LPL RESEARCH
WEEKLY MARKET COMMENTARY

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FIVE KEYS TO EMERGING MARKET OUTLOOK

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KEY TAKEAWAYS

We favor emerging market and U.S. equities for tactical asset allocations based primarily on our outlooks for global economic growth and earnings.

We expect strong economic growth to help EM offset tighter monetary policy and potentially higher interest rates in 2018.

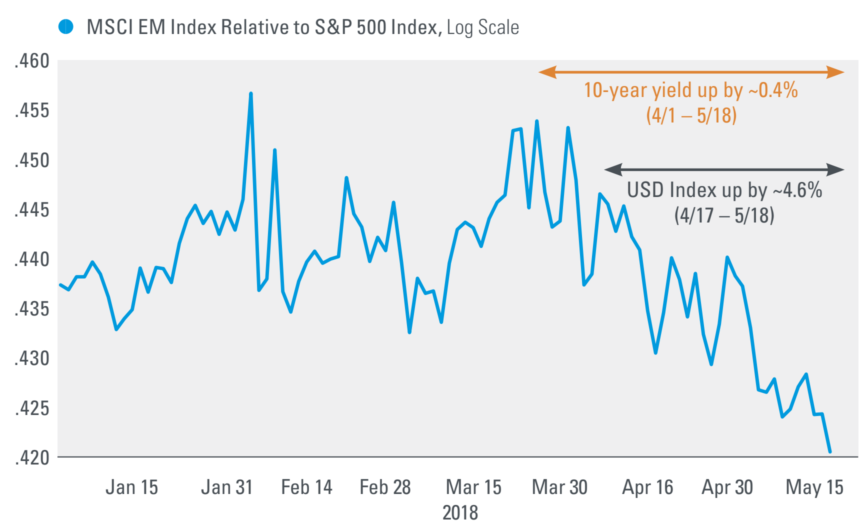
Other keys to the EM outlook include the U.S. dollar, earnings, and trade policy.

We continue to prefer emerging market (EM) equities in tactical asset allocations. EM equities have given back strong early-year gains, pushing the MSCI EM Index into negative territory year to date on a total return basis. Many headwinds have weighed on EM stocks, including rising interest rates, U.S. dollar strength (and related weakness in EM currencies), and trade war fears. Here we highlight five keys to our EM outlook.

FIVE KEYS TO EM OUTLOOK

1. **Interest rates and monetary policy.** EM's latest bout of underperformance began on April 1, when the latest move higher in the 10-year Treasury began [Figure 1]. Since April 2, the 10-year yield has gone from 2.73% to 3.07%, while the S&P 500 Index has returned 5.4% and the MSCI EM has lost 2.5%. Expectations priced into the bond market for Federal Reserve (Fed) rate hikes in 2018 (based on fed funds futures market prices) have also shifted over to four total hikes in 2018 (>50%) rather than three, with the higher inflation expectations and higher short-term rates putting some upward pressure on intermediate- and longer-term bond yields.

1 EMERGING MARKETS STOCKS HAVE UNDERPERFORMED U.S. STOCKS RECENTLY



Source: LPL Research, Bloomberg 05/18/18

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. Estimates may not develop as predicted.

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For shorter time periods, rising interest rates can cause higher volatility for EM stocks. During the so-called "taper tantrum" in the middle of 2013, EM stocks lagged the S&P 500 by about 10 percentage points (5/3/13–9/6/13). However, over intermediate and longer periods, EM stocks have tended to do well as rates rise. One-year rolling correlations between EM stocks and the 10-year yield have been positive over most of the past 30 years as economic growth and profits have won out.

Note that EM stocks performed relatively well during the most recent Fed rate hike cycle in the mid-2000s (June 2004 to June 2006), outpacing the S&P 500 when the fed funds rate rose from 1% to 5%; EM also performed well from January 1999 through July 2000, when the fed funds rate rose from 4.3% to 6.9%. EM certainly enjoyed a strong run in 2017, as the Fed hiked rates.

The EM crisis periods of the mid- to late-1990s were an exception as the Fed hiked rates and EM stocks underperformed. Beyond glaring exceptions of Venezuela and Argentina, EM economies are in stronger financial positions today. We do not see broad spillover from today's trouble spots that the Thai bhat and Russian debt crises sparked in the mid-1990s.

