

September 6, 2013

"If you want to have a better performance than the crowd, you must do things differently from the crowd."

-SIR JOHN TEMPLETON

POINTS TO PONDER


1. Significant outflows from an investment sector have consistently provided excellent buy signals over the years. If past is prologue, emerging market bonds should be at least gradually accumulated by long-term investors willing to tolerate volatility and, quite possibly, the need to average down. The compensation is high cash flow returns and a plausible opportunity to realize capital appreciation. (See Figure 1)

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2. One powerful illustration of how severe the turmoil has become in emerging markets is that Brazil's currency has tumbled 32% over the last two years. Additionally, Indian small-and mid-cap stocks are down 51% and 36%, respectively.

3. Even as Europe appears to have emerged from its dreaded double-dip recession, Asia is stumbling, in some cases badly. The once thriving economy of Thailand is now officially contracting.

4. It was difficult, if not impossible, back in 2010 to read a financial publication, or watch CNBC, without coming across a bullish view of developing stock markets. Since then, emerging markets have re-earned the pejorative "submerging", as has happened so often in the past. Over the last three years, shares prices in these formerly revered countries have lagged developing markets by a whopping 55%. (See Figure 2)

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5. According to the International Monetary Fund (IMF), China's overall capacity utilization rate has fallen from roughly 80% in 2008 to 60% last year. As Xu Qiyuan, senior research fellow at the China Academy of Social Sciences, wrote in a Financial Times op-ed article: "It (China) is now a factory that is too big for the world market."

6. Uneven global economic activity is depressing demand for oil. However, new car sales in China have totaled 54 million since 2009 versus 22 million in the previous four years.

7. The US stock market is not the only global bourse that has become heavily reliant on its central bank's uber-generosity. Per the elite research firm ISI, Japan's Nikkei index has displayed its dependency on the Bank of Japan by slamming against a reinforced steel ceiling during recent intervals when the BOJ's printing presses stood down. (See Figure 3)

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8. The US government, which seems to only know how to pile on more bureaucrats and regulations, could learn a valuable lesson from China. Over the last 30 years, the Middle Kingdom has methodically reduced its number of agencies and ministries by nearly half. Similarly, the aggregate count of central government officials has fallen from near 500,000 to

below 300,000, despite an economy orders of magnitude larger than in 1983.

9. One long-standing EVA forecast is that eventually the strongest corporate bond issuers in the sovereign debt-drenched developed world would someday be able to finance themselves at a lower cost than many governments (including the US). Interestingly, this is already happening in Asia. (See *Figure 4*)

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10. In yet another sign that the big correction in gold has catalyzed strong demand for physical bullion, the China Gold Association reports that demand for gold bars is up 87% from a year ago.

11. An additional deflationary global force right now, beyond the yen's big devaluation and China's cavernous excess industrial capacity, is the eurozone banking system. European banks are returning hundreds of billions of euros to the European Central Bank (ECB). They are funding this payback of emergency loans by shrinking their loan books, causing a stealth monetary tightening and thereby jeopardizing the Continent's faint-pulse recovery.

12. France's national retirement program, like social security in the US, is completely unfunded, otherwise known as pay-as-you-go (or, possibly, more accurately, pay-as-you-go-broke). Even in 2006, prior to the global financial crisis, its unfunded liabilities were 362% of GDP, the worst status in the European Union.

13. In a complete reversal of fortune from early 2011, the US stock market has muscled ahead while the rest of the world's markets have stagnated. As a result, American share prices have enjoyed their largest five year outperformance versus the All Countries Index (ex-US) since 1999. (See *Figure 5*)

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14. The eruption in longer term interest rates has already had a pronounced supply impact, with corporate debt issuance now running at its lowest level in five years. Thus, any meaningful demand pickup could trigger a sharp price rally.

