

# Going Viral: How to Think About Emerging Markets in the Midst of a Global Pandemic

“Going viral” has taken on several new meanings over the years. In a world where we are faced with a literal viral threat and investments created out of the phenomenon of going viral through digital platforms, we are challenged to make decisions with little visibility into the future. That said, in our opinion the future looks bright. Like all professional investors, we are strong proponents of diversification across asset classes. However, we realize that, in recent years, some asset classes have not presented a strong case for a strategic allocation. Below is what we believe investors should consider when thinking: Why emerging markets?

## NOW AND THEN

From 30,000 ft. to important long-term characteristics, current fundamentals and common objections, we believe emerging markets is an area investors should see as a capital appreciation solution now and for the future.

## STOCKS OR BONDS?

In a world where it seems all asset prices are elevated, we believe one must look for relative value. The simple way to look at this is the relationship between the 10-year Treasury bond yield versus the S&P 500 earnings yield.

### BOND EQUITY EARNINGS YIELD RATIO

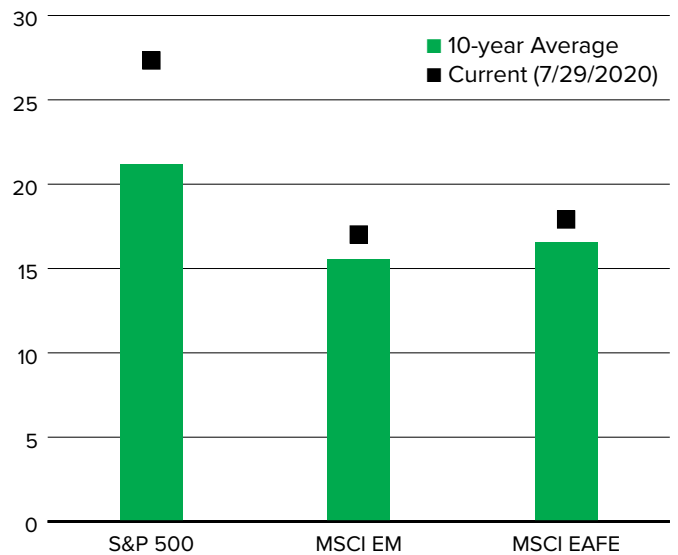


Source: Bloomberg 7/27/2020. Past performance is not a guarantee of future results.

## U.S. VS. NON-U.S.?

**Valuation:** In the current environment, where earnings have been severely depressed and volatile, we believe a fair valuation metric to review for relative comparisons is the Cyclically Adjusted P/E ratio (CAPE), also known as the long-term P/E ratio.

### CYCLICALLY ADJUSTED P/E RATIO (CAPE)



Source: Bloomberg 7/29/2020. Past performance is not a guarantee of future results.

All global equities are currently above their long-term average CAPE ratio. But non-U.S. equities are relatively less expensive in both an absolute and historical context. Valuation alone isn't a predictive characteristic, which brings us to growth.

**Growth:** With COVID-19, the scarcity of growth may lead to a greater premium for areas where growth is strongest and most sustainable. Much like we have seen on an individual stock basis in recent years where growth has commanded a significant premium, regions of the world may experience a similar dynamic.

#### GDP AND EPS GROWTH

	2019	
	GDP Growth (%)	Earnings Growth (%)
U.S.	2.3	1.7
Europe	1.3	-3.0
Emerging Markets	3.7	-2.3

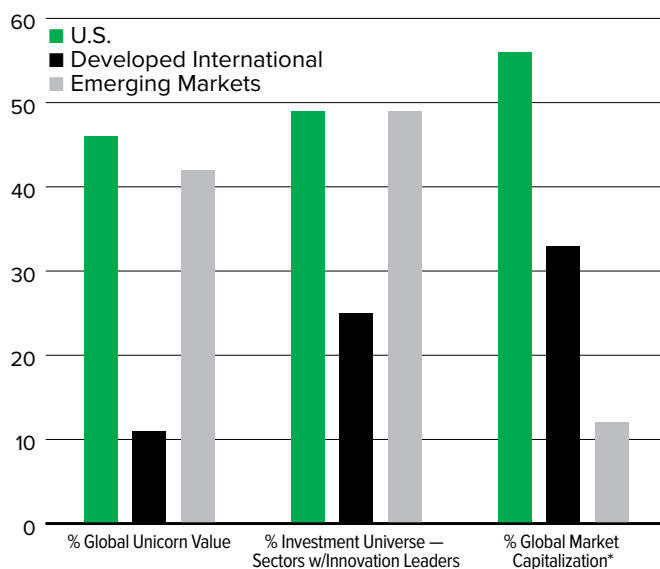
	2020E	
	GDP Growth (%)	Earnings Growth (%)
U.S.	-8.0	-18.8
Europe	-10.2	-30.8
Emerging Markets	-3.0	-8.8

