Emerging Markets

An out of favor asset class gains momentum

Emerging market equities have been an unloved asset class in recent years. While major US equity indices repeatedly reached and surpassed historic highs, emerging market equity returns languished. But is it time to take a closer look?

After suffering through a long dry spell, emerging market equities staged a recovery in 2016, with the MSCI Emerging Markets Index posting an 11.1% annual return, just short of the 11.9% for the S&P 500 (see Figure 1). This coincided with economic growth bottoming out in emerging markets. This positive streak has continued into 2017, with the MSCI Emerging Markets Index already up 11.4% for the first quarter, compared with 5.5% for the S&P 500. Several important factors may bode well for the performance of emerging market equities over the next few years:

- Improvement of key indicators such as economic growth, corporate earnings and profitability.
- The potential for rising incomes and consumption growth.
- Rapid adoption of technology/Internet helping to surpass traditional consumer channels.
- Attractive valuations relative to developed market equities.

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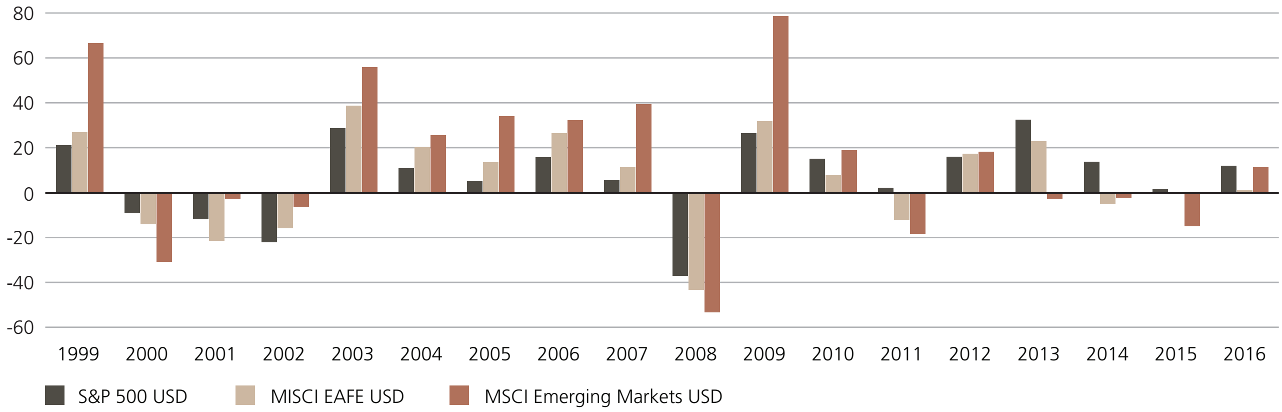
Figure 1. After languishing for several years, emerging markets are starting to recover
Calendar year returns for S&P 500, MSCI EAFE and MSCI Emerging Markets Indices (1999-2016)



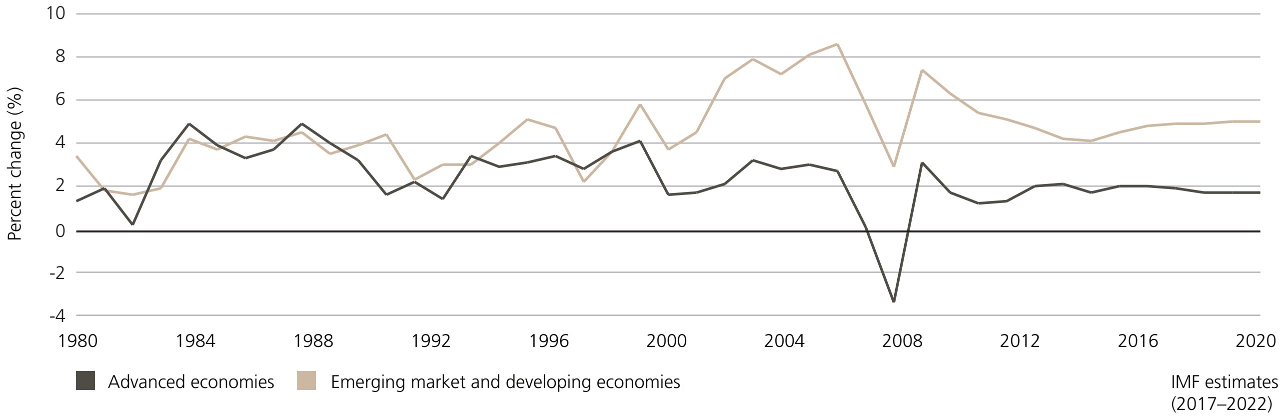
Source: Morningstar. As of December 31, 2016.

