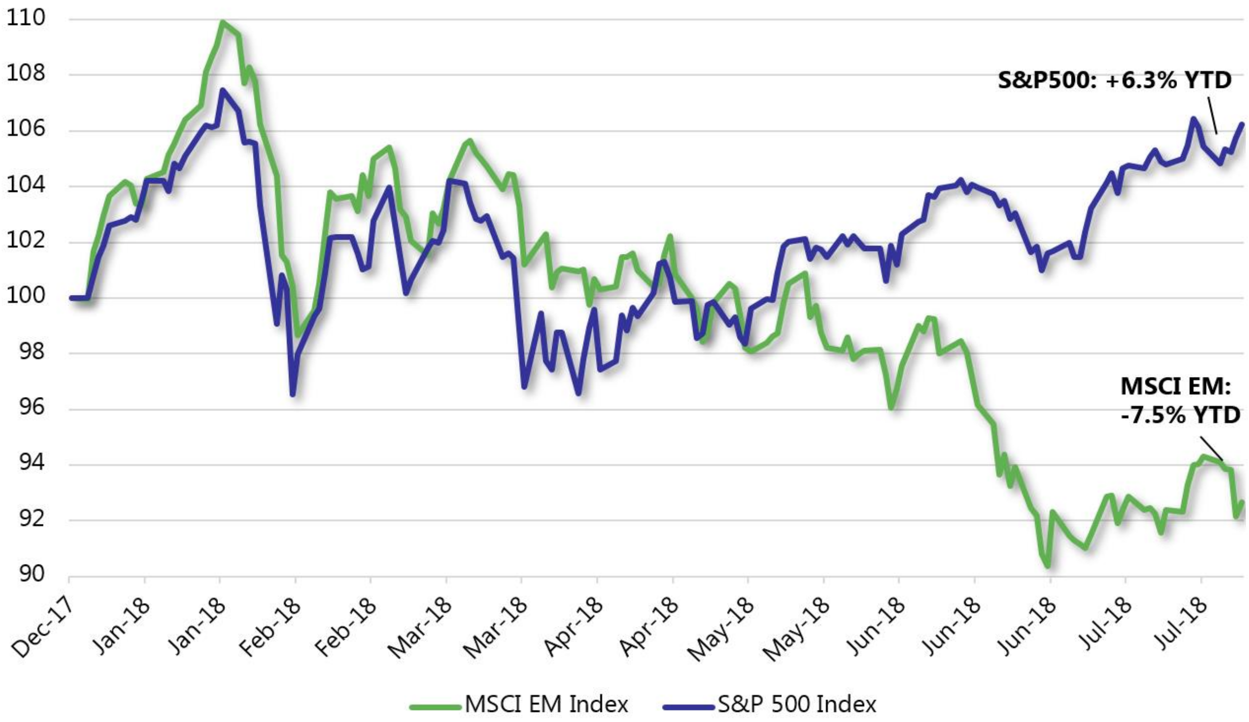
GLOBAL EMERGING MARKETS - MARKET UPDATE

TALE OF TWO MARKETS

While investors fret about trade wars and rate hikes, U.S. stock prices keep climbing. The Emerging-market stocks, not those in the U.S., are taking the brunt of investors' fears.

