The Investment Compass Points Due East: Asia's Appeal to Emerging Markets Equity Investors

Valuations, fundamentals, and a more appealing macro picture make tilting emerging markets equity exposure toward Asia a sensible proposition

- Asian emerging markets equities are fairly valued after the recent rally, but valuations remain downright cheap relative to the rich US equity market.
- Emerging markets equities as a whole are also cheap relative to US equities, but other regions are more exposed to commodity and currency risks than Asian emerging markets are. Economically, Asia is in better shape than other emerging regions.
- China remains the biggest risk for Asian exposure, and a further growth stumble or a credit crisis in the country would likely be felt across the region.

Emerging markets equities continue to be appealing on a valuation basis, particularly relative to pricey US equities. However, investors are rightly concerned that many countries included in emerging markets indexes face substantial economic headwinds now from depressed commodity prices. Investors concerned about these headwinds may be interested in exclusively targeting Asian emerging markets, thus leaving behind the more commodity-dependent components of the broad emerging markets universe including Brazil, Russia, and South Africa.

Valuations for Asian emerging markets are at par with those of the broad emerging markets universe, but they are certainly low relative to history and the US market. Further, currency vulnerabilities may be lower for Asian than non-

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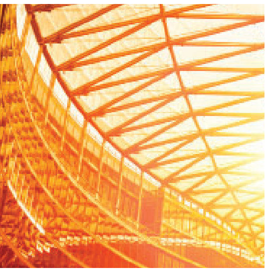
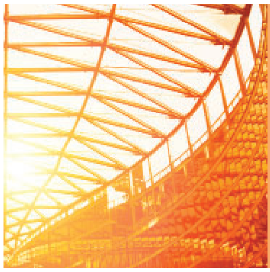




Asian emerging markets. However, investors worried about risks of a further slowdown or a credit bust in China should be aware that Asian emerging markets are heavily tilted to China (directly and via indirect exposures).

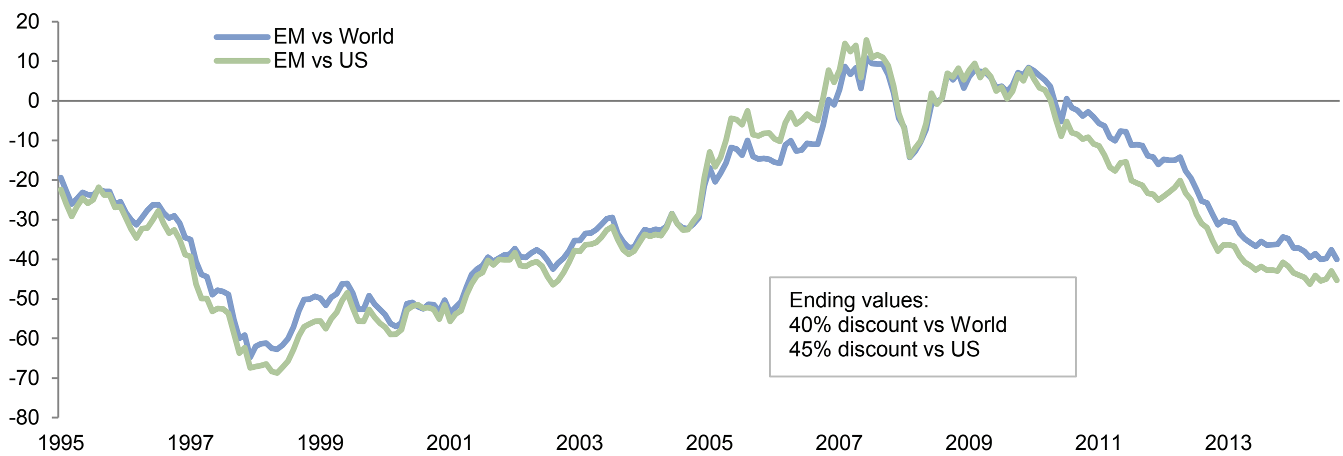
Valuations Not in a Hurry to Mean-Revert

Emerging markets equity investors may be forgiven for feeling impatient. According to our normalized valuation metrics, emerging markets became undervalued relative to the United States in November 2013 (Figure 1). Investors that began to tilt portfolios in favor of emerging markets and away from the United States at that time have watched the US market power ahead, returning 20% cumulatively since then versus 2% cumulatively for emerging markets (in US$ terms).

While we have highlighted before that valuation-based tilts often take several years to play out and initial valuations have little or no relationship to short-term performance,[1] interim underperformance is still difficult to tolerate. In October 1997, emerging markets equities reached current levels of relative undervaluation versus the United States, yet initiating an overweight at that point would have been quite painful, given that emerging markets countries suffered both a financial crisis in 1997–98 and the SARS epidemic in 2004. US$-based investors that moved tactically into emerging markets from US equities in October 1997 would have waited until August 2005 for the bet to begin paying off; not all investors can tolerate such a prolonged drought. Investors that overweight an asset class because it appears to be relatively cheap should recognize that it could take many years for the relative valuation gap to narrow.

[1] Please see "Decades of Data: Global Markets 1900–2014," Cambridge Associates Chart Book, March 15, 2015.

