LPL RESEARCH

WEEKLY MARKET COMMENTARY

KEY TAKEAWAYS

Sentiment on emerging markets (EM) is reaching levels consistent with a contrarian buy signal.

Large pullbacks are quite normal for EM, making the recent pullback a potential opportunity.

The underlying fundamentals appear to remain solid overall for EM.

September 10 2018

IS EM WASHED OUT?

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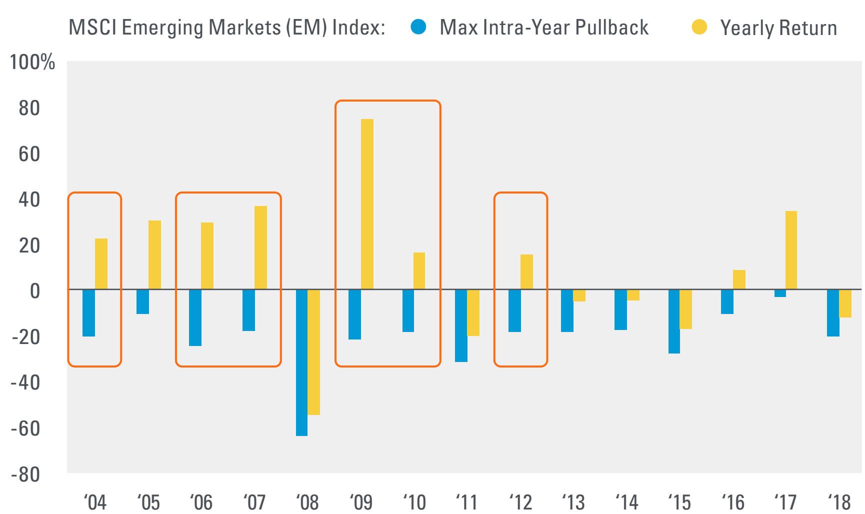
Are emerging markets (EM) washed out? Last week the MSCI Emerging Markets Index officially sank 20% from its peak in late January. This prompted many bearish headlines, such as "Emerging Markets Slide into Bear Market amid Contagion Concern," and "It's Beginning to Look a Lot Like a Crisis." At the same time, a recent survey from Bank of American/Merrill Lynch showed that global fund managers are underweight EM equities for the first time in more than a year. One thing is for sure: From a contrarian point of view, the level of pessimism we are seeing toward EM could potentially be a bullish sign.

After highlighting here some of the fundamental reasons we remain optimistic on EM equities despite recent weakness, we'll take a look at EM sentiment this week to try to answer the question: Is EM washed out?

HOW NORMAL IS EM VOLATILITY?

How common are big EM pullbacks? As Figure 1 shows, when it comes to EM, it can be quite normal. Going back 15 years, the MSCI Emerging Markets Index pulled

1 EM CAN BE POSITIVE FOR THE YEAR AND STILL HAVE LARGE INTRA-YEAR PULLBACKS



Source: LPL Research, FactSet 09/07/18

All indexes are unmanaged and cannot be invested into directly. Unmanaged index returns do not reflect fees, expenses, or sales charges. Index performance is not indicative of the performance of any investment. All performance referenced is historical and is no guarantee of future results.

back at least 15% (intra-year peak to trough) 11 times. In six of those years, the index finished the year higher. EM could not dig itself out of a big hole after heavy losses in 2014 and 2015, and ended those years in the red. However, those periods were marked earnings recessions—nothing like the solid fundamental backdrop we are seeing today.

A POSITIVE TECHNICAL SIGNAL?

EM is clearly exhibiting negative technical momentum, as the EM Index has broken below its 50-day and 200-day moving averages—and those averages are downward sloping. Momentum is only one way to employ technical analysis (not to mention the fact that there are many different flavors of momentum), and relative strength analysis of EM versus the S&P 500 Index may not give you a complete picture. However, we can look at the price ratios of other assets for additional insight on emerging-market stocks' future path.

The price relationship between gold and silver stands out to us right now. The gold-to-silver ratio measures how many ounces of silver it takes to buy a single ounce of gold. The spread was above 85 recently, which was the highest since late 2008, when the financial crisis began.

As Figure 2 shows, the previous three times the gold-to-silver ratio was near 80, the MSCI EM Index was near a low. Additionally, the EM Index is near a major trend line of potential support. Only time will tell if this scenario plays out again, but it's worth watching as a potential bullish signal for EM and a possible rotation into riskier assets.