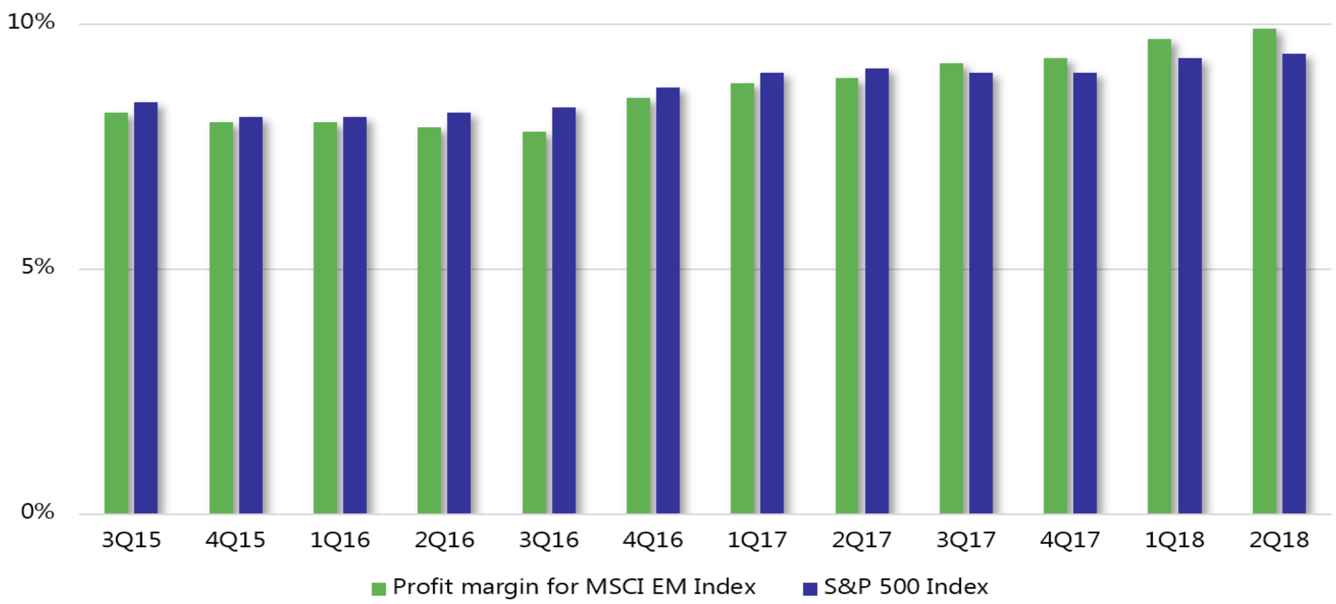
Emerging Markets taking the brunt of investors' fears



STRONG FUNDAMENTALS

While the valuations have differed significantly, the fundamentals have stayed the same. The EM index's operating margin was 14.2% in the second quarter, compared with 13.8% for the S&P 500. Profit margins were also similar — 9.9% for the EM index compared with 9.5% for the S&P 500. The average spread between the two profit margins is a thin 0.07 % since Q3 of 2015.