Figure 1. Valuation Premium/Discount for Emerging Markets Versus Both Global Developed Markets and United States (Based on Composite Normalized P/E Ratio)
September 30, 1995 – May 31, 2015 • Premium Discount (%)



Asian Emerging Markets Less Exposed Than Others to Low Commodity Prices, Federal Reserve Tightening

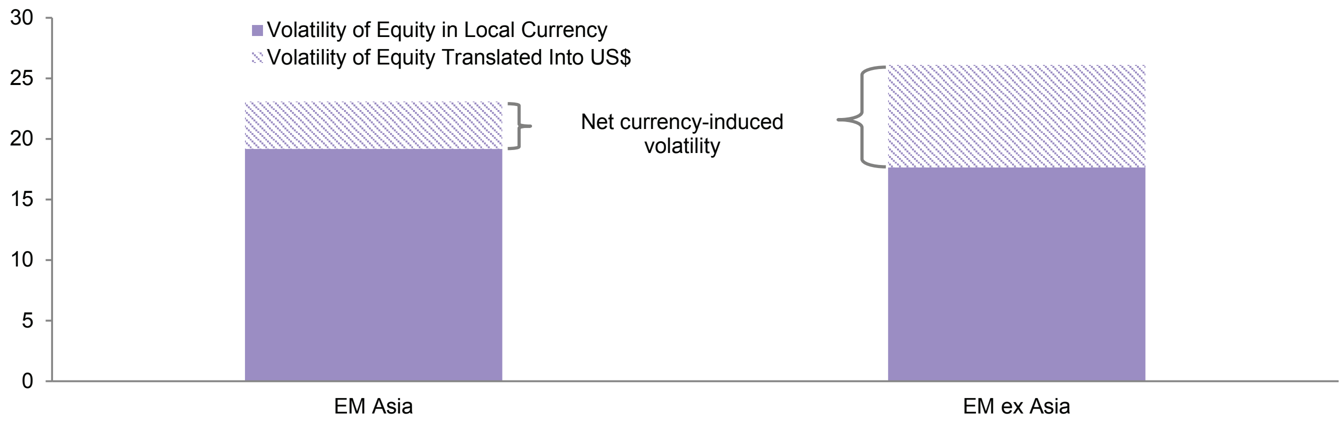
A performance drought is particularly difficult when economic conditions in the relatively undervalued (and overweighted) market deteriorate relative to the overvalued (and under-weighted) market. While some emerging markets economies have held up well, many countries face threats from slowing Chinese growth, depressed commodity demand, and the prospect of the Fed tightening. Contrast that with the United States, where the unemployment rate has been nearly halved from 2009's peak 10% level. Investors that have been underweight US equities for a year or more are in the uncomfortable situation of explaining why they are tilting toward markets that appear to be vulnerable and deteriorating rather than a market that seems to be gaining strength. The economies of both Brazil and Russia have deteriorated badly over the past year, in part because prices for oil, iron ore, and other commodities have declined. In addition to these headwinds, of course, Russia has been hammered by sanctions, while Brazil has faced revelations of massive corruption at state-controlled oil giant Petrobras.

Investors concerned about these commodity exposures should focus their emerging markets overweight on Asian markets.[2] While some Asian economies and firms face pressures from falling commodity prices (particularly Indonesia), they are the exception. Many emerging Asian markets are in fact net commodity importers. Further, US economic strength benefits Asian-listed firms that sell to US buyers (such as automaker Hyundai Motor).

Additionally, Asian markets may be less subject to instability and currency deterioration than other emerging markets regions. Over the past ten years, the currency-induced volatility of the MSCI Emerging Markets Asia Index has been just half that of the MSCI Emerging Markets ex Asia Index (Figure 2). This is in part because the shares of MSCI China (37% of the MSCI Emerging Markets Asia Index) are denominated in the Hong Kong dollar, which is effectively pegged to the US dollar; however, there appears to be little likelihood of de-pegging anytime soon. The currencies of the individual Asian emerging markets are also much less sensitive to equity markets, and to commodity prices, than those of other emerging markets. The weighted-average beta of Asian emerging markets currencies to the broad emerging markets index and to commodities over the past three years is much lower than the beta for emerging markets currencies in other

[2] Note that we don't advocate focusing the portfolio's *entire* emerging markets position on Asia—merely any portion that exceeds the strategic weighting. For example, an investor with a 10% policy allocation to emerging markets and a 13% allocation today should consider devoting that 3% overweight to Asia (with the remaining 10% exposed globally). This would constitute a relatively moderate Asia tilt at the total-portfolio level, given that the broad MSCI Emerging Markets Index already is 68% allocated to Asia. Please see additional comments on this positioning by Cambridge Associates's Chief Investment Strategist Celia Dallas in the first quarter 2015 and second quarter 2015 editions of "VantagePoint."

