OUTCOMES

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PGIM QUANTITATIVE SOLUTIONS

CHANGE THINGS UP: IS NOW THE TIME TO DIVERSIFY INTO EMERGING MARKETS?

October 2023

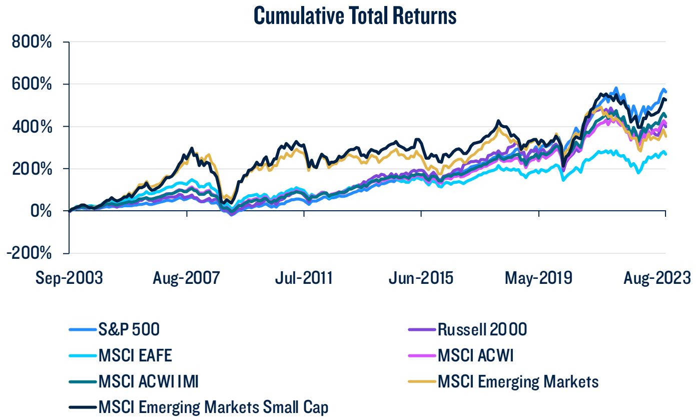
As I noted in my earlier piece, US large-cap stocks have dominated global markets this year. The investing community caught on, dubbing the handful of mega-cap stocks[1] that drove 85% of the S&P 500's return through September 2023 the "Magnificent Seven." As returns around the globe trailed those in the US, investors tended to ignore other regions and asset classes, especially emerging market (EM) stocks. I've shared my thoughts on unlocking the alpha opportunities in EM from an economic standpoint, and rather than rehash them here, I wanted to take a different tack and look at the potential for EM to be a defensive allocation in the current market, largely through diversification. In fact, looking through the lens of returns, flows, earnings, geography, and even the possible outcomes during a recession, an allocation to EM not only looks like a diversifier to an overall portfolio, but, might I suggest, even adds a measure of safety in a crowded market?

Top 5 Reasons to Revisit Emerging Markets:

1. RETURNS DIVERSIFICATION

Equity markets are crowded and dominated by US large caps. But has this always been true? Just looking at index returns, the US has in fact outpaced other major equity indexes over the last 20 years. That said, the margin is not as large as most might assume, with a cumulative return of 564% for the S&P 500, followed closely by the MSCI Emerging Markets Small Cap Index's 524% return (Figure 1). But it may not be obvious to many that the US largely trailed EM (and the rest of the world!) for the first part of the 2000s. It was only during the period after the Global Financial Crisis (GFC), perhaps driven by artificially low interest rates, when US markets really dislocated from EM. That dominance was disrupted, at least in part, during the COVID pandemic, but the return pattern implies that the US cannot continue its supremacy. Simple correlations (Figure 2) also point to the diversification of returns of EM to an overall portfolio, with both large- and small-cap EM roughly 70% correlated to the crowded US trade.

Figure 1: S&P 500 Leads Over 20 Years



Return	S&P 500	Russell 2000	MSCI EAFE	MSCI ACWI	MSCI ACWI IMI	MSCI Emerging Markets	MSCI Emerging Markets Small Cap
2003 - 2009	26%	36%	77%	60%	54%	212%	230%
2010-2019	257%	206%	79%	145%	164%	49%	38%
2020-2023	48%	19%	16%	31%	35%	-2%	37%
Total	564%	398%	268%	414%	447%	353%	524%

Source: FactSet. Data as of 8/31/2023.

[1]The "Magnificent Seven" include Nvidia, Meta Platforms, Amazon, Microsoft, Apple, Alphabet, and Tesla.

Figure 2: Correlation of Markets

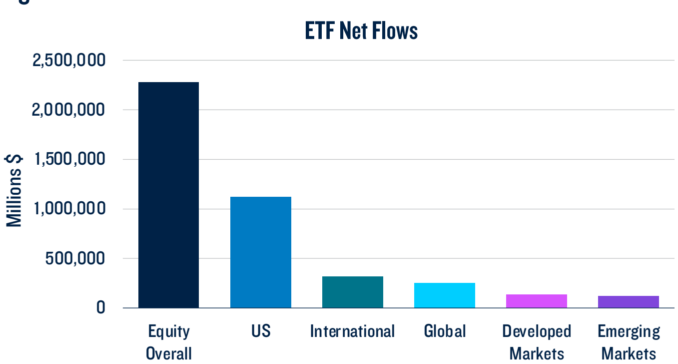
	S&P 500	Russell 2000	MSCI EAFE	MSCI ACWI	MSCI ACWI IMI	MSCI Emerging Markets	MSCI Emerging Markets Small Cap
S&P 500	1.00						
Russell 2000	0.89	1.00					
MSCI EAFE	0.87	0.79	1.00				
MSCI ACWI	0.96	0.87	0.97	1.00			
MSCI ACWI IMI	0.97	0.89	0.96	1.00	1.00		
MSCI Emerging Markets	0.74	0.69	0.86	0.87	0.83	1.00	
MSCI Emerging Markets Small Cap	0.74	0.70	0.85	0.86	0.83	0.95	1.00

Source: FactSet. Data as of 8/31/2023.

