EM Stocks Poised to Benefit From Fed Pause

The Fed's shift to a dovish stance could boost emerging market (EM) equities.

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KEY INSIGHTS

- We have increased the allocation to emerging markets (EM) stocks in T. Rowe Price's multi-asset portfolios, which are now overweight the asset class.
- EM equity valuations are at reasonable levels relative to historical averages; however, price/earnings ratios are still meaningfully lower than they were in early 2018.
- The pause in Fed rate hikes and the end of U.S. growth exceptionalism should temper the U.S. dollar's strengthening trend against EM currencies, benefiting EM equities.

Against a backdrop of reasonable valuations combined with accommodative policy measures in China and a dovish shift by the Federal Reserve, we have increased the allocation to emerging markets (EM) stocks in T. Rowe Price's multi-asset portfolios, which are now overweight the asset class. The pause in Fed rate hikes and a moderating growth differential to other major developed economies should temper the U.S. dollar's strengthening trend against EM currencies, benefiting EM equities.

We also expect Chinese government stimulus measures and available tools to be sufficient to stabilize the country's growth at a somewhat more moderate level, which should support the broad universe of EM stocks. However, there may be a lag between policy implementation and the effect on economic activity. Additionally, EM equity valuations remain at attractive levels, even after the January 2019 rally, and concerns about broad EM contagion from mid-2018 have receded meaningfully.

U.S. Exceptionalism Ends

After raising the federal funds rate in December, the Fed pivoted to a dovish monetary policy stance in early January amid uncertainty over the potential economic impact of the U.S.-China trade dispute as well as the U.S. government shutdown and declines in major global equity markets. Investors now expect the central bank to pause its rate hikes at least through the first half of 2019 as it monitors incoming economic data. The Fed pivot also signaled the end to the U.S. exceptionalism of 2018, when U.S. expansion notably outpaced economic growth in other developed markets.

Last year's fiscal stimulus-driven uptrend in U.S. growth and steady Fed rate increases also led the U.S. dollar to broad gains against EM currencies.

"The Fed pivot also signaled the end to the U.S. exceptionalism of 2018...

> Beijing has stepped up targeted stimulus measures that should help put a floor under slowing growth and cushion China's economy from the effects of poor sentiment resulting from weaker trade with the U.S.
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> **— Eric Moffett**
> *T. Rowe Price Asian EM Equity Portfolio Manager*

Country-specific issues in several major emerging markets accentuated the weakness in EM currencies. For example, the Brazilian real lost over 14% against the U.S. dollar in 2018 and the Turkish lira declined nearly 29%. However, the pause in Fed rate hikes should moderate the upward pressure on the U.S. dollar. Also, "in contrast with last year, when many EM central banks kept interest rates relatively high or raised them to defend their currencies, the Fed's dovish turn could even allow some EM central banks to cut rates to boost growth," says Charles Shriver, multi-asset portfolio manager and cochair of the Asset Allocation Committee.

Chinese Authorities Seem Committed to Boosting Growth

China's growth is slowing, although its economy is still expanding at a much faster rate (likely at least 6% annually) than any developed markets and most other emerging countries. An abrupt slowdown in the Chinese economy would weigh on global growth, but its heaviest impact would be on other emerging markets. However, the Chinese government has the monetary and fiscal policy tools to stimulate growth. We think that the Chinese authorities are committed to avoiding a hard economic landing, although the impact of current policy measures may be less dramatic and more focused on domestic consumption than earlier instances that featured a greater emphasis on areas of fixed-asset investment, such as infrastructure.

