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The Return of Decoupling: Four Factors Driving U.S. and Emerging Markets Apart

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Key Takeaways:
- EM weakness is not likely to spread to other markets.
- Pressure on the Chinese economy could impact investor interest in EM stocks.
- Political uncertainty may continue to fuel EM volatility.
- Most major Latin American and Asian economies remain healthy.

For much of 2018, the U.S. and Emerging Markets (EM) have been moving in opposite directions (decoupling).The S&P 500 continues to power upward, while emerging market equity prices are down ~20% overall from their high, despite a brief rally in July. (See Figure 1 below.)

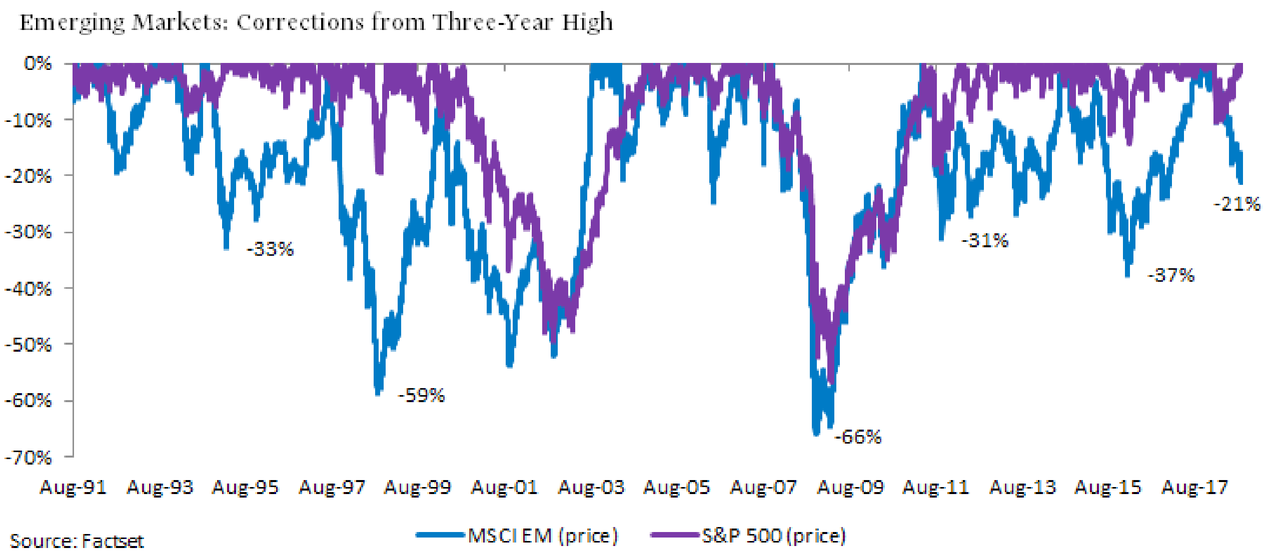

Figure 1: Even though EM stocks are more volatile, they've historically moved in tandem with U.S. markets. The last time U.S. and EM equities decoupled was back in the mid-1990s when the U.S. economy was in the midst of the technology boom and emerging markets were hit with a series of economic crises. Many EM countries are stronger now so this time around it's likely an issue of containment not contagion.

What's causing this divergence? We believe it's the following four factors:

1. Ongoing U.S. - China Trade War

Retaliation seems to be front and center in the trade dispute between the U.S. and China. In addition to issuing retaliatory tariffs, Chinese officials have allowed their currency to depreciate near an artificial floor of 7 Yuan/USD since April. The risk that China could make a policy decision that's not in its best interest increases each time trade tensions escalate (think the latest round of tariffs announced in mid-September). Such a misstep could create economic instability at a time when the country is focused on shifting from investment-based growth to consumption based (like the U.S.). The high level of debt China incurred during its investment boom also hangs in the backdrop as a potential source of instability.

As we saw in 2015/2016 and are witnessing again, pressure on the Chinese economy can reverberate across the EM landscape and cause investors to de-risk (shift away) from the entire asset class.

2. Uncertainty about Policy Decisions

Actions taken or not taken by government officials often impact investors' perception of a country's stability and investment opportunities. Such is the case for emerging markets right now. Pronounced currency crises in Turkey and Argentina kicked off the most recent volatility in EM. Both countries started 2018 with structural imbalances that were compounded by policy mistakes. The reversal of the Central Bank of the Republic of Turkey's unorthodox monetary policy was a welcome pivot for the markets in mid-September. However, questions still linger as to how Turkey will secure financing for its external deficit. The Argentine peso came under pressure once again as the government asked the International Monetary Fund (IMF) to speed up its loan disbursement. Angst surrounding the upcoming presidential election in Brazil also presents concern for investors as the country tries to claw its way to recovery. Finally, there's growing concern about whether central bankers can combat the sharp depreciation in EM currencies without jeopardizing growth.

Historically, when investors turn bearish on the EM asset class, market reactions to political or policy shocks are more pronounced–both on the upside and downside.

3. Pockets of Economic Weakness

Coming into the year, the popular narrative was global synchronization. Why? For the first time since the early stages of the 2008 financial crisis recovery, major global economies appeared to be firing on all cylinders. But the anticipated synchronization hasn't happened. Instead, the economic momentum that carried international markets into 2018 has slowed. In emerging economies, even outside of Turkey and Argentina, there are pockets of weakness. South Africa entered a recession in Q2 and Brazil hasn't fully recovered from its 2015/2016 recession. Still, the overall picture is encouraging as most of the major Latin American and Asian countries are quite healthy. The composite EM Purchasing Managers Index (PMI) was above 50 (a sign of expansion) in August and the IMF is forecasting an overall EM growth rate of 4.9% for 2018.

But, for now, the economic data and other fundamentals favor the U.S., which continues to experience solid growth thanks to the tax stimulus, deregulation and strong corporate earnings.

4. Strong U.S. Dollar

The dollar has strengthened throughout 2018 due in part to the factors described above and a more hawkish-than-expected Fed. In response, many EM currencies have depreciated. Countries whose imports exceed their exports (current account deficits) are at risk for further deterioration until their trade imbalance can contract. The good news is most countries have improved their trade balances over the past five years.

Looking at EM stock prices strictly in terms of local currencies (not factoring in the exchange rate), emerging markets are down only 2% through mid-September. In fact, in local currency terms, the equity markets of Brazil, Colombia, Peru, India, Malaysia, Thailand, and Russia are all positive as of September 24, 2018. This means the majority of underperformance in EM can be attributed to currency depreciation against the dollar.

The divergence between EM and U.S. equity performance isn't likely to reverse until the dollar's direction shifts.

Staying the Course

During the current market cycle, we've seen EM risk-off (bearish) events in 2011, 2013 and 2015/2016. So despite improvements to their governance structures and institutions, EM countries remain prone to severe bouts of volatility. However, this volatility doesn't appear to be a repeat of the 1990s contagion.

We still believe the underlying fundamentals in emerging markets are robust, and that countries with current account (trade) and external debt vulnerabilities have already been exposed. Plus, the pressure experienced over the summer has shifted to the Chinese market. Of the 25 countries in the MSCI EM index, China's performance in the past three months (July-September) trails every country except Argentina, Turkey and Greece.

As of the end of September, we expect the decoupling to continue, primarily because of the uncertainty around the U.S. - China trade dispute, and we're positioning portfolios accordingly. If or when the drivers discussed above turn neutral or positive, we would expect the divergence in performance to close.