LPL RESEARCH

WEEKLY MARKET COMMENTARY

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IS TURKEY A REASON TO SELL EM?

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KEY TAKEAWAYS

We think emerging markets (EM) contagion fears resulting from the crisis in Turkey may be overdone.

EM broadly has many solid fundamentals, including economic growth, favorable demographics, and attractive valuations; we expect a compromise with China on trade.

We acknowledge that it's possible for Turkey, even with globally insignificant markets, to spark contagion fears, and we're watching the situation closely.

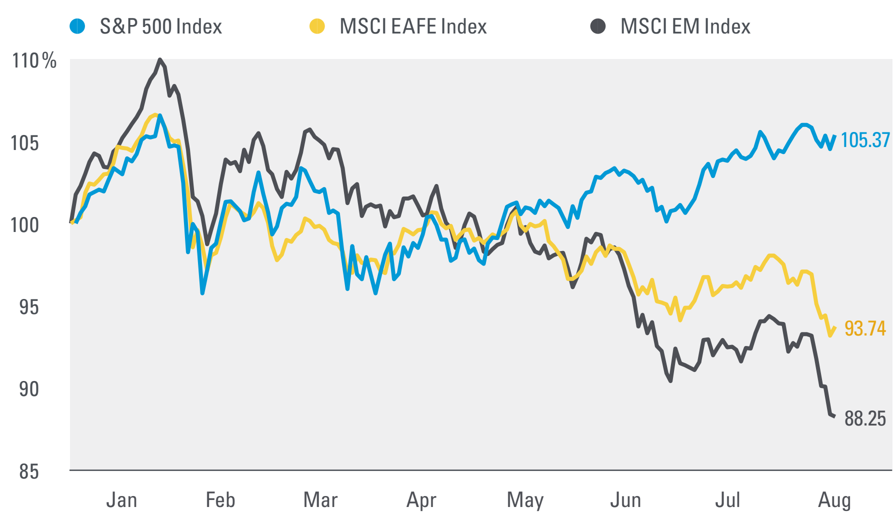
The Turkish currency crisis is threatening an otherwise favorable EM outlook. Emerging market (EM) equities have experienced significant selling pressure this month amid the ongoing trade dispute between the U.S. and China and the crisis in Turkey, which has sparked contagion fears and threatened to send the country into recession. After last week's 3.7% decline, the MSCI EM Index has lost 9.9% year to date [Figure 1] on a total return basis and is 19.7% below its January 26, 2018, record high. Meanwhile, the S&P 500 is just 0.8% below its record high on that same date. So what should EM investors do now?

WHY NOT BAIL?

While we think EM contagion fears may be overdone, there has clearly been some fundamental deterioration in the space and heightened uncertainty prevents high conviction. So why not sell now? Here are several reasons:

- **Turkey likely a one-off.** Turkey has one of the worst current account (trade) deficits among EM countries, with heavy reliance on external U.S. dollar funding.

1 EMERGING MARKET (EM) STOCKS HAVE DRAMATICALLY UNDERPERFORMED THE U.S. ON TRADE, TURKEY FEARS



Source: LPL Research, Bloomberg 08/17/18

Data normalized as of 01/01/18.

All indexes are unmanaged and cannot be invested into directly. Unmanaged index returns do not reflect fees, expenses, or sales charges. Index performance is not indicative of the performance of any investment. All performance referenced is historical and is no guarantee of future results.

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Add a political skirmish with the U.S. and what appears to be a series of policy mistakes by Turkish President Recep Tayyip Erdogan, and you have a unique situation that does not appear to have a lot of direct implications for other major developing countries.

- **The Turkish economy is extremely small.** A recession in Turkey would not have a meaningful impact on global growth, given the economy represents slightly over 1% of global gross domestic product (GDP). Skeptics might say Greece's economy is also small and yet its crisis negatively impacted global markets a few years ago. That's fair, but the primary concerns during the European debt crisis centered on Italy and Spain, economies and markets that are clearly big enough to impair the global economy. Despite Turkey's economic challenges, we continue to believe developing economies in aggregate can grow GDP at 4.8% in 2018, in line with Bloomberg consensus forecasts, even as China's economy slows a bit. Additional descriptions and disclosures are available in our publication *Midyear Outlook 2018: The Plot Thickens*.
- **Turkey represents a marginal half-percent weight in the EM index.** In fact, despite Turkey's equity market getting cut in half this year, four countries have contributed more to this year's drop in the EM Index: Brazil, South Africa, South Korea, and China (those four countries account for 58% of the MSCI EM Index in total).