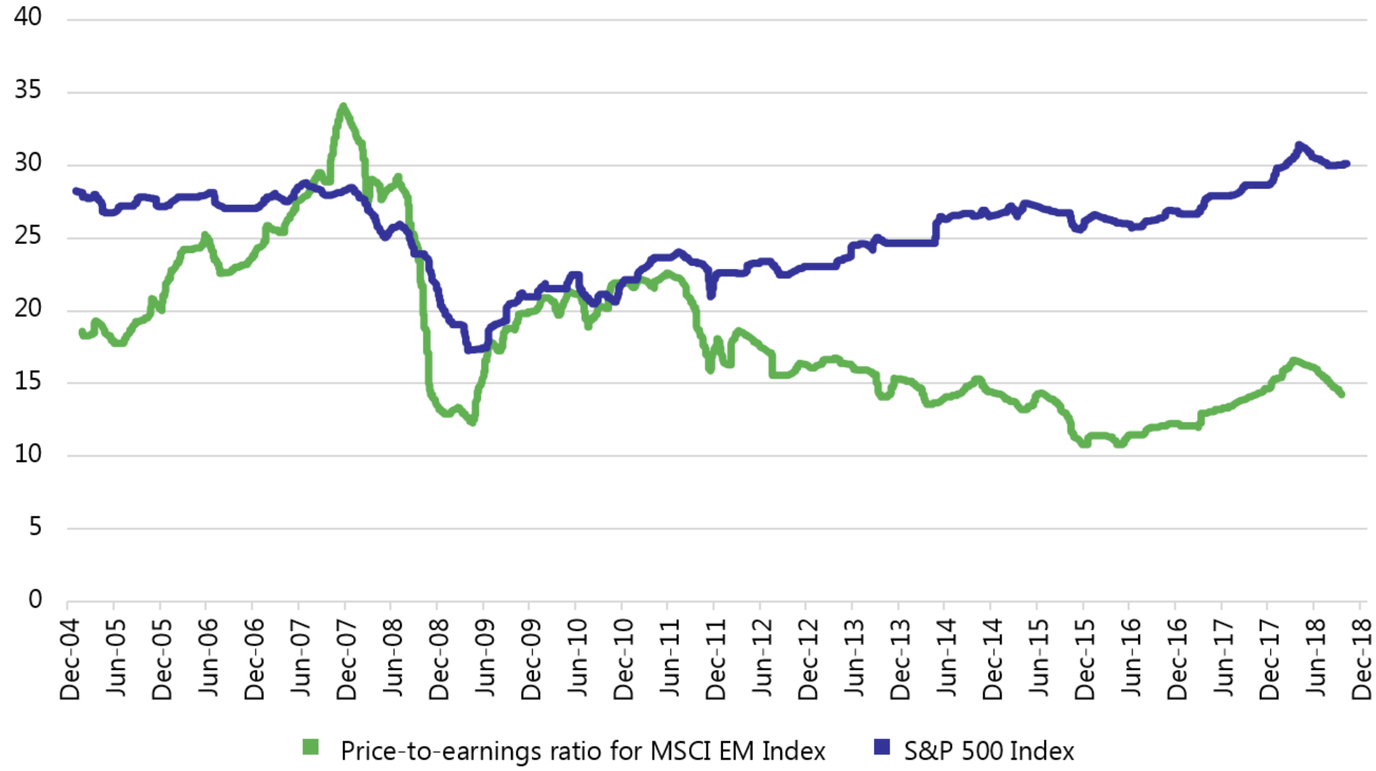
Emerging Market companies have been as profitable as those in the US



ATTRACTIVE VALUATIONS

Even though fundamentals are the same, the Emerging-market companies are far cheaper. The EM index's price-to-earnings ratio is 13.3 based on 12-month trailing earnings per share, compared with 21.1 for the S&P 500. That difference is even more stark when looking beyond one year. The EM index's P/E ratio is 14.7 based on 10-year trailing average EPS, compared with 29.5 for the S&P 500.

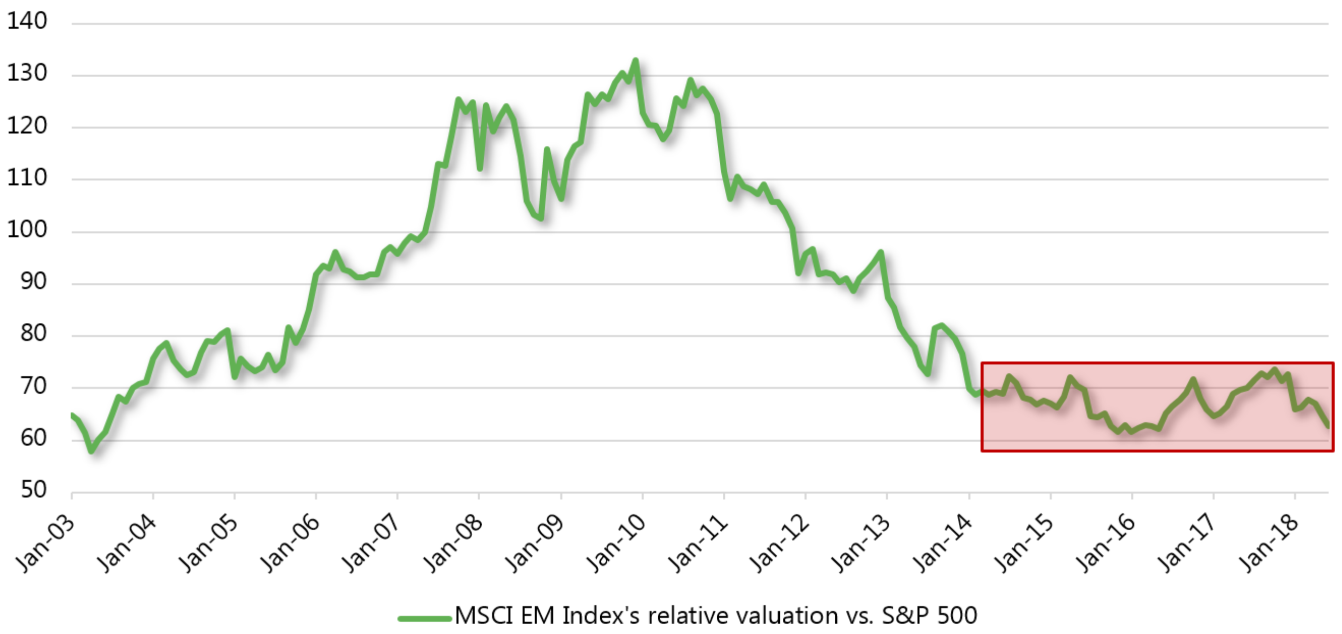
EM stocks appear to be more mindful of the risks



