



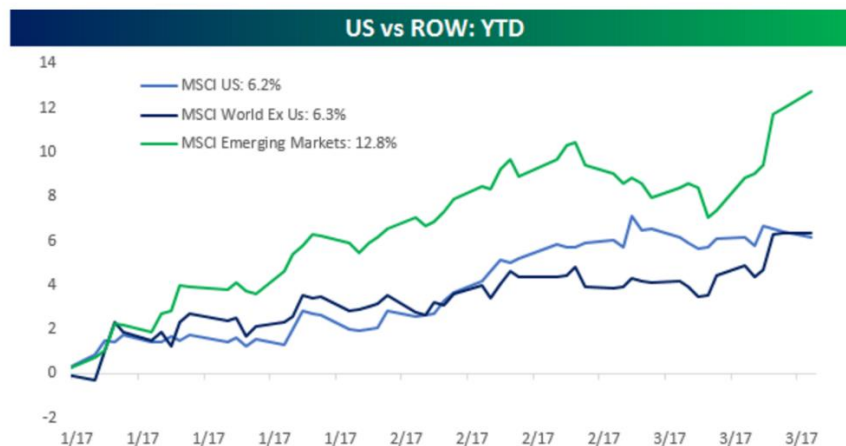
ARE EMERGING MARKETS FINALLY READY TO LEAD AGAIN?

SUMMARY

- Emerging markets are leading the way in asset class performance so far in 2017. Many are predicting that this trend will continue, however examining the past several years gives us pause from getting too bullish.
- The Fed raised rates last week by 0.25%. This move was expected. The consensus is for 2 more rate hikes this year. We agree with that analysis.

EMERGING MARKETS ARE SHOWING SIGNS OF LIFE

We have been seeing several articles suggesting emerging markets (EM) could outperform US markets again, after lagging the past five years. Some of this chatter stems from the simple fact the EM is leading the way so far in 2017:



Source: Bespoke Investment Group

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The issue is simple. We have seen this before, as emerging markets often outperform US stocks to start the year.

The following chart shows the performance of the iShares Emerging Market ETF (Ticker: EEM) relative to the S&P 500 ETF (Ticker: SPY):



In five out of the past six years, emerging markets outperformed the S&P 500 to start the year. Over that entire period, though, they have struggled and underperformed.



There is some evidence that the worst is behind us:

10 Year Performance Rankings As Of

2008	2013	2016
EM 9.6%	EM 10.8%	Small Cap 9.2%
Comdty 7.2%	Mid Cap 10.5%	Mid Cap 8.8%
Bonds 7.6%	REITs 8.5%	Large Cap 6.9%
REITs 7.1%	Small Cap 7.4%	REITs 5.1%
TIPS 7.0%	Large Cap 7.3%	Bonds 4.2%
Mid Cap 3.8%	International 6.8%	TIPS 4.2%
Cash 3.3%	TIPS 4.7%	EM 1.1%
Small Cap 1.3%	Bonds 4.7%	International 0.6%
International 1.2%	Cash 1.6%	Cash 0.6%
Large Cap -1.3%	Comdty 0.2%	Comdty -6.8%

In the decade ending in 2008, emerging markets was the best performing asset class. This remained true in 2013. Since then, EM’s performance lagged fixed income, and barely outperformed cash.

Asset class performance tends to *mean revert*. Strong performers attract investor capital, which often leads to further price appreciation. Eventually, there is not enough additional capital to keep the party going and performance begins to falter. Once the “story” changes, capital flees and prices fall. We have seen this play out time and again, with the most recent examples (besides emerging markets) being gold, commodities, and residential real estate.

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The good news is that this also applies in reverse. Asset classes that struggle for years can mean revert to the upside. This fact alone does not suggest the time for emerging markets to outperform has come, however it is a lot easier to outperform when expectations are low and performance has been poor.

AS EXPECTED, THE FED RAISES SHORT TERM RATES

The Federal Reserve raised short-term rates by 0.25% last week. The change a boost to your savings accounts, but also means it will be more expensive to borrow from your credit cards and home equity lines of credit. It is important to point out that even with the hike, rates are still historically low.

The move was not a surprise. The Fed has signaled the desire to “normalize” rates for months now. The idea is as the economy moves along and employment data remains strong, there is no need to leave rates so low. The Fed is constantly balancing their mandate, which is to keep employment up and inflation low.

In her comments with the rate hike, Chairman Janet Yellen indicated that recent improvement in optimism among consumers and business would not push the Fed to move any more aggressively. Instead, the Fed wants to see if good feelings translate into actual spending and investment:

“We exchange around the table what we learned from our many business contacts, and I think it’s fair to say that many of my colleagues and I note a much more optimistic frame of mind among many, many businesses in recent months. But I’d say most of the business people that we’ve talked to also have a wait and see attitude, and are very hopeful that they will be able to expand investment and are looking forward to doing that, but are waiting to see what will happen. So, we will watch that. And, of course, if we were to see a major shift in spending reflecting those expectations, that could very well affect the outlook. I’m not seeing it — I’m not seeing that at this point. But the shift in sentiment is obvious and notable.”

Source: Avondale Asset Mgmt

The consensus is for three rate hikes in 2017, which we agree with. It is important to point out that the Fed is hyper sensitive to the data, whether it be economic or market driven. A major market decline, or a couple of quarters of slower than expected growth is all it would take for them to punt the next rate hike to 2018.



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