Vol. 10, Issue 34
Dec. 9, 2016

Something to Think About

COMMON CENTS

If every year in the future flies by as quickly as 2016 has for me, I am going to go buy a burial plot and cheap suit for Christmas. Outside of 2008, it has been one of the craziest years I can remember in my career. I suppose I can blame a somewhat bizarre Presidential campaign for part of it. The mealy mouthed Federal Reserve also gets some blame. Finally, I have two teenagers, and I will leave it at that.

However, where the rubber meets the road, from a pure investment standpoint, the emerging markets have been the biggest surprise for me, or least the returns in emerging market stocks. After all, there has historically been a very strong positive correlation between developed and emerging market returns. Certainly, the emerging markets are more volatile, but the return direction is ordinarily the same.

Now, the emerging markets had something really going against them in 2015, namely a surging US dollar. This means money is flowing out of other markets and into ours, making foreign currency denominated securities less attractive in relative terms. Further, a strong dollar usually leads to lower commodity returns. Since many emerging economies are heavily reliant on natural resources, 2015 was a disastrous year, just disastrous. Throw in a slowing grower China, and, it was a recipe for disaster.

But, that was 2015. What about this year?

We started the year believing the US dollar wouldn't have the same strength this calendar year, as the markets had already 'built in' a couple of Fed rate hikes. Even so, there was nothing in the crystal ball to suggest the dollar was going to fall apart either. As a result, we slightly increased our allocation to international securities from a pretty significant underweight to simply an underweight. That seemed to be the path of least resistance.

Well, something strange happened on the way to the forum.

Even though much of what we anticipated happened in terms of currencies and overall economic growth/conditions has happened over the balance of the calendar year, a 2-month sell off in the US dollar (March & April) put a charge in both energy prices and emerging market indices. Another slight dip in our currency in mid-summer, and I mean slight, didn't do anything for natural resources, but emerging stocks took another leg up….almost in spite of themselves.

With that said, looking at the individual markets paints a weird looking picture as I type here today. After all, Shanghai is **down** a little over 14% YTD (through 12/9) in US dollars. Mexico is also in the red a shade under 8%. India (Bombay Sensex) hasn't done much of anything (0.49%), and South Korea has had a relatively pedestrian 4%, or so, year.

On the flipside, Brazil is somehow up over 60%; Russia, for all its myriad problems, is up over 45%, and Chile has posted +25%. Finally, South Africa is up around 12.5%, and Taiwan has posted a little over 16%. Even so, when you weight out those GDPs (India, China, Mexico, South Korea relative to the surging stock markets), it should be not that much of a year, right?

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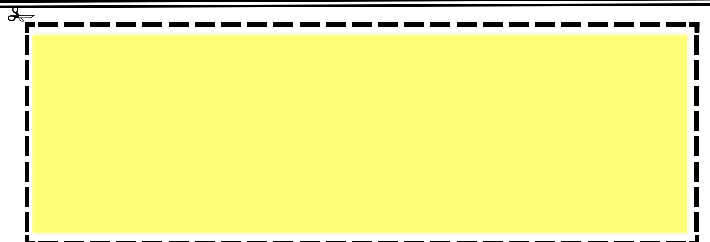

Something to Think About Cont.

Well, if emerging market indices were weighted by GDP size, this would have been an awful year for the emerging markets. China, alone, would have been enough to send them into the ditch. However, they aren't; they are weighted by the capitalization of the companies.

To that end, while mainland China's economic dwarfs that of Taiwan, Chinese stocks make up 23% of the Vanguard FTSE Emerging Markets ETF (VWO), and Taiwanese account for 15%. While Mexico's economy is over 3 times that of South Africa's, the latter has a 79% higher weight in the VWO than the former. Finally, although its economy is 5-6 times smaller than China, Brazil accounts for almost 10% of the ETF, and Russia another 4%.

Perhaps not all that strangely, the P/E ratio on VWO shot up from roughly 12.5 at the end of last year to over 17.6 today.

The kneejerk reaction would be: "come on Norris. I mean, the increase in energy prices caused emerging markets to rally like they did. Come on." To be sure, and no argument. However, what if I were to tell you the weight to oil & gas in VWO is 7.5% and around 5.8% in the S&P 500, or thereabouts. Is that a significant enough difference to account for a such a disparity in returns? To account for a sharp spike in multiples and valuations?

You know, logically speaking, probably not. However, this is investing, and I learned a valuable lesson this year as it flew past me:

> It doesn't matter if your conviction is spot on accurate in the macroeconomic sense. It doesn't matter if your conviction on the dollar is almost completely accurate. Heck, it doesn't matter if the earth is hurtling towards the sun at a high rate of speed. If energy prices are going up, forget historical correlations, sovereign debt ratings, and all the valid reasons you have. Hold your nose, and overweight emerging markets relative to developed in your international allocation. A simple market weight won't be quite enough.

Hey, you know, at least I learned something in 2016. My teenagers don't think I know much of anything at all.

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