Figure 2. Currency-Translation Impact on the Volatility of Asian and Non-Asian Emerging Markets
June 30, 2005 – May 31, 2015 • Annualized Standard Deviation (%)



regions, stemming in part from the generally lower commodity exposure. (Figure 3).[3]

While Asian currencies are currently more stable than those of other emerging markets nations, could this change rapidly (the Swiss franc, for example, was rock-steady versus the euro, until it was not)? Are Asian currencies and economies at significant risk of deteriorating, as they did during the crisis of 1998? While it is impossible to rule out a crisis, clearly Asian markets are in much better shape than they were in 1997, and they are also in better shape than other emerging markets peers (Figure 4). Current accounts for Asia are in surplus, and Asian markets are not overly dependent on foreign lenders. Additionally, foreign exchange reserves (primarily in China but in other countries as well) serve as a bulwark against crises; they are today nearly 30% of GDP for Asia versus about 11% in 1997.

Are Asian equities more or less vulnerable to liquidity withdrawal associated with the eventual end of loose US monetary policy? It is impossible to predict with certainty the impact of the Fed tightening, but during 2013's Taper Tantrum, emerging markets outside Asia fell 13.7% for US$-based investors, while Asian emerging markets fell less than half as much despite having exposure to two of the "Fragile Five"[4] (some, but not all, of the difference can be attributed to the Asian index's large weight in China's managed currency).

[3] Beta is a measure of the strength, direction, and magnitude of a historical statistical relationship. For example, the emerging markets Asia weighted-average beta of 0.12 to commodities indicates that a 1% monthly increase of the Bloomberg Commodity Index was associated with a 0.12% increase in the value of emerging Asian currencies versus the US dollar. Betas are generally not static, and the relationship of Asian currencies to equities and commodities might increase or decrease somewhat in the future.

[4] The "Fragile Five" was a term coined in 2013 to refer to five emerging markets countries seen as particularly vulnerable: Brazil, India, Indonesia, South Africa, and Turkey.

Figure 3. Sensitivity of Emerging Markets Currencies to Commodities and to Emerging Markets Equities
May 1, 2012 – May 31, 2015

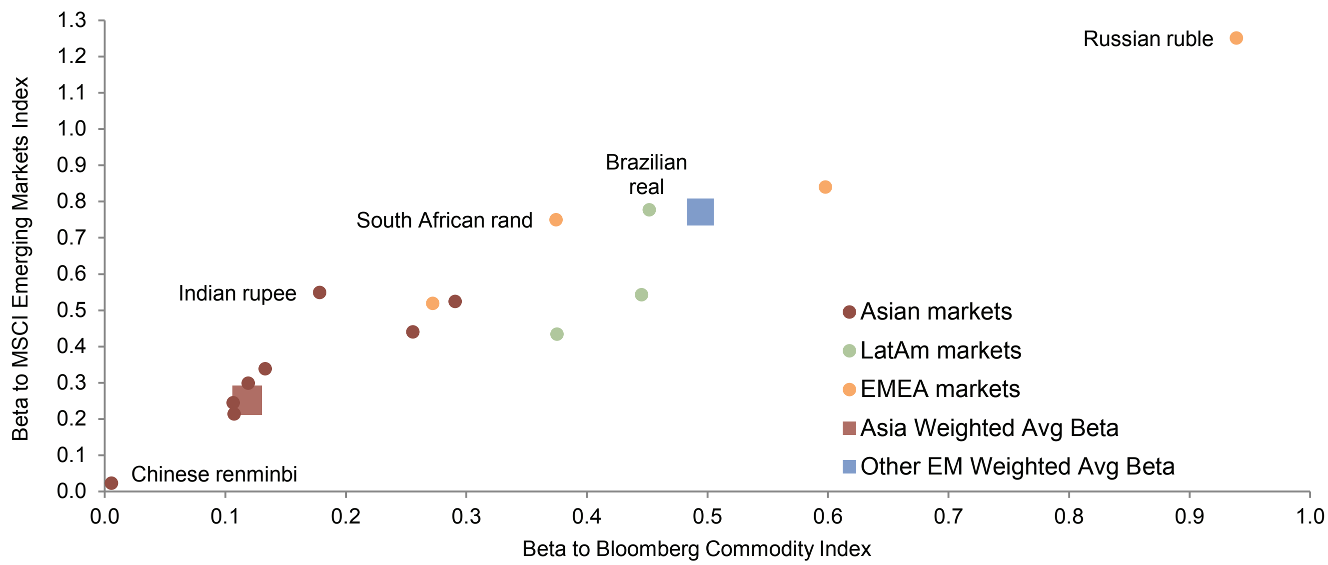
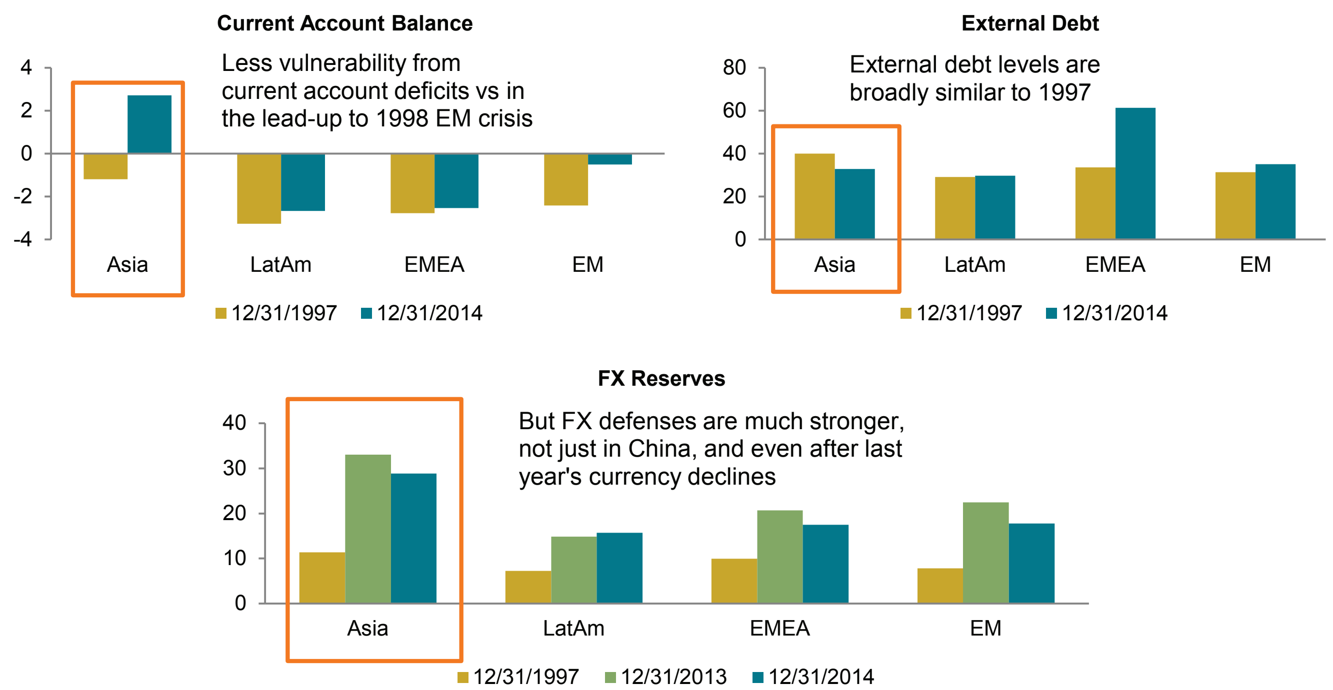