EM EQUITIES CHEAPEST IN 15 YEARS VS US EQUITIES

For those with a long-term view, neither the two-year rally nor the five-month slide has dramatically changed the valuation argument for emerging-market stocks. For the past four years, they have traded within a range of low valuations relative to the U.S. market.

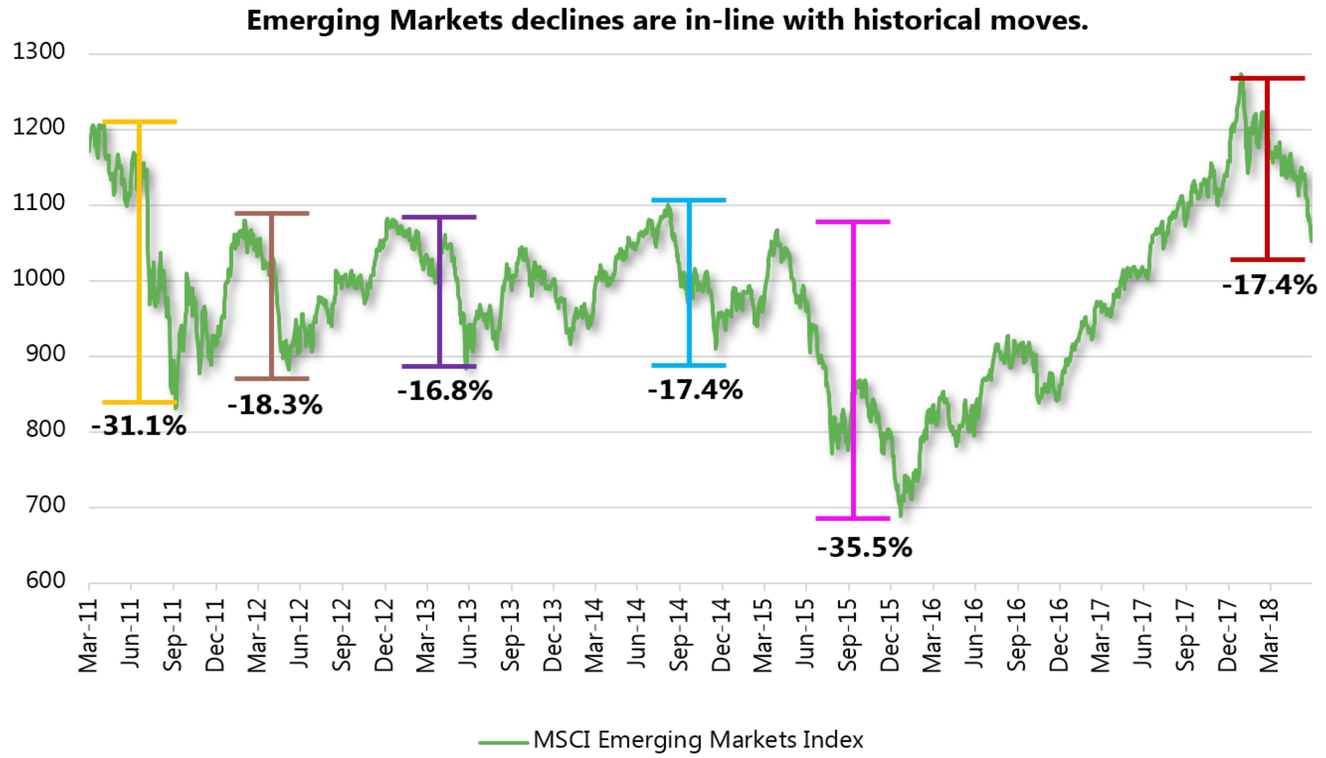
Emerging stocks near the cheapest in 15 years versus US market