2. FLOWS DIVERSIFICATION

Following the return patterns seen above, investors have allowed the run-up in US returns to impact their asset allocation. Even over the last three years, investment flows have remained very narrow, with the overwhelming majority of equity allocations having been funneled into US stocks, with emerging markets barely making a blip (Figure 3). I find this chart very interesting: it clearly shows the sharp magnitude of global investors' singular focus. Of course, the US is proportionally larger to the rest of the world from an economic standpoint, but to have next-to-nothing invested in EM, to me, suggests an unrealistic assumption that what worked yesterday will continue to work tomorrow, or the proverbial driving forward while looking in the rearview mirror.

Figure 3: Time to Buck the Trend

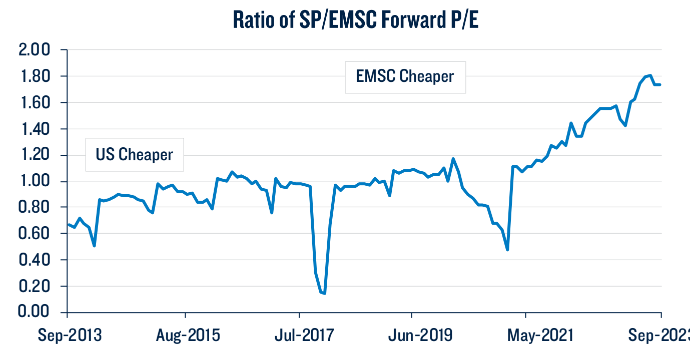


Source: Bloomberg. Data from 9/30/2020-9/30/2023.

3. EARNINGS DIVERSIFICATION

Investors' laser-like focus on the US market over the last several years has, of course, driven up stock prices substantially. Earnings results of US companies, however, have not kept up, particularly when compared to emerging markets. Take a look at the slope of the line showing the forward price-to-earnings ratio of the S&P 500 relative to the MSCI Emerging Markets Small Cap Index (Figure 4), specifically focusing on the period following COVID. It's really notable how much more expensive US stocks have gotten since then.

Figure 4: Earnings Divergence - Opportunities to Diversify



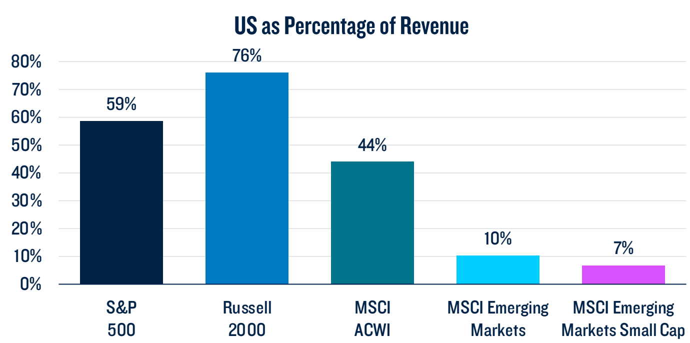
Source: Bloomberg. Data as of 9/14/2023.

4. GEOGRAPHIC DIVERSIFICATION

It goes without saying that risk management is at the forefront of most investors' priorities. We can talk about stock risk or even sector risk, but let's talk about geographic risk. And I don't just mean geopolitical risk associated with investing outside of your home country. Let's take a look at the proportion of revenues generated from US sources across a number of indexes (Figure 5). It's a given that the main US indexes – the S&P 500 and Russell 2000 – generate the majority of revenues from domestic companies. But even a global index like MSCI ACWI derives nearly half of its revenues from the US.

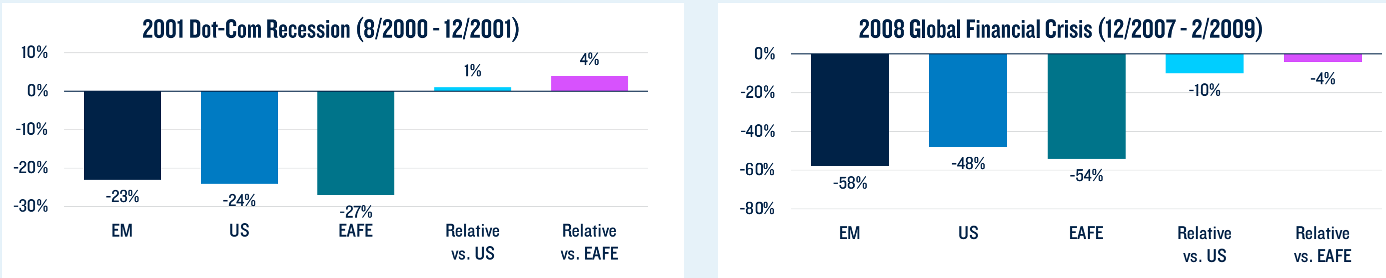
Another way to think of that tilt away from the US is a tilt *toward* something, and in the case of EM, that tilt is toward areas with extended growth potential. Take India, for example, which is roughly 1% of revenues in the S&P 500, yet is over 11% in EM and more than 21% in EM Small Cap. Another diversification win!