Also worth noting is that, based on our expectations for a modest pickup in growth and inflation, we have maintained our year-end 10-year Treasury yield forecast range of 2.75–3.25%, suggesting limited upside potential to yields from here. We expect low interest rates overseas and contained inflation in the U.S. to prevent a significant move higher in interest rates.

2. **The U.S. dollar.** The U.S. Dollar (USD) Index has rallied about 5% since mid-April. At the same time, EM currencies have struggled mightily, particularly in crisis-riddled Argentina and Turkey, driving EM stock weakness. History tells us that EM has tended to struggle during strong dollar periods such as May 2014 through March 2015 (USD up 22% and EM underperformed the S&P 500 by 15%). EM struggled during the Asian currency crisis period in the mid- to late-1990s, but the asset class performed well during the dollar rally in 2005 (the dollar rallied 13% as the Fed was hiking rates). So the relationship is not entirely clear cut.

   Beyond the obvious negative currency translation effects of a strong dollar for U.S.-based investors in EM stocks, we do not think the strong dollar should be particularly worrisome for broad EM investors for several reasons. First, further gains may be limited due to structural downward pressures. Second, EM exporters benefit from cheaper exports when their currencies are weak. Third, generally better current account balances (essentially the value of a country's exports less imports) put the biggest EM countries in a good position to weather dollar gains. Last, fewer pegs to the dollar help give EM countries currency flexibility.

3. **Economic growth.** We see advantageous demographics, early-cycle acceleration, and commodities gains all helping offset slowing but stable growth in China, potentially resulting in solid economic growth for emerging economies in 2018.

   That economic growth would be good news for EM stocks, which have historically done well when economic growth in EM economies has accelerated relative to that of developed economies. More specifically, when that gross domestic product (GDP) growth differential between emerging and developed economies has widened, the EM stocks have tended to outperform the S&P 500 [Figure 2]. EM GDP is expected to grow 5% in 2018, compared with 2.4% in developed markets, for a differential of 2.6% (Bloomberg consensus). In 2019, that differential is expected to widen to near 3%, based on Bloomberg consensus forecasts.

4. **Strong earnings growth.** That stronger economic growth outlook for emerging economies is translating into an improving

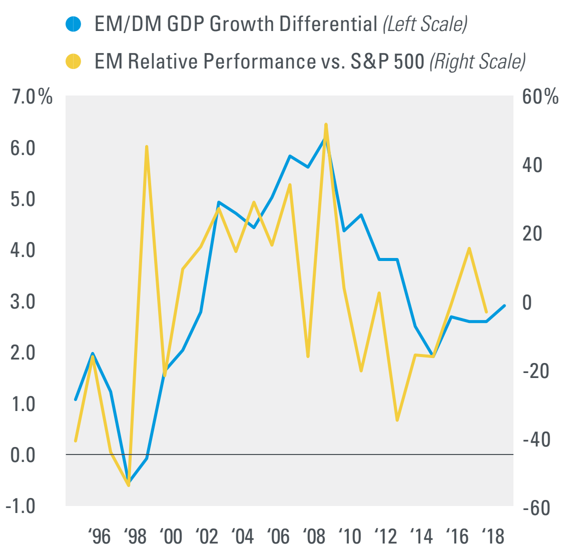
earnings growth outlook. Consensus estimates from FactSet are calling for a strong 17% increase in earnings for the MSCI EM Index, better than the comparable U.S. figure if the impact of the U.S. tax law is excluded. S&P 500 earnings growth is expected to increase by about 20% in 2018, or about 13% excluding the tax law's impact.

Not only is strong earnings growth expected in EM, but growth expectations have been revised higher by 2% year to date [Figure 3], indicating strong growth and positive momentum (we are seeing the same thing in the U.S. by the way). This pace of earnings growth far exceeds the sub-10% increase currently expected for the developed international markets measured by the MSCI EAFE.

5. **Trade policy.** Trade policy is a risk to the economic growth outlook in EM, particularly for China and Mexico. Our base case remains an agreement will be reached between China and U.S. that will have minimal negative incremental impact on the Chinese economy, or the U.S. economy for that matter.