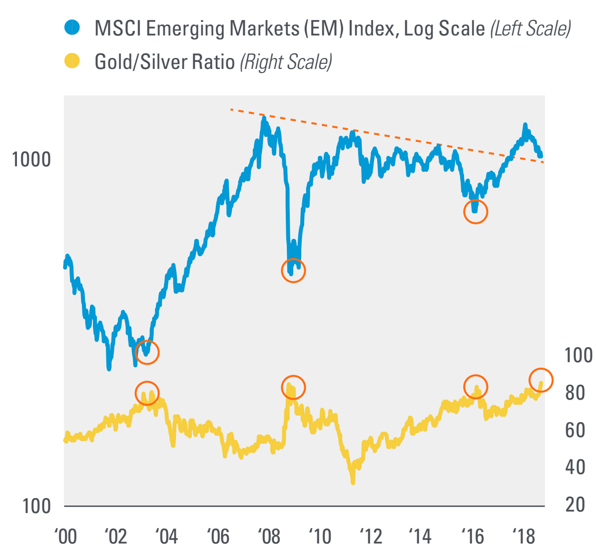
OTHER GAUGES OF SENTIMENT

Here are some other factors to consider when gauging sentiment in EM:

- **Significant U.S.-EM divergence.** EM has not diverged this much from the U.S. stock market since the mid-1990s. While this gap could close if U.S. stocks drop, we expect it to be resolved through EM gains.
- **Weak breadth nearing a contrarian signal.** About 35% of stocks in the MSCI EM Index are below their 200-day moving averages, not far from the 20% level where EM has typically bottomed out (as was the case in early 2016).
- **Low valuations.** Simply put, we think a lot of bad news is priced into EM stocks, especially given the mostly favorable economic backdrop and positive earnings growth outlook.

Though just one small data point, we were encouraged by EM's resilience on Friday after the strong wage growth number in August's employment report sparked fears of accelerated Federal Reserve (Fed) rate hikes. Latin American markets, including the influential Brazil, have perked up lately, which is a positive sign.

2 IS THE GOLD/SILVER RATIO SIGNALING AN EM BUY POINT?



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POTENTIAL CATALYSTS

Though timing on these is very difficult to predict, we see several potential catalysts that could help turn around EM:

Trade dispute resolution. Based on how much China and the U.S. have to lose from a full-blown trade war, we continue to expect a compromise that results in little, if any, negative impact on the two economies. Although a resolution to the dispute may not come until after the midterm elections, we see a trade deal with China as likely and a potential positive catalyst for EM.

U.S. dollar reversal. Even though EM countries are not as U.S. dollar sensitive as they were a decade or two ago, dollar strength is a problem for financially weaker countries, such as Turkey. The greenback may soon run into resistance given U.S. trade imbalances and indebtedness, while a trade deal is a potentially bearish catalyst.

Earnings stability. Aggregate earnings estimates for EM have fallen by about 4% over the past three months, while earnings estimates for the S&P 500 have risen by 3% during that time (based on FactSet consensus estimates for the next 12 months). We expect the still solid EM economic growth outlook to help support the EM earnings outlook. Stimulus injections into some of the weaker economies to boost growth and support currencies (including China) should help as well, in addition to the potential for trade dispute resolution and U.S. dollar reversal.

CONCLUSION

EM could be an intriguing contrarian idea given that the bearish sentiment appears to be approaching extreme levels. Though the fundamental picture has dimmed a bit in recent months amid challenges facing the financially weaker countries, we believe most of the fears surrounding EM will pass fairly soon. We do not see many more dominoes left to fall in this EM crisis episode. For suitable investors who do not own EM stocks, or who are aggressive contrarians, the group may be looking increasingly buyable here.

We're looking for positive catalysts to emerge in the coming months, suggesting the potential for a pivot in EM performance in the near term. We do not expect much spillover into the U.S. economy and markets. We especially are encouraged by the stability in U.S. credit markets in recent months. Comparisons with the period of EM weakness the mid-1990s are instructive and suggest that it may be possible for U.S. stocks to hold their own amid overseas weakness. That said, a pullback and volatility before midterm elections is normal and quite possible. ■

Thanks to Ryan Detrick for his contributions this week.

IMPORTANT DISCLOSURES

The opinions voiced in this material are for general information only and are not intended to provide specific advice or recommendations for any individual. To determine which investment(s) may be appropriate for you, consult your financial advisor prior to investing. All performance referenced is historical and is no guarantee of future results.

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Investing in stock includes numerous specific risks including: the fluctuation of dividend, loss of principal, and potential liquidity of the investment in a falling market.

Investing in foreign and emerging markets securities involves special additional risks. These risks include, but are not limited to, currency risk, geopolitical risk, and risk associated with varying accounting standards. Investing in emerging markets may accentuate these risks.

All investing involves risk including loss of principal.

INDEX DESCRIPTIONS

The Standard & Poor's 500 Index is a capitalization-weighted index of 500 stocks designed to measure performance of the broad domestic economy through changes in the aggregate market value of 500 stocks representing all major industries.

The MSCI Emerging Markets Index is a free float-adjusted market capitalization weighted index that is designed to measure the equity market performance of the emerging market countries of the Americas, Europe, the Middle East, Africa and Asia.

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