Figure 4. Emerging Markets Macro Indicators
1997–2014 • Percent of GDP (%)



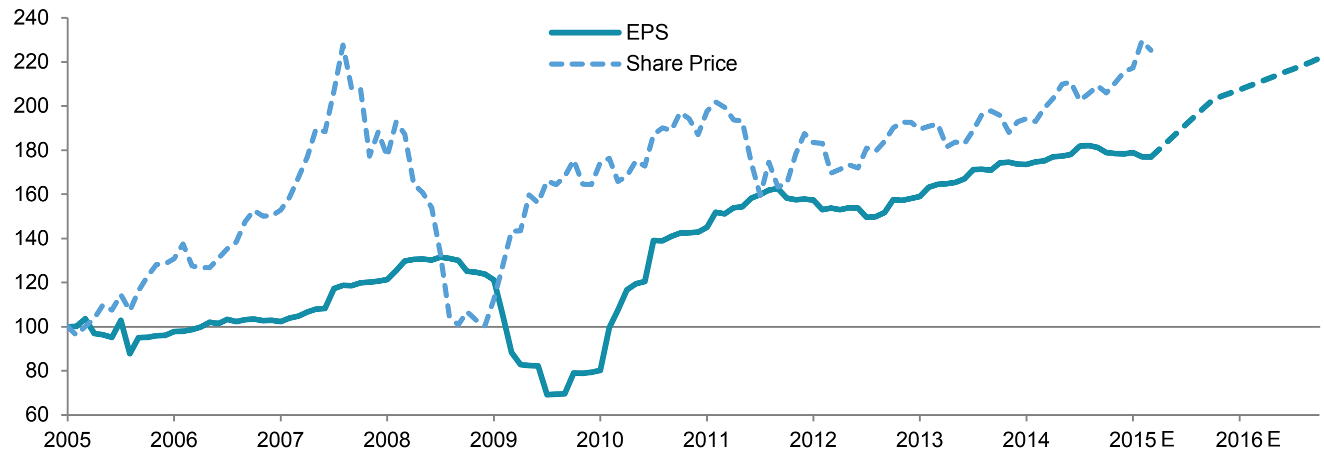
Fundamentals and Valuations Appear Reasonable

While it is difficult to generalize, firms in Asian emerging markets appear to be on somewhat more steady ground than those in other emerging markets. While Brazil's massive Petrobras corruption scandal has impacted credit markets across the country and called the state-controlled firm's accounting into question, and Europe, the Middle East & Africa (EMEA) have been impacted by Russia sanctions and plummeting commodity prices, Asian firms have quietly notched decent earnings growth, relatively independent of the path of commodity prices. Asian emerging markets companies increased earnings per share (EPS) at a reasonable clip of about 5.5% annually over the past ten years,[5] and the consensus forecast pencils in increases of roughly 10% each for calendar years 2015 and 2016 (Figure 5). Share prices have increased slightly faster over the ten-year period, but valuations remain reasonable.