Faster growth in a slow growth world

In the years following the financial crisis of 2008-2009, global economic growth slowed considerably. Yet despite the slowdown in the developed world, emerging market economies surfaced as a bright spot, even posting 2.9% growth in gross domestic product (GDP) in 2009 during the worst of the economic crisis. In contrast, advanced economies slipped by 3.4% for the same year.[1] And despite current global uncertainty amid last year's surprise outcomes in the Brexit vote and the US presidential election, emerging markets GDP grew 4.1% in 2016 compared with 1.7% for advanced economies.

Going forward, the International Monetary Fund (IMF) also expects emerging and developing markets to grow 4.5% and 4.8% in 2017 and 2018, respectively. That's more than twice their estimates for the advanced economies, which are expected only to grow by approximately 2% in both 2017 and 2018 (see Figure 2). Emerging economies now account for more than 75% of global growth in output and consumption, almost twice their share 20 years ago.[2] As emerging markets continue to develop, these trends are expected to continue, with the IMF estimating that the share of global GDP from emerging markets could increase from 38.8% (in USD terms) today to 60% by 2035.

Figure 2. Actual and estimated percent change in gross domestic product for developed and emerging markets



Source: IMF, 2017.

1 Gross domestic product (GDP) is the monetary value of all the finished goods and services produced within a region's borders in a specific time period and is commonly used as an indicator of economic health.
2 International Monetary Fund, "World Economic Outlook, April 2017: Gaining Momentum?"

Favorable demographics: an engine for growth

While some investors may have concerns about a slowdown in the developed economies, emerging markets may present regional opportunities that are not overly dependent on overall global economic growth. Given favorable demographics and rising incomes, increased personal consumption by their own populations may be a significant factor driving regional economic growth in emerging markets. The IMF estimates that 80% of the world's population lives in emerging markets. While many of them are poor, collectively they are getting a little bit richer every day. This means more spending and evolving consumption trends toward discretionary items like healthcare, education and leisure. Not only are the populations in emerging markets larger and growing, they are also younger than those in developed markets, which may contribute to an expanding middle class.

In 2009, the size of the "global middle class" was approximately 1.8 billion, representing 27% of the world's population, and is expected to grow to 3.2 billion by 2020 and 4.9 billion by 2030.[3] Much of this increase will occur in developing countries, such as China and India. In fact, by 2030, it is estimated that all of Asia could represent as much as two-thirds of the global-middle class population.[4] Households just entering the middle class often seek to buy consumer durables (e.g., washing machines, air conditioners, automobiles, etc.), as well as services including tourism, entertainment, health, education and transportation. As a result, the burgeoning middle class in emerging markets can be an important engine for economic growth in the decades to come. While there are other factors—such as productivity growth, foreign exchange rate fluctuations, and changes in developed markets demand—that affect emerging markets equities, the growth dynamics in emerging markets appear promising alongside slower growing developed economies.

The combination of these structural underpinnings, stronger economic growth and attractive valuations make emerging markets equities an attractive long term proposition. Emerging markets offer investment opportunities that aren't overly dominated by the "new normal" of sluggish economic growth. That's why long-term, investors might want to consider adding an allocation to emerging markets equities within an overall diversified portfolio. Your Financial Advisor can help you select investment solutions that provide appropriate, diversified exposure to a range of asset classes, including emerging markets.

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Index definitions:
The S&P 500 Index is an unmanaged, weighted index comprising 500 widely held common stocks varying in composition. Returns consist of income, capital appreciation (or depreciation) and currency gains (or losses).

The MSCI Emerging Markets Index is a market capitalization-weighted index composed of different emerging market countries in Europe, Latin America and the Pacific Basin.

The MSCI EAFE Index is an index of stocks designed to measure the investment returns of developed economies outside of North America.

3 OECD, 2017.
4 Brookings Institute, 2017.

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