	2021E	
	GDP Growth (%)	Earnings Growth (%)
U.S.	4.5	26.3
Europe	6.0	35.2
Emerging Markets	5.9	30.7

Source: GDP Growth: International Monetary Fund, 7/29/2020. Earnings Growth (MSCI indices): Thomson Reuters I/B/E/S, 7/26/2020. **Past performance is not a guarantee of future results.**

Valuation along with growth can be powerful predictive characteristics, however, the world is rapidly changing. Investing in areas of the economy and businesses with long-term sustainability is important. Which brings us to the emerging-markets opportunity. What are you investing in? Why should it receive a premium in the future? Which businesses are going to be relevant in five or 10 years from now? We can look to what the market has favored in recent years, innovation, as a guide. Innovative technologies, consumer platforms and business models have been the focal point of investors. Those companies that can create and implement innovation have generated superior economic value. With COVID-19, many of these innovative trends have accelerated and will likely prevail in a sustainable manner for many years.

#### AN INVESTMENT CASE FOR A STRUCTURAL EMERGING MARKETS ALLOCATION



Source: Bloomberg 7/29/2020. **Past performance is not a guarantee of future results.**

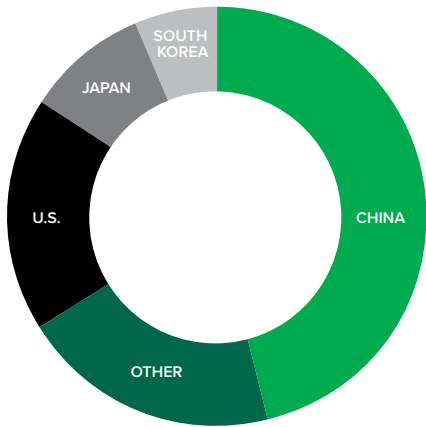
**Innovation vs. Market Capitalization** — Unicorns, a term that refers to private companies with market values greater than \$1 billion, are considered the “nursery” for future innovation leaders and soon-to-be public companies (IPOs). This bodes well for the future growth and expanding investment universe in emerging markets.

If opportunity lies in innovative businesses, we believe that emerging markets may have such opportunities. It is home to many of the world’s most innovative up-and-coming companies. Yet, emerging markets punches below its weight, still only accounting for a small portion of the global stock market. This is likely to change with time.

In addition, the current investment universe has established innovation leaders, giving investors a compelling investment case for a near-term allocation to emerging markets.

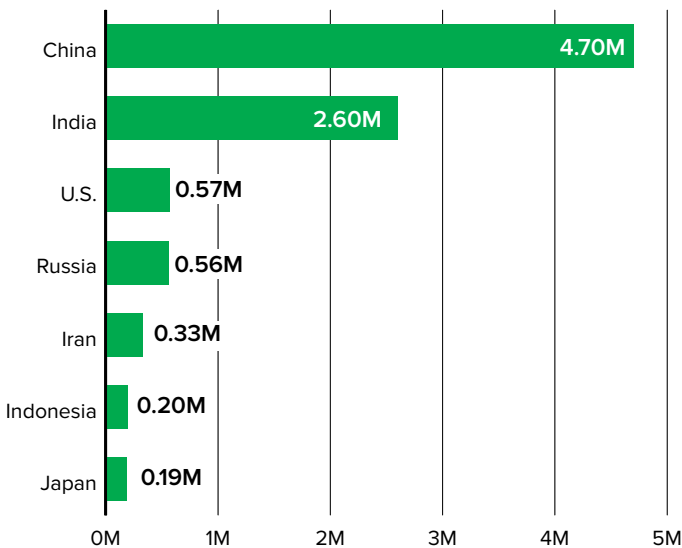
It is important, as a long-term investor, to understand the characteristics that can drive trends sustainably into the future. For example, if the U.S. implements more stringent IP protection with China, will that lead to a decline in their ability to innovate? Several statistics point to the ongoing ability for China to create and continue their path of entrepreneurial success across several industries.

**PATENT APPLICATIONS BY COUNTRY (2018)**



Source: WIPO — World Intellectual Property Indicators 2019.

**COUNTRIES WITH THE MOST STEM GRADUATES (2016)**



Source: World Economic Forum.

China accounts for nearly half the patent applications in the world. It is also home to the most graduates from science, technology, engineering and mathematics (STEM) programs. This will enable them to continue to develop globally competitive technology and medicine. Areas where we are likely to see them thrive for many years ahead.