Our ROE-adjusted valuations indicate that Asian emerging markets are now fairly valued after April's gains, though on the cheap side of our fair value range, with shares priced at 13 times normalized earnings versus a historical median of 15 times. To be sure, the shares have been much cheaper during some prior periods, such as the Asian financial crisis in 1998, the SARS epidemic in 2003, and the global financial crisis. Yet given stretched valuations in the United States, the fair values available in emerging Asia are very attractive. Further, emerging markets

[5] This is nearly double the 3.3% annualized growth pace for per-share earnings in global developed markets. The MSCI Asia Index has grown EPS at a slightly faster pace than the broad Emerging Markets Index (5.5% versus 5.4%), with some of that difference likely attributable to the commodity boom that lifted earnings for Latin American, Russian, and South African firms (the earnings impact of the recent commodity bust has likely not yet filtered through the data completely).

Figure 5. Growth in Share Prices and EPS in Emerging Markets Asia
March 31, 2005 – May 31, 2015 • March 31, 2005 = 100 (Local Currency)



Asia trades today at par with broad emerging markets, roughly in line with history (Figure 6).

As is the case in other regions, valuations across Asian countries are not at uniform levels (Figure 7). Most of the Asian market's relative cheapness comes from heavyweights Korea and Taiwan. India still has a (fading) post-election afterglow, and multiples there are about 10% above historical levels.[6] And valuations in China, while still reasonable, have risen rapidly as mainland Chinese equity investors, who now find Shanghai-listed shares to be somewhat rich, have begun hunting for relative bargains in Hong Kong–listed shares.[7]

[6] Please see Aaron Costello et al., "India: Can the Bull Market Continue?," Cambridge Associates Research Brief, April 16, 2015.
[7] Please see Aaron Costello, "What's Behind the Recent Rally in Chinese Equities?," C|A Answers, April 21, 2015.

Lower Commodity Risk and Currency Volatility ≠ Lack of Risk

While many Asian emerging markets are net importers of raw materials, and Asia is generally less at risk from the recent commodity price decline than other emerging markets regions, the continent carries plenty of risk.

The health of the Chinese economy is likely to have an outsized impact on Asian emerging markets generally. The Chinese leadership must steer the economic battleship away from over-reliance on investment, which has accounted for an average of more than 45% of GDP growth over the past five years (Figure 8), and boosting the share of growth from consumption is proving to be

Figure 6. Valuations of Emerging Markets Asia and Broad Emerging Markets Equities
November 30, 1995 – May 31, 2015

