Market Commentary

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Should Investors Steer Clear of Emerging Markets Now?

The global coronavirus (COVID-19) pandemic has affected both developed and emerging market (EM) countries alike; however, some have highlighted the risks that EM economies, in particular, may face as economic growth and investor sentiment fall. While it's true that historically, many EM countries have suffered disproportionately in times of crisis from large capital outflows that led to severe economic and market instability, today, many of these countries seem better prepared to handle such a crisis.

One cannot paint EM equities with a broad brush, as they include 26 countries spread across three major geographic regions: Asia; Latin America; and Europe, Middle East, and Africa (EMEA). Asia is the most important region to consider for equity investors as Asian countries, such as China, Taiwan, and South Korea, make up 60%-80% of EM equity indexes. The remainder is split between Latin America (e.g., Brazil and Mexico) and EMEA (e.g., South Africa and Russia), which each make up 10%-20%.

When evaluating the current risks of investing in EMs, an obvious place to start is with the immediate risk posed by coronavirus. Although there are differing opinions about how China has responded to the virus, as a whole, the Asian region appears to have navigated the pandemic well. Due to their collectivist culture (the idea of prioritizing the good of society over the individual), they quickly implemented widespread containment measures such as school and workplace closures, travel restrictions, contact tracing, social distancing, and face masks. On the other hand, Latin America and EMEA face greater risks as the virus is less contained in those regions.

As another important facet of this crisis, the collapse in oil prices has inflicted pain on oil producers, including those in Latin American and EMEA nations. Once again, however, the vast majority of EM countries stand to benefit from lower energy costs as Asia is a net importer of oil.

It's also noteworthy that coming in to this crisis, many EM economies were on sounder financial footing than at times in the past. For example, almost all major EM countries have substantially larger foreign exchange reserves than they did 10 or 20 years ago. These bolstered reserves will enable EM countries to better support their currencies during periods of large capital outflows.

The current account balances of most emerging market countries are also positive. A country's current account primarily reflects its level of exports minus imports and indicates whether the nation is a net lender (or borrower) to the rest of the world. While Latin American countries have deficits, most of the countries in Asia and much of EMEA have current account surpluses.

While it's true that many EM countries have governments with less capacity to support their economies through large expansions in federal spending and central bank easing programs in the near term, this kind of stimulus can't support long-term expansion anyway. Sustainable economic growth is predicated on labor force growth and productivity growth, both of which favor EM countries as they boast larger and younger populations (compared with developed countries) and are making notable advances in artificial intelligence, robotics, and supercomputers.

While there are risks to EM economies' growth potential, like the threat of deglobalization, we believe EM equities still deserve an allocation in investors' long-term portfolios. Over the short term, we expect continued volatility and potential setbacks; however, EM countries overall are more resilient today than in the past and, in some respects, more resilient than many developed countries. For those willing to hold on through the inevitable bumps along the way, we believe the long-term growth potential of EM equities can help power investor portfolios toward their long-term return goals.

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