The chart above shows their relative valuation based on the long-term price-earnings ratio. It calculates price as a multiple of earnings in the past 10 years, adjusted for inflation.

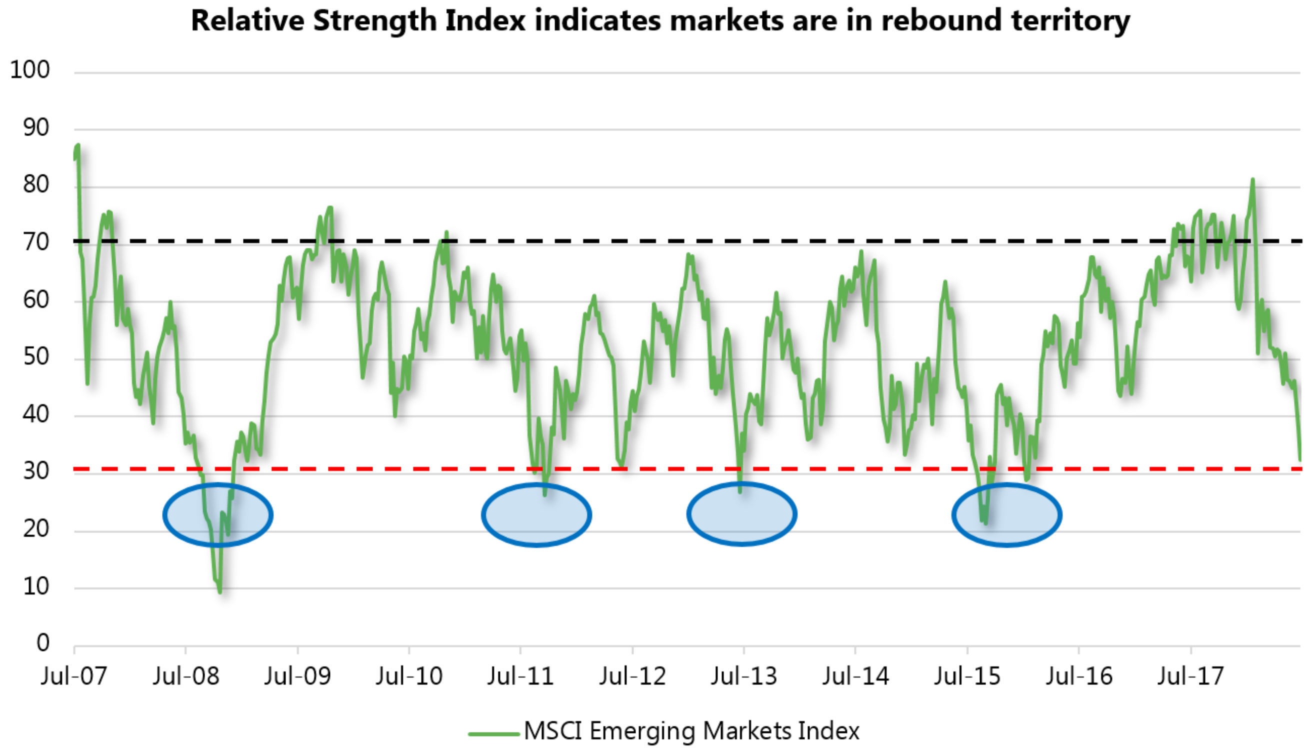
EM DECLINES IN-LINE WITH HISTORICAL MOVES