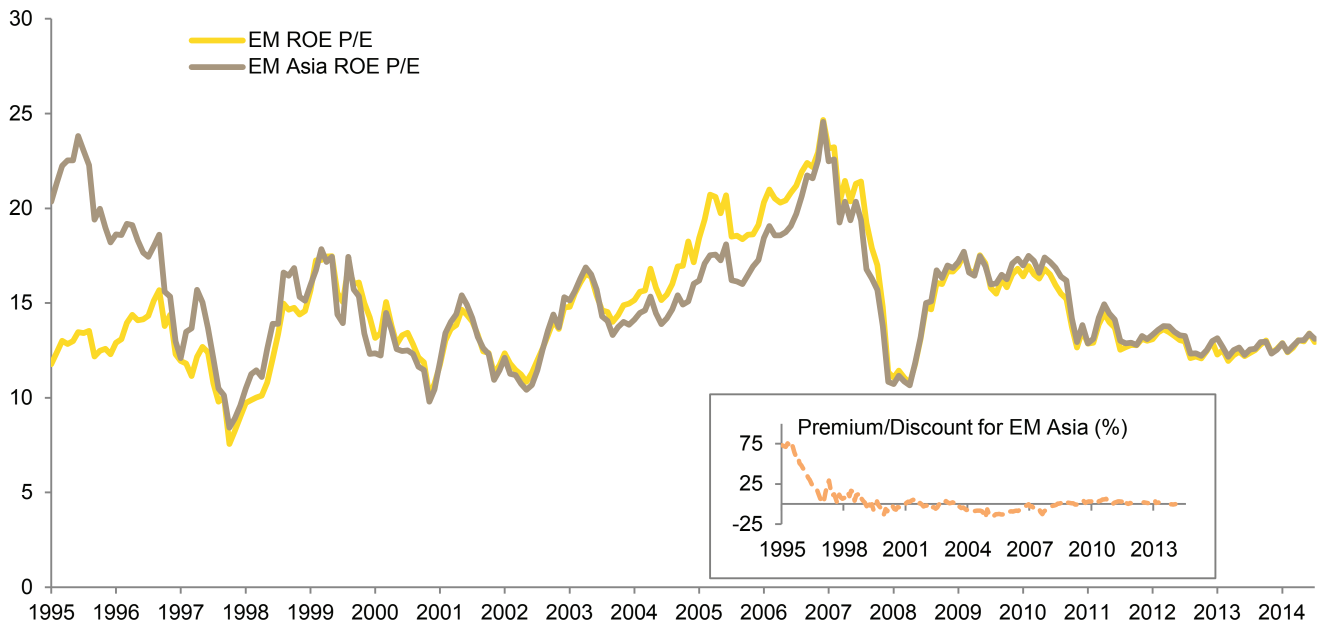
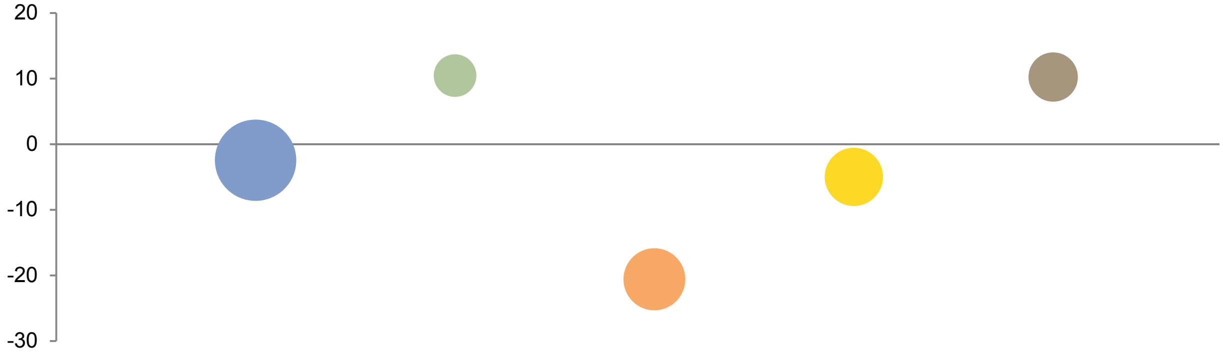
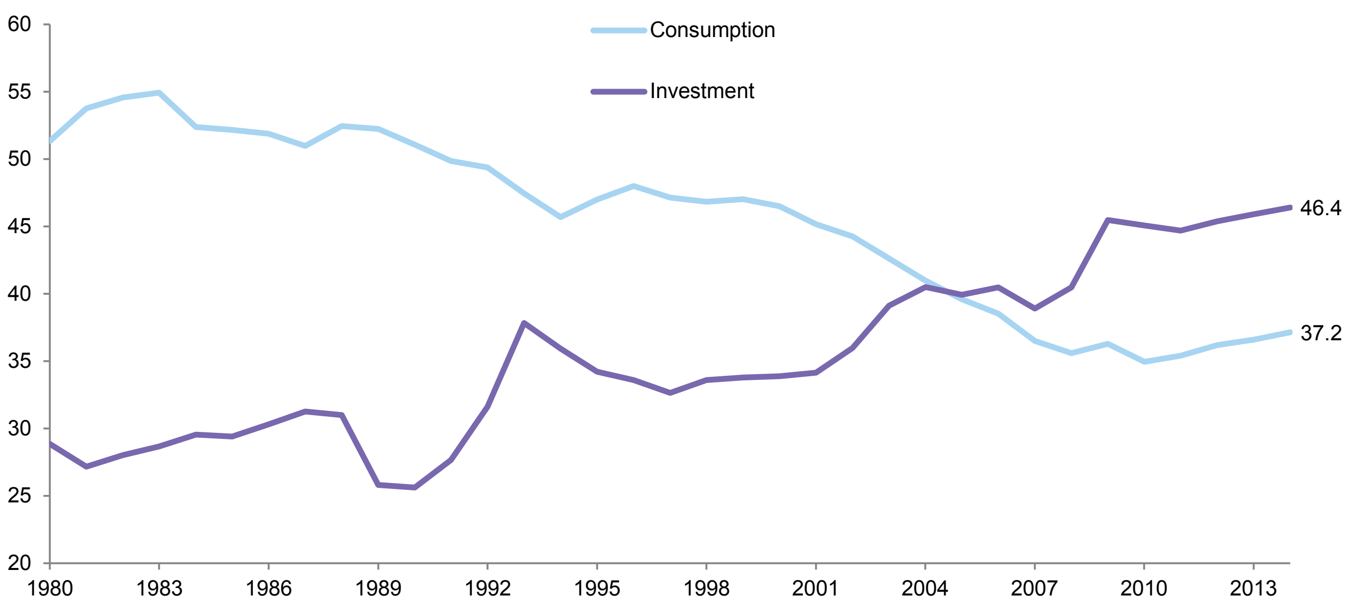


Figure 7. ROE-Adjusted P/E Ratio of Emerging Markets Asia Countries
As of May 31, 2015 • Deviation From Median (%)



EM Countries:	China	India	Korea	Taiwan	Other EM Asia
Current P/E:	13.5	17.7	10.3	18.0	22.0
Median P/E From 1995–2015:	13.9	16.1	13.0	19.0	19.9
Percentile of Current P/E Level:	47.6	62.1	20.0	35.7	58.7
Index Allocation Percentage:	36.6	10.1	21.2	18.8	13.4

