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Why Emerging Markets Are Still Worth the Trouble

Yes, the two-year rally, rising interest rates and trade turmoil give investors pause. But exposure to emerging markets still makes sense.

Investors, say many investment strategists, should still have some exposure to emerging-markets economies such as China, South Korea, Taiwan, India and Brazil. **ILLUSTRATION:** JAMES YANG FOR THE WALL STREET JOURNAL

By Dan Weil

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After a torrid two-year rally in emerging-markets stocks and bonds, the gut reaction of investors might be to pull back. After all, rising U.S. interest rates and a possible trade war, combined with the run-up of the past two years, would seem to work against the investments moving forward.

But many investment strategists say that long-term investors, including those tending to their 401(k)s, should fight their guts. They recommend against reducing your holdings in the stocks and bonds of such countries, which include such growing but still-riskier economies as China, South Korea, Taiwan, India and Brazil.

Their bottom line: It's still generally wise to have 5% to 10% of investment assets constantly allocated to such markets.

"There are a lot of moving parts" to interest rates and trade, says Alex Bryan, director of passive-strategy research at investment-information firm Morningstar. "It's hard to predict how they will unfold. You shouldn't time the market based on events." The best strategy, he says, is to maintain a diversified portfolio—and emerging-markets investments can play an important role in that respect.

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The past two years have been excellent for emerging markets. The MSCI Emerging Markets Stock Index soared 44% during that period, while the Bloomberg Barclays Emerging Market Local Currency Government Bond Index climbed 15%.

Some experts worry that the good times will end as the U.S. Federal Reserve continues to raise interest rates and trade conflicts brew. The argument is that higher rates in the U.S. and other developed nations make their investments, particularly bonds, more attractive than those in emerging markets.

In addition, rising U.S. rates can push the dollar higher, making shares of foreign stock and bond funds worth less in dollar terms.

What history says

Still, research shows that in the previous four cycles when the Fed increased rates, emerging-markets stocks outperformed the MSCI All Country World Index in three of them, says Michael Sheldon, chief investment officer at RDM Financial Group in Westport, Conn.

The idea that rising U.S. rates hurt emerging markets applied more in the late 1990s, "when developing economies were in some sort of disarray," says Karim Ahamed, investment strategist at HPM Partners in Chicago. "But that has changed since the financial crisis. Over time, a lot of these economies have straightened out." Now, many emerging-markets economies have lower debt-to-GDP ratios than the U.S. and Japan, Mr. Ahamed says.

Developing nations benefit from younger populations than their developed brethren, a rapidly growing middle class and a shift away from manufacturing toward more consumer-based economies. Emerging markets now account for 40% of world GDP, and economists expect that percentage to rise rapidly.

In any case, some say emerging markets will suffer less than developed markets as rates increase. "Developed stocks markets could actually be more vulnerable," says Jack Ablin, chief investment officer at Cresset Wealth Advisors in Chicago. That is because it is mainly central banks in developed economies that are increasing rates, which can damp a country's economic growth, thereby depressing corporate earnings.

In addition, despite the rising-rate environment, U.S. rates remain well below historical averages, Mr. Sheldon notes. So the ascent of U.S. rates might not have a major impact on emerging markets.

"If rates rise more slowly than expected, it might not hurt emerging-market stocks at all," Morningstar's Mr. Bryan says. "I wouldn't make a tactical adjustment [to emerging-markets allocations] based on interest rates." Fed officials have indicated they expect to raise rates another two or three times this year.

When it comes to potential trade tussles, the argument is that emerging markets would endure the most pain because many developing economies are dependent on exports. But Mr. Ahamed points out that the dependency has lessened as many of these nations begin to shift their emphasis to internal consumption. And in any case, at this point, it looks like trade spats will have a more bilateral focus, such as the U.S. vs. China, than world-wide, he says.

The tariffs announced by President Donald Trump in March apply only to steel and aluminum, Mr. Bryan notes.

"It's unclear whether they will be extended beyond that and how countries will respond," he says. "It's hard to forecast their impact on emerging markets."

Investors shouldn't base their allocations on uncertain developments, many expert say. "It's noise," Mr. Bryan says. "The best course is to be diversified and maintain a long-term strategic allocation."

Still looking cheap?

As for stock valuations, now is actually a good time to build an exposure to emerging markets, because they look relatively cheap despite the run-up, strategists say. Emerging markets have a forward price-to-earnings ratio of 12, compared with 17 for the U.S. and 16 for the world as a whole, according to MSCI and J.P. Morgan.

"Emerging-market stocks are now priced attractively," Mr. Bryan says.

Even when U.S. bull markets falter, those at the Shenzhen Stock Exchange could cushion the blow for emerging-markets investors. **PHOTO:** ISTOCKPHOTO/GETTY IMAGES

Emerging-markets stocks account for 8% of world stock-market capitalization, which is largely why he and others in general recommend a 5% to 10% equity allocation for emerging markets.

Two funds Mr. Bryan recommends are iShares Core MSCI Emerging Markets ETF (IEMG) and iShares Edge MSCI Min Vol Emerging Markets ETF (EEMV). Both are well diversified.

The first has an annual expense ratio of only 0.14 percentage point and holds stocks of all sizes. The second is designed to be more risk-averse; it excludes small-capitalization stocks and generally seeks to reduce volatility.

Bond yields beckon

On the bond front, Mr. Ahamed finds emerging markets attractive, too. Yields there are higher than in developed markets. For example, Vanguard Emerging Markets Government Bond ETF (VWOB) yields 4.7%, compared with 2.73% for Vanguard Long-Term Treasury ETF (VGLT).

The solid fiscal health of many emerging markets also buoys their bonds, Mr. Ahamed says. And many emerging-markets central banks have the capacity to cut interest rates if their economies slump. That would boost their bond prices, benefiting bondholders.

Mr. Ablin agrees with Mr. Ahamed that emerging-markets bonds are attractive, but he doesn't recommend a constant exposure to them like he does to emerging-markets stocks. That's because he invests in bonds for safety, and emerging-markets bonds generally aren't as stable as those in the U.S.

"I use bonds as a source of a specific cash flow at a specific date," Mr. Ablin says. "From that perspective, it's still uncertain whether emerging-market bonds deserve a seat at the table."

His base case is zero allocation to emerging-markets bonds, but at times like now when they're attractive, he recommends that 5% to 10% of a bond portfolio be allocated to emerging markets. "If the emerging-market bond market deteriorates relative to U.S. bond markets," Mr. Ablin says, he will reduce the allocation again.

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