  Note that the country's weight in the JPMorgan Emerging Market Bond Index is higher, at 4-5%. EM debt, an asset class we have not recommended this year, is the topic of tomorrow's *Bond Market Perspectives* publication.
- **Turkey's external debt load is manageable.** About $220 billion in Turkish debt is held by foreign investors, which is very small relative to the size of the European Central Bank's balance sheet, at over $4 trillion (only about 5%), making the prospect of a bailout—should one be needed—quite manageable.
- **Trade dispute resolution a potential catalyst.** Based on how much China and the U.S. have to lose from a full-blown trade war, we continue to expect a compromise that ends up having little if any negative impact on the two economies. We see eventual resolution—though possibly not before the midterm elections—as a potential positive catalyst for EM. The odds of a deal went up late last week following reports that talks are scheduled for later this week. See our *Weekly Market Commentary* on June 25, 2018, for our thoughts on global trade tensions.
- **Dollar rally may soon run its course.** Even though EM countries are not as U.S. dollar sensitive as they were a decade or two ago, the strength of the dollar (up about 10% over the past 6 months) is still part of the problem for EM. The greenback may soon run into resistance given the still-large U.S. current account deficit (we export far less than we import and tariffs won't help much) and the expanding budget deficit. A compromise on trade—if we get it—may help foreign currencies. The Federal Reserve is a wildcard.
- **A lot of bad news appears to be priced in.** Following a near bear-market decline of nearly 20% from the January 26, 2018, peak through August 16, EM stocks are trading at a more than 30% discount to the S&P 500 on a forward 12-month earnings estimates basis. That discount to the S&P 500 is larger than any applied to EM since the mid-2000s, despite the potential for near 5% gross domestic product growth in EM in 2018 (compared with 2% in Europe and 1% in Japan) based on Bloomberg consensus forecasts. And while earnings estimates have come down recently [Figure 2], double-digit earnings growth over the next year (based on FactSet consensus estimates) is a reasonable expectation. Valuations don't help us time our entry and exit points typically, but we believe patient investors in EM may be rewarded over time.

CONCERNS

We maintain our cautiously positive view of EM equities but certainly acknowledge the risks. As we learned from the Asian currency crises in the late 1990s that started with the Thai bhat collapse, or Greece after the financial crisis, a small country with seemingly inconsequential financial markets can spark contagion fears and cause sizable losses globally.

We don't expect that to happen with Turkey, but future market flare-ups are possible given the country's heavy reliance on foreign borrowing, runaway inflation, a central bank that is not independent, and souring U.S. relations. There does not appear to be a quick fix here, though aggressive interest rate hikes by the Turkish central bank and the release of an American pastor who is the source of the political dispute with the U.S. would be a good start.

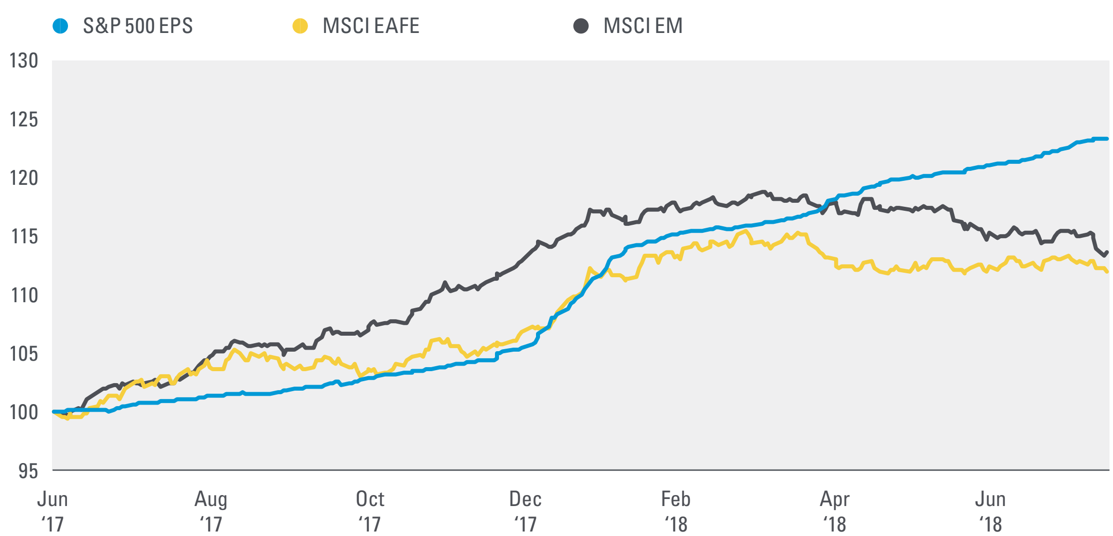
We have seen some signs of fundamental deterioration recently in the form of earnings estimate reductions for the MSCI EM Index as shown in Figure 2. Over the past three months, EM estimates for the next 12 months have come down by 3.6%, while comparable S&P 500 Index estimates have risen 3.5%. We believe the existence of potential catalysts, solid—even if slightly slower—earnings growth, and low valuations justify maintaining an (appropriate-sized) EM equity allocation for suitable investors.

CONCLUSION

Despite the Turkey situation, EM broadly has many solid fundamentals, including economic growth, favorable demographics, and attractive valuations. We look for an eventual compromise on trade, suggesting the potential for a pivot in EM performance. ■

2 EMERGING MARKET (EM) EARNINGS EXPECTATIONS HAVE FALLEN AS U.S. ESTIMATES HAVE RISEN

Earnings per Share (EPS), Estimates for the Next 12 Months (Source: FactSet)



Source: LPL Research, FactSet 08/15/18

Data series are indexed to 100 as of 06/30/17.

The economic forecasts may not develop as predicted.

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The economic forecasts set forth in the presentation may not develop as predicted and there can be no guarantee that strategies promoted will be successful.

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All information is believed to be from reliable sources; however LPL Financial makes no representation as to its completeness or accuracy.

INDEX DESCRIPTIONS

The Standard & Poor's 500 Index is a capitalization-weighted index of 500 stocks designed to measure performance of the broad domestic economy through changes in the aggregate market value of 500 stocks representing all major industries.

The MSCI EAFE Index is a capitalization-weighted index that tracks the total return of common stocks in 21 developed-market countries within Europe, Australia and the Far East. The MSCI Emerging Markets Index is a free float-adjusted market capitalization index that is designed to measure equity market performance of emerging markets.

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