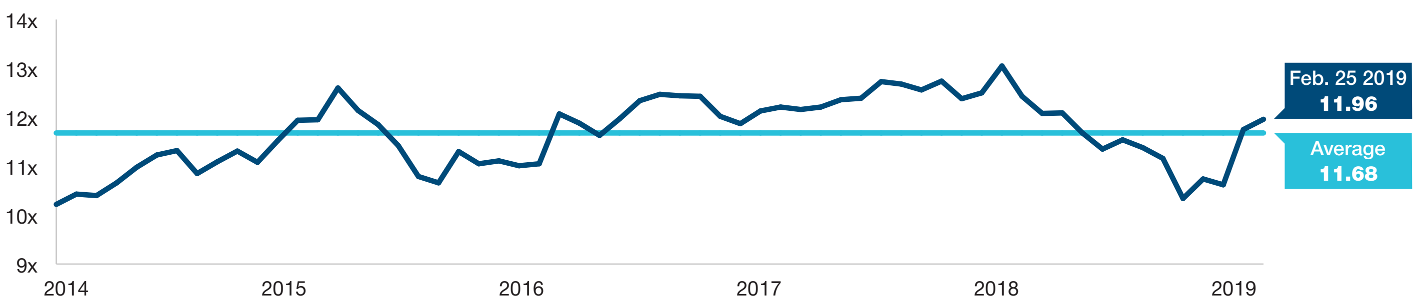
The continuing trade tensions with the U.S. are a meaningful risk to Chinese growth, but the trade situation could provide further motivation for China's government to boost the economy. "Beijing has stepped up targeted stimulus measures that should help put a floor under slowing growth and cushion China's economy from the effects of poor sentiment resulting from weaker trade with the U.S.," explains Eric Moffett, a T. Rowe Price Asian EM equity portfolio manager.

EM Valuations Remain Attractive

EM stocks, as measured by the MSCI Emerging Markets Index, lagged the S&P 500 Index of U.S. equities by nearly 18 percentage points in the first nine months of 2018, driving EM equity valuations to meaningfully attractive levels, particularly relative to U.S. valuations. However, having sold off earlier in the year, EM stocks held up much better than the U.S. market in the fourth quarter of 2018 (-7.40% for the MSCI EM Index versus -13.52% for the

(Fig. 1) EM Valuations Climbed in Late 2018 but Still Reasonable

Price to 12-month forward earnings



Source: MSCI.

> ...valuations of EM stocks are reasonably attractive, especially considering their potential for healthy earnings growth and their solid profitability metrics.
>
> **— Gonzalo Pángaro**
> *EM Equity Portfolio Manager*

S&P 500), which reduced their relative valuation advantage to some degree.

Following the January 2019 rally in equities, EM valuations are now at reasonable levels relative to historical averages; however, price/earnings ratios are still meaningfully lower than they were in early 2018. The price to 12-month forward earnings ratio for the MSCI Emerging Markets Index was 11.8 on January 31, up from 10.6 on December 31 but still below the 12.5 level at the end of December 2017. Overall, "valuations of EM stocks are reasonably attractive, especially considering their potential for healthy earnings growth and their solid profitability metrics," says Gonzalo Pángaro, EM equity portfolio manager.

Fading Fears of Systemic EM Risk

On a broader level, the fears of systemic contagion that crept into EMs during the sell-off in the first half of 2018 have all but disappeared as uncertainties facing some large emerging markets have been resolved. Brazil elected an investor-friendly president, Jair Bolsonaro, over a leftist candidate who many viewed as less likely to implement needed structural reforms.

Turkey's economy has come back from the brink of a collapse in mid-2018. Investor sentiment toward EMs has broadly improved as a result, supporting the asset class in the near term.

Preference for Cyclical Exposure to EMs Over International Value

We are mindful that slowing global growth presents a headwind to cyclical asset classes such as EM stocks as well as international value stocks. We prefer to take cyclical exposure to EMs rather than international value stocks, which are also reliant on cyclical growth, as a more data-dependent Fed coupled with moderating strength in the U.S. dollar and stabilization in Chinese growth at a high level should benefit EM stocks more than international value companies. In addition, we believe EM equities should benefit from secular growth in the consumer and technology sectors, while moderating prospects for European economic growth and the associated potential for higher interest rates are likely to challenge the European financial stocks that account for a relatively large proportion of the international value market.

In addition to the potential risk from decelerating global growth, there are other factors that could weigh on EMs. If the Chinese government is not able to provide enough stimulus to avoid a sharp slowdown or if the U.S.-China trade dispute escalates and drags on, EM stocks are likely to disproportionately suffer. Also, a policy error from the Fed, in which the central bank continues to tighten monetary policy and drive the U.S. dollar higher even as the U.S. economy slows, could trigger another broad sell-off in EM currencies. However, we still believe that EM stocks present a positive risk/reward trade-off in the current environment.

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