15. Numerous impediments stand in the way of the US reclaiming its normal 3% real, or inflation-corrected, GDP growth rate, such as a slower growing labor force and government regulations gone viral. However, both housing and fiscal restraint (such as it has been) should be much less of a dual headwind in the future than they have been over the last few years. (*See Figures 6-8*)

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Get 'em while they're cold! What self-respecting hot dog hawker would shout out those words? Not any that would want to keep their job, that's for sure. While that makes total sense when it comes to pushing franks at the ballpark, it's a very different story with regard to the financial markets—or at least it should be.

Unfortunately, though, countless investors, and far too many investment professionals, only want to buy what's hot. A classic and current case in point is emerging markets. When they were outperforming the US back in 2010, they were all the rage, as noted in several past *EVA*s. As is always the case, there was a compelling storyline for why they should continue to excel, much as there was for tech during the height of that maniacal episode in the late 1990s.

In the case of emerging markets, the siren song went something like this: Since emerging markets represented 26% of GDP and only 16% of market capitalization, they were nearly assured to continue besting their so-called rich peers, as they had done so dramatically in 2009 and 2010, by closing that gap. There was also the related allure of faster growth. We heard repeatedly for years via the ads of a certain money management firm on CNBC that emerging markets offered a "structurally higher growth rate" (doesn't almost everything sound more impressive when you put "structurally" in front of it?).

Unfortunately, as so often happens, this thesis—some might say fad—came a cropper, as is vividly illustrated by PTP 4. Instead of benefiting from a narrowing of the gap between GDP and market value, it went the other way. Today, the developed world represents 32% of global economic activity but just 14% of market capitalization! Obviously, it achieved the faster (though disappointing) growth but markets, as they often do, haven't cooperated. To make matters even worse, the developing world's higher economic growth rate turned out to be more cyclical than structural and lately the cycle has been heading the wrong way.

Moreover, as also frequently occurs, once a particular investment sector has disappointed its fan base, a wicked backlash of bitterness and derision is unleashed. To paraphrase William Congreve, hell hath no fury like an investor scorned. This is exactly where both developing world stocks and bonds find themselves these days: deep in the market's penalty box with little apparent hope of reprieve.

Just a few months ago, it was the (not-so) precious metals that were winning the gold and silver medals for most despised asset classes. But, once again, as is the recurring experience, almost as soon as the enmity hit a truly fever pitch, gold and silver suddenly lost the "not-so" qualifier

and have fashioned a powerful, though incomplete, rebound.

Perhaps befittingly, the same culprit pulled the rug out from under both precious metals and the emerging markets—and it's a most likely prankster at that.

The investment equivalent of dumpster diving? A few years ago, I was asked by a highly successful investment colleague, who subjects herself almost every week to reading *EVA*, why I was so bearish on emerging markets (EMs). My response at the time wasn't that I thought they would go down but rather that my team and I felt the US market seemed to offer much better value, especially on a risk-adjusted basis. (In hindsight, I should have been less charitable toward the EMs.)

Today, however, there has been such a radical shift in valuations that the Evergreen attitude toward the developing world is definitely evolving toward being more constructive. For example, the largest emerging market ETF, run by Vanguard, is selling at just 10.6 times 2013 estimated earnings. This is versus the US at around 16. On our favored price-to-sales metric, which eliminates the distortions caused by the business cycle on profits and profit margins, EMs are at just 1x (times sales) vs the typical 1.4x. In the US, this number is presently 1.5x.

Moreover, the most influential EM, China, is now trading at just 8.5 times forward earnings estimates, compared to a P/E of 28.3 in November of 2007, when these pages warned of a bubble in Chinese shares. South Korea, another key developing economy, is even a bit cheaper, at 8.2 times 2014 earnings.

Looking at price-to-book value, the numbers are even more arresting. The EMs are trading at just 1.5 times book value, the lowest point of the last 10 years save for during the worst of the global financial crisis. In the US, shares trade at 2.4 times book value.