Figure 8. Chinese Consumption and Investment (% GDP)
1980–2014

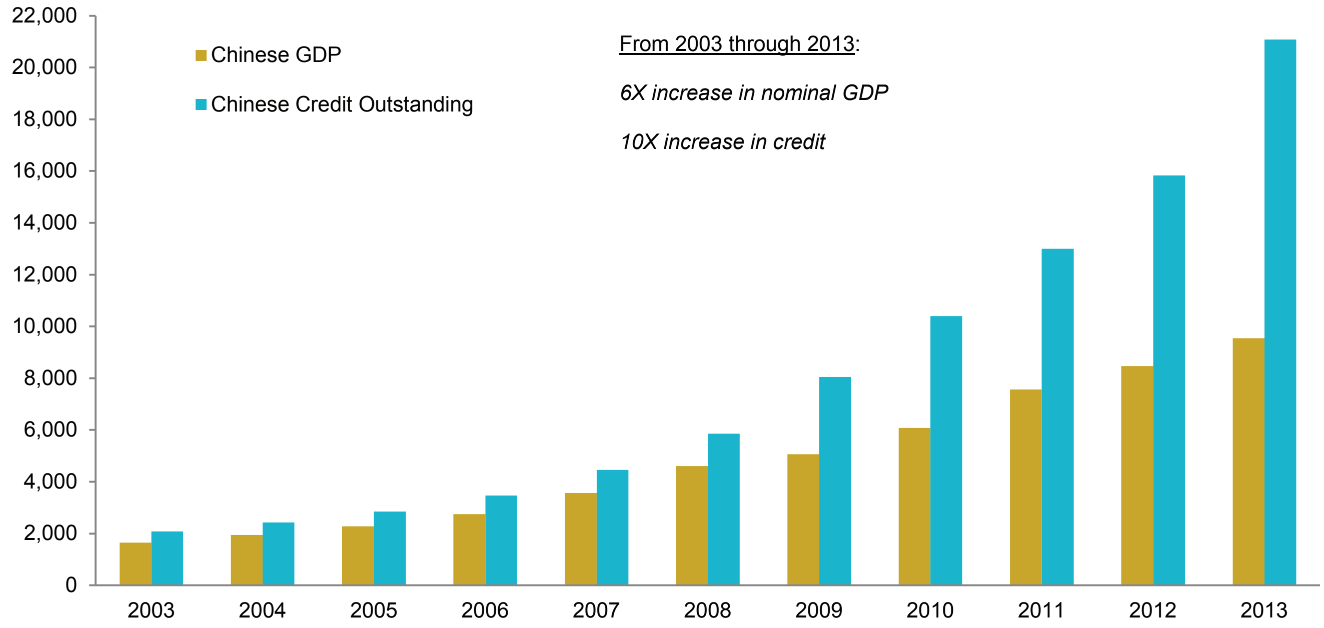


challenging (the primary issue is not that consumption is meager, but rather that generating total growth of 7% or more is becoming increasingly difficult, and thus the government has continued to lean on investment to boost growth). The government's 7% growth target for 2015 would have been viewed as quite puny a few years ago, while today it is seen as perhaps unrealistically high. As Chinese growth continues to decelerate, investors are betting that President Xi will continue to roll out aggressive stimulus, adding to such measures as the lowered bank-reserve requirements that were announced recently.

While Chinese growth has slowed substantially in recent years, the credit bender remains unchecked. From 2007 to 2014, the Chinese credit/GDP ratio has *expanded* by a remarkable 83% of GDP. This compares to growth of less than 30% of GDP for Brazil and less than 20% of GDP for the United States.

Credit held steady at around 125% of GDP from 2003 until 2008, when the Chinese government unleashed a flood of lending to steady the economy amid the global financial crisis. Once the dust from that global explosion had cleared, it became apparent that Chinese government entities, corporations, and households were continuing to massively expand their balance sheets. As of the end of 2013, Chinese credit stood at about 221% of GDP. Perhaps more impressive has been the enormous growth of nominal credit (Figure 9). From 2003 to 2013, Chinese credit grew *10-fold* in US$ terms.

Figure 9. Chinese Credit
Fourth Quarter 2003 – Fourth Quarter 2013 • Billions (USD)



Where could problems crop up? Corporate debt markets are rife with stories of opaque, conflict-ridden borrowers, a couple of which have hit a wall over the past year. The local government bond market is very large at about RMB 26 trillion (US$ 4.2 trillion) and depends on frothy property markets. The shadow banking market, including trusts and wealth management products, has expanded to 56% of GDP, and the implied backing of the banks that sponsor the products appears to have supported many unsavory lending practices and lending to highly cyclical borrowers. The Chinese consumer is generally not highly levered (household debt is 24% of GDP), but as home prices roll over, cracks in those markets may appear as well.[8] Finally, given the opacity of many credit markets in the country, it is possible that the worst problems will come from sectors that have not already been highlighted as problematic. Regardless, Chinese banks have probably not adequately provisioned for credit losses.

Should China's economic stimulus be inadequate to the task, or if the country's scattered credit events this year prove to be dangerous cracks in the dam, investors could revolt. Even though only one-third of the MSCI Emerging Markets Asia Index is allocated to China, the country's economic dominance indicates that a meaningful "divergence" of Chinese equities from those of other Asian emerging markets is unlikely in the event of a China rout. In other words, if China stumbles badly, emerging markets outside Asia are unlikely to emerge unscathed.