Stocks have fallen by the same degree that they dropped during the euro-area debt crisis, the Federal Reserve "taper tantrum" and the oil-price crash in 2014. Each of those past moves was made up for in the subsequent months.



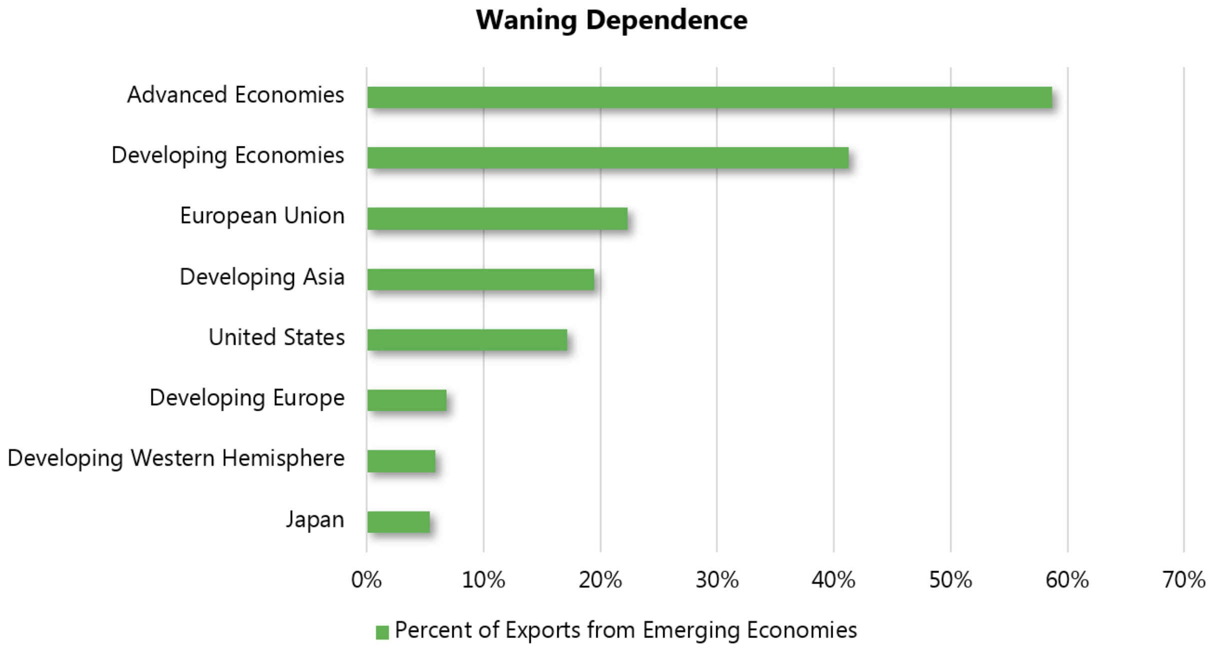
TECHNICALS INDICATE REBOUND

The graph below looks at the relative strength index on the weekly chart for the MSCI gauge. It's quite close to what traders call the "oversold" level, when a rebound becomes more likely.



HOW MUCH CAN A TRADE WAR HURT?