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Based on the above facts, there's little doubt the EMs are cheap, but does that mean they are a good buy? Or are they cheap for a reason, in other words, the classic "value trap"? To answer those questions, it might be helpful to consider what has caused this valuation face-plant by the EMs.

If you suspect that one leading "perp" contender might be the same entity that has caused so many market gyrations over the last 13 mostly star-crossed years—and that it is spelled FED—please move to "Go" and collect \$200!

Of babies and bath water. It has recently dawned on me that FED and PED, as in Performance Enhancing Drug, make eerily similar acronyms. The Fed's version of PED, of course, is trillions of, to use another acronym, MMM (Magically Manufactured Money). Yet, in another flummox of the prevailing logic of three years ago, the Fed's PED didn't create rampant inflation in the US. However, it did cause massive sums to flow toward the higher yields in the developing world.

It does seem like the poor EMs often suffer the first shock waves when the Fed's policies begin to go awry. This time is no exception as they have clearly been the main casualty of Mr. Bernanke's taper talk. Yet, it is likely there are more negative catalysts at work.

Among the minor quibbles we had with the bull story back in 2010 and 2011 for most of these countries, in addition to looking fully priced, were the sketchy rule of law, endemic corruption, pervasive cronyism, questionable accounting, byzantine regulation, ineffectual corporate governance, and the recurring tendency of home governments to appropriate the assets and/or cash flow of even some of the largest companies. Other than that, we were raging bulls!

Unfortunately, far too many developing countries have done very little to address these acute structural flaws. The abundance of liquidity flowing their way undercut the desire to implement the urgently needed reforms (if you think this sounds a lot like what we're doing in the US, you get another \$200 of Monopoly Money, or MM, which come to think of it, is a lot like the Fed's MMM).

However, not all emerging markets deserve to be tarred with the same indiscriminate brush. There are numerous countries in Asia, for example, that are in strong financial shape, have embraced reforms, and truly do have structurally higher growth rates.

In conjunction with our partners at GaveKal, we are in the process of adding exposure for Evergreen clients to the better-positioned Asian countries and companies in order to take advantage of the recent plunge in currencies, stocks, and bonds in this dynamic part of the world. Given GaveKal's local presence and years of demonstrated investment success in Asia, we are excited to be able to access this region via their expertise and capabilities, especially when bargains abound.

On the other side of the world, in our hemisphere, the story is largely the same. The damage has been widespread and the selling intense. Consequently, we are able to buy bonds from the largest energy company in South America, which sits on enormous offshore oil reserves that are the envy of the energy industry, yielding 6% to a 10-year maturity. It possesses a solid investment-grade rating and this particular issue is denominated in dollars (i.e., no currency risk/reward).

Similarly, in old Mexico, where actually there is new blood in charge, we are preparing to buy 10-year government bonds, also yielding over 6%. In this case, we want the currency exposure in order to, hopefully, capture a rebound in the beaten-down peso. Mexico is among the most reform-minded of all EMs and is even restructuring its long mismanaged national energy company, Pemex.

Thus, for now, Evergreen is playing the turmoil in EMs on the debt side rather than with equities (other than in Asia through GaveKal). Prices on bonds are low enough, and yields are high enough, that we believe stock-like returns are achievable. As seen in Point to Ponder 1, investors obviously don't want even emerging market bonds when they're cold, despite extremely appetizing yields.

As far as stocks go, there certainly could be more downside. One pundit was quoted by *Investor's Business Daily* this week to the effect the EM stocks should sell at valuation discounts of 70% to 80% versus their rich world peers. Wow! Where did all the love go? What happened to visions of structurally higher growth rates and converging market caps to GDP?

The more negative the crowd becomes on this asset class, and the more Fed-generated collateral damage occurs, the more interested a rational long-term investor should become. In that regard, the next few months could be right up there with some of the best buying opportunities in emerging markets of the last 15 years.

Even though it's contrary to human nature, get ready to get 'em while they're cold!!

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