**Growing wealth of the middle class, millennials and adoption of technology:** Emerging markets is home to the largest consumer base in the world. One that continues to grow in size and wealth. It is also a population that has adopted technology. This bodes well for those companies with a competitive edge, particularly those with the ability to reach their consumers through smartphones.

**SMARTPHONE TRENDS FAVORABLE IN EMERGING MARKETS**



Size of China's mobile payments industry is 50 times that of the U.S.

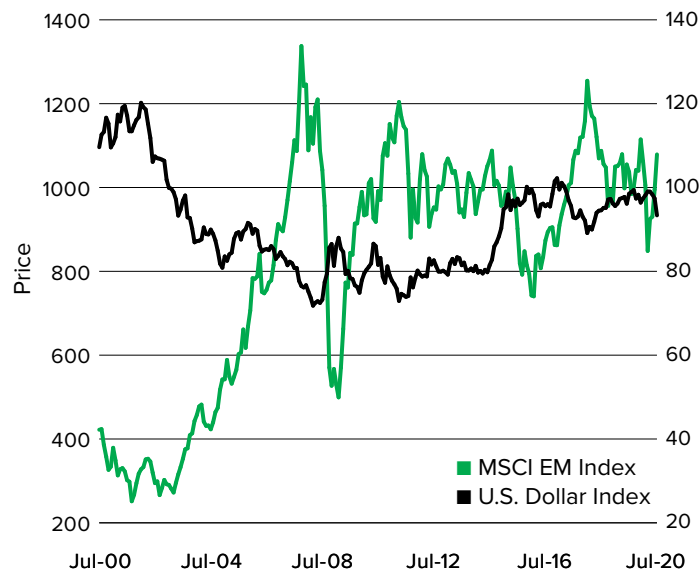
Emerging market consumers spend 33% more time on mobile devices.

Source: World Economic Forum.

**A headwind may become tailwind:** After a decade long appreciation cycle, the U.S. dollar has been softening and there is fundamental evidence that it could weaken from here. U.S. fiscal spending, interest rates, the inability to contain COVID-19 relative to other countries, and a general reversal in the flight to safety that prevailed in the early stages of the virus are potential drivers of a weaker U.S. dollar. Emerging markets have generally done well in a weak dollar environment, mostly because major inputs costs, like oil, are quoted in dollars and a lot of sovereign debt is borrowed in dollars.

## U.S. DOLLAR INDEX COMPARED TO MSCI EMERGING MARKET INDEX

Historically, emerging-market equities have had significant negative correlation with U.S. dollar



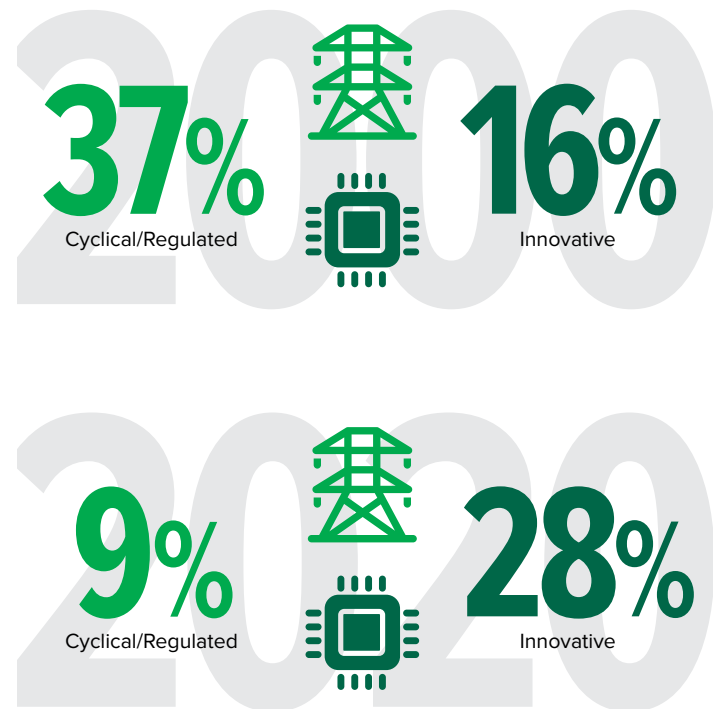
Source: Bloomberg. Past performance is not a guarantee of future results.