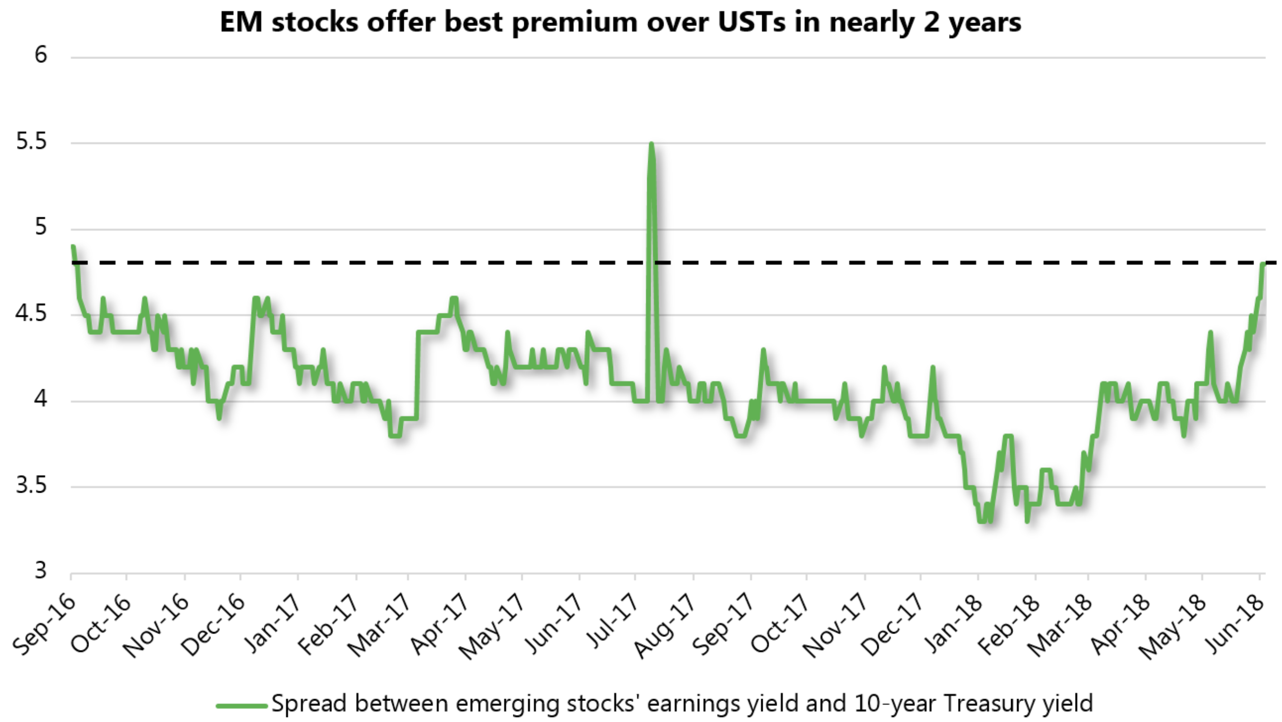
The U.S. needs emerging markets more than emerging markets need the U.S. Only 17% of developing-nation exports go to America, but 46% of U.S. exports flow the other way. Even China, whose dependence on the U.S. is greater than the emerging-market average, derives only 21% of its overseas sales from there.



This is not to say that the trade war doesn't matter. It's a clear and present danger, but it's a short-term risk and doesn't undermine the fundamental case for emerging-market investment.

WILL HIGHER US TREASURY YIELDS END THE RISK RALLY?

The gap between the earnings yield of emerging-market stocks and 10-year U.S. Treasuries has been widening since January. For every $1,000 invested, the stocks offer $48 more per year than the Treasuries. A surge of 139 basis points in this spread has given emerging-market equities a yield cushion to help withstand further hardening of U.S. rates.



DOES THE DOLLAR MATTER FOR STOCKS?

Unlike currencies, developing-nation stocks have an ambiguous relationship with the dollar. A stronger U.S. currency boosts the shares of exporters, while spurring local inflation and undermining aggregate demand.

A stronger dollar reduces emerging markets' relative value, and a weaker one raises it. That means if investors take a bearish view on the greenback, they might turn bullish on these stocks.

Dollar Effect: Weaker USD boosts EM stocks relative value