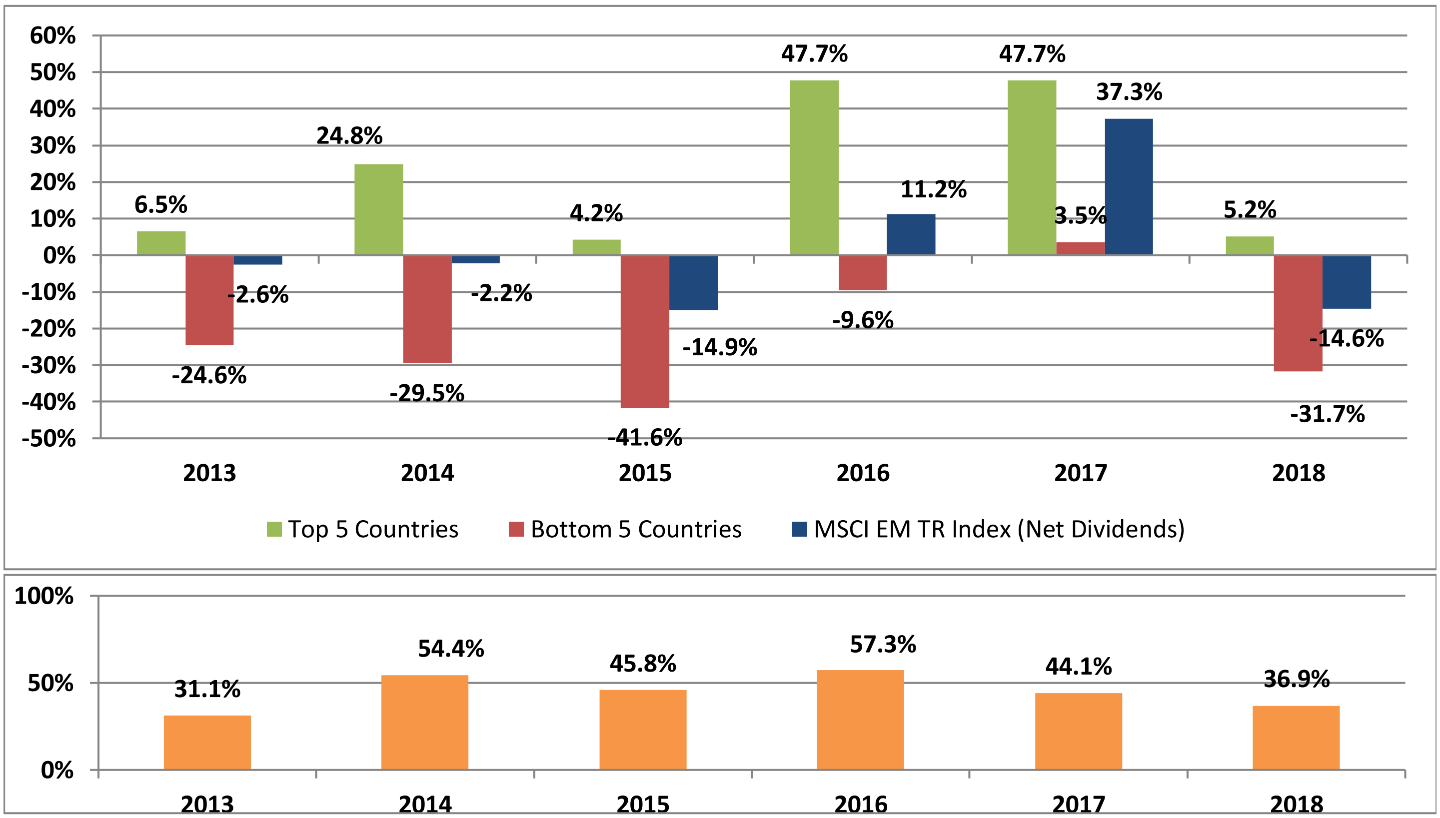
Figure 10. Country Selection as Dominant Factor Driving EM Returns



Source: MSCI Report "The Relative Strength of Industries and Countries in Emerging Markets," September 2014

It is important to note that historically the country factor has proven to be dominant in driving EM total return contributions, as found in research undertaken by MSCI (*"Built to Last: Two Decades of Wisdom on Emerging Markets", 2012 and "The Relative Strength of Industries and Countries in Emerging Markets," September 2014*) – e.g. Figure 10. Furthermore, it is of interest to note the historically large and stable dispersion of returns at the country level between pools of top- and bottom-performing country indices, as illustrated in Figure 11 which shows such annual statistics for the last six years.

Figure 11. Return Dispersion Across Countries in Emerging Markets: Opportunity to Capture Alpha
(Top Panel: Actual Annual Returns, Bottom Panel: Annual Dispersion between Top 5 and Bottom 5 Countries)



Source: Glovista Investment & MSCI

Concluding Remarks

The above discussion has offered a synoptic summary of the past three decade history for the EM equities asset class, highlighting a number of salient structural and macro developments defining absolute and relative return performance during such period. As we look ahead, we conclude with a bullish 10-year investment thesis towards the asset class both in absolute and also relative terms versus developed peers. Moreover, at the factor level, we expect the country factor to play a dominant role in the generation of excess returns within an EM equities only portfolio over the coming decade. Glovista's 20-year track-record long strategy provides an historical perspective for our positive assessment of the opportunities for alpha generation in such environments. In that light, we anticipate at normalizing higher our portfolios' tracking error budget to historical average levels so as to benefit from such 'blue sky' environment facing our strategy.

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