Our view is similar regarding ongoing North American Free Trade Agreement (NAFTA) negotiations between the U.S. and Mexico (Canada is important too but is not an emerging economy). We expect a reworked version of NAFTA that has minimal incremental negative impact on the Mexican economy, though we acknowledge corporate Mexico faces some risk in the event of supply chain disruptions, possibly in the auto sector.

2 EM STOCKS HAVE TENDED TO OUTPERFORM WHEN ECONOMIC GROWTH ACCELERATED RELATIVE TO DEVELOPED ECONOMIES



EM - Emerging Markets

DM - Developed Markets

GDP - Gross Domestic Product

Source: LPL Research, IMF, Bloomberg 05/18/18

EM represented by MSCI EM Index.

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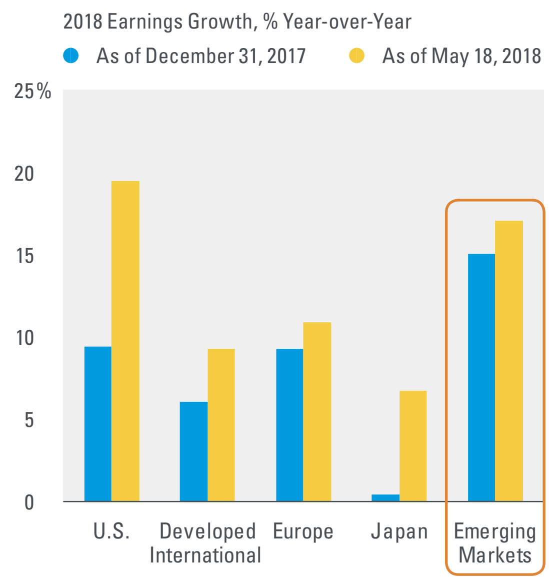
3 STRONG AND IMPROVING EARNINGS GROWTH EXPECTED IN EMERGING MARKETS



Source: LPL Research, FactSet 05/18/18

Indexes represented include S&P 500, MSCI EAFE, MSCI Europe, MSCI Japan, and MSCI Emerging Markets.

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The latest (self-imposed) deadline for the U.S. to reach a NAFTA agreement appears to have been missed, so this situation will take more time to be resolved (possibly past U.S. midterm elections). Bottom line, headline risk related to trade policy will linger and we will continue to watch the narrative out of Washington, D.C. closely for further clarity. Headlines over the weekend regarding U.S-China talks are encouraging.

CONCLUSION

We continue to favor EM (and U.S.) equities over their developed international counterparts for appropriate investors, primarily due to our favorable economic and earnings growth outlook coupled with attractive valuations. However, we recognize that several headwinds, including rising interest rates (along with Fed rate hikes), U.S. dollar strength, and trade headlines, may lead to continued elevated volatility in the short term. We expect moves in interest rates and the U.S. dollar to be contained, and we are comfortable with the economic risk from U.S. trade policy, though we will continue to monitor that situation closely. ■

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.

The economic forecasts set forth in the presentation may not develop as predicted and there can be no guarantee that strategies promoted will be successful.

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.

Currency risk is a form of risk that arises from the change in price of one currency against another. Whenever investors or companies have assets or business operations across national borders, they face currency risk if their positions are not hedged.

All investing involves risk including loss of principal.

International investing involves special risks such as currency fluctuation and political instability and may not be suitable for all investors. These risks are often heightened for investments in emerging markets.

Government bonds and Treasury bills are guaranteed by the US government as to the timely payment of principal and interest and, if held to maturity, offer a fixed rate of return and fixed principal value.

INDEX DESCRIPTIONS

The MSCI Emerging Markets (EM) Index captures large and mid cap representation across 23 emerging markets (EM) countries. With 822 constituents, the index covers approximately 85% of the free float-adjusted market capitalization in each country.

The MSCI EAFE Index is recognized as the pre-eminent benchmark in the United States to measure international equity performance. It comprises the MSCI country indexes that represent developed markets outside of North America: Europe, Australasia, and the Far East.

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 U.S. Dollar Index measures the performance of the U.S. dollar against a basket of foreign currencies: EUR, JPY, GBP, CAD, CHF and SEK. The U.S. Dollar Index goes up when the dollar gains "strength" compared to other currencies.