Institutions at the crossroads as focus shifts from emerging markets to US equities

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A new year has brought a fresh wave of uncertainty to emerging market investment. High profile problems in Argentina, Turkey and, most recently, Ukraine, and fears the booming Chinese economy faces a hard landing have all unsettled global equity investors with emerging markets exposure.

Other factors have also played their part.

The continuation of so-called "tapering" of the US Federal Reserve's quantitative easing (QE) programme in 2014 has prompted major global equity investor outflows from emerging markets previously buoyed by the quest for yield in the sustained low interest rate environment QE helped create. Recent market jitters have also prompted many investment managers to reassess their emerging markets exposure across a range of geographies with Brazil, India, Turkey and South Africa all hiking interest rates to protect their currencies. According to a 2014 survey by Bank of America Merrill Lynch the number of global investors looking to allocate funds to emerging markets dipped to a record low of 29% in February[1] with confidence in the outlook for US and European growth rising sharply. Stocks of global companies exposed to emerging markets have also experienced extreme volatility in global equity portfolios this year, with turbulence impacting global stock markets, including UK and European exchanges.

Some investors in blue chip global equities have been surprised to find just how exposed their portfolios are to emerging market profits. FTSE 100 companies alone now generate an estimated 33% of their profits from emerging markets.[2] According to MSCI statistics, emerging markets also represent about 24% of overall revenues for companies listed on the MSCI Europe index.[3] In the current volatile market this represents significant risk.

A changing picture

Given the current market volatility, global equities could soon make a decisive shift away from emerging markets holdings. While some investors may be prepared to weather their rising risk, more risk-averse global investors may soon tire of emerging markets volatility and could instead seek to capitalise on more stable returns via exposure to US or mainstream European stocks.

Over the last decade it has been a logical step to gain exposure to emerging markets based on their rapid growth and the rising spending power of middle class consumers in countries such as China and India. In contrast, 2013 was a year when growth slowed and global investors really began to ask questions about emerging markets.

An overheating Chinese property market, and concerns over shadow banking in the country are just two examples of the systemic issues developing in emerging markets which could prompt a prolonged slowdown. Solutions to these problems are not likely to come in the short term, and investors are beginning to shift in their conviction on the great emerging market growth story.

US appeal

As global investors reassess both the direct and indirect country-specific exposures in their equity portfolios, the US market is looking increasingly attractive. While direct equity investment in US companies should deliver the most immediate growth prospects there is also potential value in investing in multinational companies with major US exposure.

Although rapid GDP growth in the US is unlikely, we believe the domestic economy should sustain positive trend growth over the next two to three years. Signs of recovery in the domestic real estate market,

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falling unemployment figures and rising consumer confidence are all positive indicators, and point to a strong short- to medium-term growth outlook in the US market.

Ultimately, from a global perspective, investors must select equities and companies that offer an optimal balance of risk and return. In future, global equity investors will have to look increasingly closely at their specific exposure to emerging markets. Given recent market conditions, fiduciaries investing for the best opportunities may well decide to allocate the bulk of their investment exposure to more stable markets such as the US.

However, scope for indirect US exposure is somewhat limited, especially in comparison to emerging markets. Despite the strong emerging market presence of a number of US corporates, these markets represent just 5% of revenues for companies on the American S&P 500 index in 2013[4] and 15% of overall revenues for MSCI United States index listed companies.[5]

Given the current market conditions, direct exposure to the US market may be a more attractive option. US equities generated strong performance returns in 2013, with major indexes such as the S&P 500 and Dow Jones Industrial Average making impressive gains.

Strength in reserve

One of the most positive domestic economic developments has been the rapid exploitation of US shale oil and gas reserves. This process, driven by innovative exploration and mining technologies, is transforming the US energy picture.

With natural gas prices in the US near all-time lows, despite a recent spike due to abnormally cold weather, downward pressure on energy costs coupled with the development of new industrial processes such as 3D printing could help fuel a US manufacturing renaissance.

As growth cools in emerging markets such as China, falling resource demand should also drive commodity prices down, helping to lower input costs for US companies while keeping prices stable for domestic consumers – ultimately increasing their disposable income.

While many US corporates have deferred spending in recent years, concerned by the slow pace of domestic recovery, this may also be about to change. With US corporate cash balances at record levels of above $2 trillion there is considerable room to invest.

A US capital spending recovery now appears likely as competition increases and companies seek to invest in new equipment and upgrade existing infrastructure. This is expected to bring particular benefits to the information technology and industrial sectors – which both suffered from significant underspend in recent years, in turn boosting underlying equity values.

Market innovation

In the domestic market, a quiet revolution is also underway to develop and exploit a range of sophisticated new technologies in areas such as pharmaceutical development, where US healthcare reforms are driving new demand for affordable healthcare solutions.

In this sector, advances in complex areas such as genetic mapping are now helping pharmaceutical companies to spearhead the development of new drugs to treat conditions such as multiple sclerosis in more effective and manageable ways.

Advances in science, coupled with recent US healthcare reforms, suggest the sector is entering a new wave of innovation which could ultimately benefit both patients and investors alike.

Elsewhere, US innovation is also helping companies to make major strides in areas such as IT security and social media-based communications. Despite its maturity, commercial aerospace is just one other sector that looks poised to gain from broader recovery, as domestic airlines seek to renew and update their fleets.

With these developments in mind, we believe a healthier US economy, strong corporate performance and improving market sentiment will continue to support US equities in 2014, resulting in an extremely positive outlook for investors.

1. Bank of --America Merrill Lynch Survey. International Business Times 19.02.14.

2,4. How emerging markets sell-off will hit FTSE 100 shares. Daily Telegraph 08.02.14/S&P Dow Jones Indices.

3,5. Reuters 02.03.14/MSCI figures.