Figure 5: Opportunity from Diversification of Revenues



Source: FactSet, PGIM Quantitative Solutions. Data as of 9/15/2023 based on FactSet estimates of the underlying securities, weighted to reflect index weight.

Figure 6: Emerging and Developed Market Equity Returns During Recent Recessions



Source: FactSet. Data from 8/2000 - 2/2009.

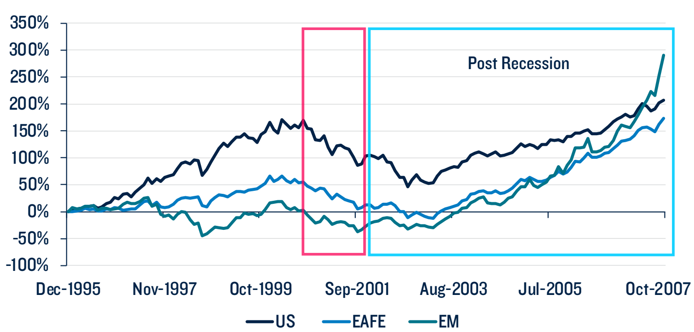
5. RISK OF RECESSION

Throughout the summer, most market watchers seemed to agree that the likelihood of a near-term recession had significantly decreased compared to the outlook at the start of 2023, the proverbial Goldilocks scenario. But back-to-school season brought markets back to questioning that assumption, as interest rates and oil prices spiked sharply, and stocks (including those Magnificent Seven!) tumbled. So, what if Goldilocks is wrong and a recession materializes? Should investors keep doubling down on US names, given the conventional wisdom that emerging market stocks are more sensitive to business cycles and to the macro environment in general, and will likely underperform developed markets during recessionary periods?

Don't forget that not all recessions are created equal. Let's take a look at the two most recent recessionary periods: the dot-com recession of the early 2000s and the recession that followed the GFC. Figure 6 shows that the performance of emerging market equities, as compared to developed market stocks, differed notably during those two periods.

To understand this divergence in relative performance let's look at two key factors: relative valuations heading into a recession and the relative performance over an extended period before a recession. Not having the tech sector dominance prevalent in the US, emerging markets as an asset class trailed developed markets and therefore looked very attractive from a valuation standpoint heading into the dot-com recession. Indeed, emerging markets fell less than developed during that recession, and continued to outperform in the years following (Figure 7).

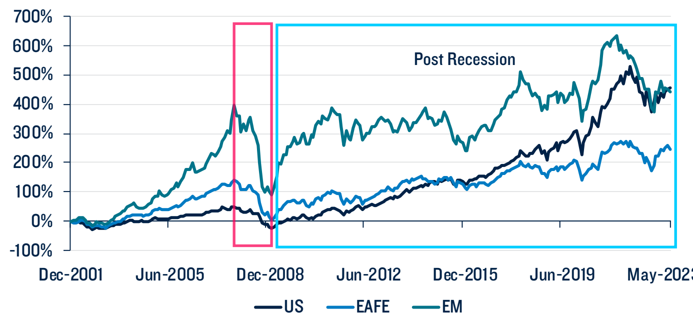
Figure 7: Emerging Markets Lead During & After Dot-Com Recession



Source: FactSet. Data from 12/29/1995-10/31/2007.

The same examination of the recession that followed the GFC reveals the opposite. Emerging markets had fairly stretched valuations relative to developed markets heading into the GFC recession after years of outperformance. Emerging markets fell significantly more than developed during that recession and continued to trail them in the years following (Figure 8).

Figure 8: Emerging Markets Trail During & After GFC Recession



Source: FactSet. Data from 12/28/2001-5/31/2023.

Given the divergence in earnings seen in Figure 4, EM is very cheap relative to the US currently, so even if a recession is in the cards, I think that emerging markets are more likely to perform like they did during the dot-com recession than during the recession after the GFC.

Emerging markets exist as an asset class to provide diversified returns to an investor's portfolio, something that seems to have been forgotten in the current markets. Perhaps by looking at EM as a risk diversifier in an uncertain market, investors can unwind their portfolio from crowded US names and be better positioned for whatever comes next.

NOTES TO DISCLOSURE

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