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Equity overweight raised on improving EM outlook

We think EM stocks are poised for a comeback.

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BOTTOM LINE

Federated's PRISM asset allocation committee this week decided to up our recommended overweight to equities to 80% of maximum in our stock-bond model, with the increase going to emerging markets (EM) on an improving outlook. The move, funded by taking money out of our allocation to cash, raised the EM from a neutral 4% in our model to an overweight 5%. Here's our thinking behind the move:

2018 was by no means a banner year for equities, but it was particularly bad for EM stocks. The MSCI EM Index fell 24% from late January to year-end 2018, compared with a 12% decline in the S&P 500. We got ahead of this, lowering the EM allocation in our stock-bond portfolio model from overweight to neutral at the beginning of 2018 because we felt:

- The U.S. economy would strengthen in 2018 due to President Trump's favorable fiscal policy passed into law at the end of 2017. That turned out to be correct as GDP rose 2.9% in 2018 versus 2.2% in 2017.
- The Federal Reserve was likely to sharply tighten monetary policy in 2018. It did, with four quarter-point rate hikes and a reduction of their balance sheet.

- The dollar would strengthen versus the euro, from about 1.26 dollars per euro to 1.15. The dollar ended up rallying to about 1.12. EM currencies and the dollar tend to trade inversely.
- The strong dollar would exert downward pressure on oil prices. It did, as West Texas Intermediate crude prices opened 2018 at around $60 and fell to about $42 by year-end. Oil is a crucial commodity for many emerging market economies.

What's different now? We expect all of these trends to reverse, with GDP slowing (we estimate real growth will come in at 2.6% in 2019), the Fed remaining on pause for most if not all of the year, the dollar treading water and oil prices continuing their climb (they have rebounded nearly 40% over the past three months due to better global supply/demand balance). These fundamental developments are all favorable for the EM, whose relative valuation is now very attractive, especially given 2018's underperformance. While it has rallied, the EM has underperformed the S&P by another 3% so far this year.

A trade deal with China almost certainly would rev the EM engine. We maintain a largely out-of-consensus view that the ongoing trade war between the U.S. and China **will be favorably resolved shortly**, and that China will agree to purchase some $200 billion more annually in U.S. goods, such as agricultural products (soy beans and corn), energy (natural gas), autos, aerospace electronics and semiconductors. At the same time, we expect some progress on the critical issue of China's alleged theft of U.S. corporate intellectual property. These would lead to the U.S. lowering or eliminating many of the temporary tariffs enacted to bring China to the bargaining table. This could help to boost China's stated GDP of 6.6% in 2018, its slowest rate of growth in nearly three decades. Because China is an important part of the EM index and because the Shanghai Composite Index plunged 31% in 2018, an economic rebound should boost EM stocks.

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DISCLOSURES

Views are as of the date above and are subject to change based on market conditions and other factors. These views should not be construed as a recommendation for any specific security or sector.

Gross Domestic Product (GDP) is a broad measure of the economy that measures the retail value of goods and services produced in a country.

The MSCI Emerging Markets Index was created by Morgan Stanley Capital International (MSCI) to measure equity market performance in global emerging markets.

S&P 500 Index: An unmanaged capitalization-weighted index of 500 stocks designated to measure performance of the broad domestic economy through changes in the aggregate market value of 500 stocks representing all major industries. Indexes are unmanaged and investments cannot be made in an index.

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