Thoughts on Implementation

Investors that wish to implement an Asia tilt within their emerging markets allocations have several options. Certain active managers benchmarked to global emerging markets indexes have perennial overweights to Asia, so employing these managers can bump up the portfolio's exposure to Asia relative to Latin America and EMEA. Exchange-traded funds are available tracking the MSCI Emerging Markets Asia Index for investors that wish to implement this advice passively. Active managers benchmarked to the MSCI All Country Asia ex Japan Index are another useful tool. The Asia ex Japan benchmark differs modestly from the Emerging Markets Asia Index, because the former includes a 13% allocation to Hong Kong and a 6% allocation to Singapore.[9] And finally, single-country managers (such as a China equity manager) could also be employed as part of the Asia tilt.

While sizing of the emerging markets Asia tilt should be determined by the investor's unique circumstances and preferences, we would keep

[8] For more on Chinese credit risks, please see Aaron Costello et al., "China: Prepare for Stress," Cambridge Associates Research Note, October 2014, and Tim Hope's "A Matter of Trust(s): Chinese Banks' Wealth Management Products," Cambridge Associates Research Brief, May 16, 2014.

[9] The Hong Kong market, like the China H-share market, is denominated in the managed Hong Kong dollar, and it trades at an ROE-adjusted P/E ratio of 10.6, which is about 0.9 standard deviation below the historical average multiple of 14.3. The Singapore market trades at a 13.3 multiple, which is about 1.0 standard deviation below the historical average multiple of 18.0.

it modest in most cases.[10] A clean approach may be to devote the portfolio's tactical overweight position to Asia (as in the example we noted earlier, where the 10% strategic policy target allocation is invested in broad global emerging markets managers, while the overweight slice of perhaps 2% or 3% is invested in Asia-focused managers).

Conclusion

While no longer undervalued because of recent price appreciation, valuations today for emerging markets are quite reasonable, and they remain downright cheap relative to rich US markets. Yet investors may be skittish about the risks posed by sharply lower commodity prices. For those investors, tilting emerging markets exposure toward Asia is a compelling alternative. Asian emerging markets are less likely to be dinged by further falls in commodity prices; the currencies have been less volatile and less levered to equity and commodity markets. Economically, Asia is in much better shape than prior to the 1998 Asian financial crisis. Valuations are not expensive and provide some compensation for risks, which primarily stem from the possibility of a further growth stumble or credit crisis in China. ■

[10] This is not a high-conviction overweight, because there is not a valuation rationale for overweighting Asia and underweighting non-Asian emerging markets, and because the present commodity headwinds for non-Asian emerging markets could shift to neutral unless commodity prices resume their fall.

Sean McLaughlin, Managing Director
Michelle Wu, Investment Associate

Exhibit Notes

Valuation Premium/Discount for Emerging Markets Versus Both Global Developed Markets and United States
Sources: MSCI Inc. and Thomson Reuters Datastream. MSCI data provided "as is" without any express or implied warranties.
Note: The composite normalized price-earnings (P/E) ratio is calculated by dividing the inflation-adjusted index price by the simple average of three normalized earnings.

Currency-Translation Impact on the Volatility of Asian and Non-Asian Emerging Markets
Sources: MSCI Inc. and Thomson Reuters Datastream. MSCI data provided "as is" without any express or implied warranties.

Sensitivity of Emerging Markets Currencies to Commodities and to Emerging Markets Equities
Sources: Bloomberg L.P., MSCI Inc., and Thomson Reuters Datastream. MSCI data provided "as is" without any express or implied warranties.
Note: Eight countries with MSCI EM Index weights below 1% are not included in the analysis.

Emerging Markets Macro Indicators
Sources: International Monetary Fund, Oxford Economics, and Thomson Reuters Datastream.
Note: The current account balance data are the average of countries in the respective regions, while the external debt and FX reserves data are the median of countries in the respective regions.

Growth in Share Prices and EPS in Emerging Markets Asia
Sources: J.P. Morgan Securities, Inc., MSCI Inc., and Thomson Reuters Datastream. MSCI data provided "as is" without any express or implied warranties.
Note: EPS for 2015 and 2016 are forecasts.

Valuations of Emerging Markets Asia and Broad Emerging Markets Equities
Sources: MSCI Inc. and Thomson Reuters Datastream. MSCI data provided "as is" without any express or implied warranties.
Note: The return on equity (ROE)–adjusted P/E ratio multiplies the current trailing P/E multiple by the ratio of current ROE to historical ROE for each market.

ROE-Adjusted P/E Ratio of EM Asia Countries
Sources: MSCI Inc. and Thomson Reuters Datastream. MSCI data provided "as is" without any express or implied warranties.
Notes: Bubble size determined by country weight. The ROE–adjusted P/E ratio multiplies the current trailing P/E multiple by the ratio of current ROE to historical ROE for each market.

Chinese Consumption and Investment (% GDP)
Source: Thomson Reuters Datastream.

Chinese Credit
Sources: International Monetary Fund and Thomson Reuters Datastream.