## EMERGING MARKETS: OBJECTIONS TO INVESTING IN THE REGION

**Emerging markets is a cyclical, commodity driven market that benefited from China's growth and infrastructure boom, but China's growth is slowing:**

China is decelerating, but it is still the second largest economy in the world. Growth of just 4% creates a meaningful amount of economic activity, adding roughly the equivalent of Sweden's annual GDP. Also, emerging markets has a different investment case than it did 20 years ago. As seen above, with the innovation boom and also supported by the evolving investment landscape.

## THE EVOLVING INVESTMENT LANDSCAPE — 2000 TO 2020



Source: World Bank, Bloomberg, FactSet 12/31/2019.

**U.S. elections:** In 2017, the U.S. slashed corporate tax rates, instantly increasing profitability and earnings for many corporations. Depending on U.S. election results in November, the corporate tax reform could be rolled back, resulting in a squeeze on U.S. corporation profitability. This may increase the attractiveness of emerging-market stocks as their profitability gains a relative advantage.

**Emerging markets debt:** Debt in emerging markets remains a risk as they continue to borrow, particularly if the global economy takes longer than expected to recover. However, for the most part, debt burdened countries do not consist of a large part of the equity universe. Countries that have had the greatest issues in recent years, like Turkey and Argentina, are relatively insignificant in the equity world. Also, the world used to be less integrated and, thus, less concerned about emerging-market crises. Whereas now, rescue packages and organized debt restructurings are more prevalent and likely. Contagion is less of a risk.

## China's equity rally has been driven by an unsustainable retail surge:

Yes, China has experienced inflows from retail investors, much like the Robinhood phenomenon the U.S. has seen during the pandemic. For China, many are comparing it to 2014 when a retail boom cycle led to a bust in the market. While this is always a risk, there are differences this time that may mitigate the risk. There are more foreign institutional investors, more local institutional investors (active mutual fund issuances are four times what they were a year ago), and the government is more aware of the risk. As such, we believe there are more active participants to temper the risk.

## Emerging markets has been a bad place to invest

**compared to the U.S.:** On a relative basis, emerging markets has not performed well over the last decade and investors have been waiting for the tide to turn. Historically, regional leadership has worked in cycles. In the early part of the century, emerging markets prevailed, though, since the financial crisis, the U.S. has outperformed emerging markets. Despite this relative underperformance over the last 10 years, emerging markets has still created value for investors. While volatility is generally higher, investors have seen return for that additional risk.



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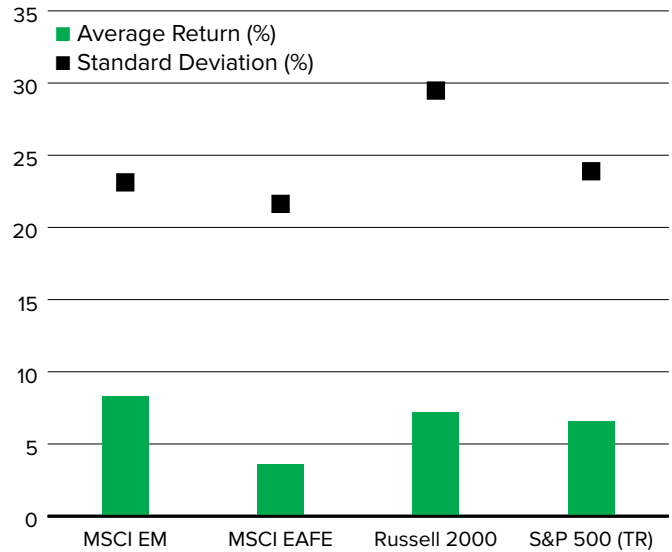
**Risk factors:** Investment return and principal value will fluctuate and it is possible to lose money by investing. International investing involves additional risks, including currency fluctuations, political or economic conditions affecting the foreign country, and differences in accounting standards and foreign regulations. These risks are magnified in emerging markets. Investments in countries with emerging economies or securities markets may carry greater risk than investments in more developed countries. Political and economic structures in many such countries may be undergoing significant evolution and rapid development, and such countries may lack the social, political and economic stability characteristic of more developed countries.

The impact of COVID-19, and other infectious illness outbreaks that may arise in the future, could adversely affect the economies of many nations or the entire global economy, individual issuers and capital markets in ways that cannot necessarily be foreseen. In addition, the impact of infectious illnesses in emerging market countries may be greater due to generally less established healthcare systems. Public health crises caused by the COVID-19 outbreak may exacerbate other pre-existing political, social and economic risks in certain countries or globally. The duration of the COVID-19 outbreak and its effects cannot be determined with certainty.

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## EMERGING MARKETS HAS OUTPERFORMED WITH COMPARABLE RISK



Source: Morningstar. Data from 01/01/2001 – 6/30/2020. **Past performance is no guarantee of future results.**

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