

Tales from the Emerging World

The Strange Shape of the Coronavirus Crash

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The global pandemic has triggered the fastest market crash since 1929, but it is unusual for more than its speed and scale.

Normally a sudden bear market punishes the most highly valued investments of the late bull market, the old leaders become laggards, and new leaders emerge. This time, the outperformers are the same countries, sectors and companies that did well over the last decade—namely the United States, tech and megacaps—while almost everything else continues to underperform.

In part, this upside down market can be explained by the nature of this crisis. Several hot trends of the era Before Coronavirus—including e-commerce, online education and digital leisure—have grown even more popular in the era After Coronavirus. However, the rush to the familiar extends beyond the tech themes, and the gap between the valuations of leaders and laggards has widened to even greater extremes.

In a rare moment of global panic, it may sound premature to look forward to normalcy, and reversion to the mean. But to us, many asset classes, countries, sectors and stocks which looked historically underpriced when the pandemic began are looking even more attractive now.

The 2010s were the worst decade for emerging stock market returns since the 1930s. When the coronavirus began to impact stock markets in mid-February, emerging markets were 18 percent below their long-term trend in absolute terms, while U.S. stocks were 19 percent above their long-term trend. When markets hit their recent lows on March 23rd, both the U.S. and EM were down sharply, leaving the U.S. 22 percent below—and EM 44 percent below—their long-term trends. That low in EM has been matched only once since emerging market records began in the late 1980s, at the bottom of the bear market that followed the tech bust in 2001.¹

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¹ MSIM, Bloomberg, FactSet, Haver. As of April 1st 2020.

Within emerging nations, the same entirely novel process — of bull market leaders still leading — is unfolding in this new bear market. By sheer coincidence, the most overvalued markets were the first hit and first to recover from the pandemic, and have pushed outperformance to new heights.

The striking chart below shows that investors are clustering their bets in countries where the pandemic appears to have peaked or has been contained, led by China, South Korea and Taiwan, which were already outperforming and relatively expensive before the pandemic broke out. And they are shunning emerging countries where the pandemic has yet to reveal its worst intentions, which includes virtually all the rest.

A similar clustering is underway in industries, with investors fleeing to what they see as the relative safety of industries that were doing well before the virus outbreak, including communications, consumer services,

semiconductors, tech hardware and internet retailing. Any industry impacted directly by the lockdowns, including energy, material, autos and transport, has been pummeled. Many of those industries were also underperforming before the pandemic.

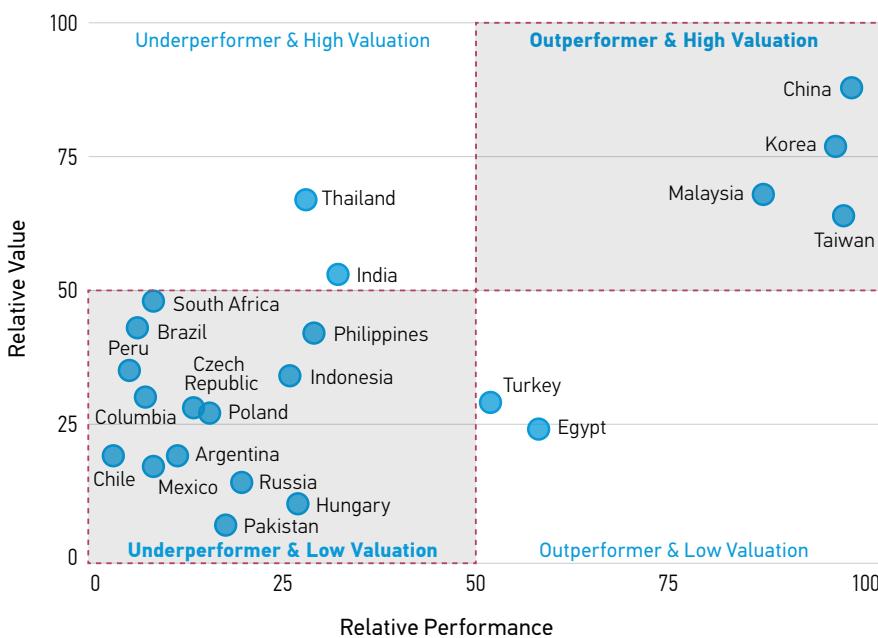
In this flight to the familiar, investors are sticking to the same big, liquid stocks they held before the contagion began. Our research shows that one of the most important factors driving the relative performance of stocks since the intense selloff began in mid-February is liquidity.

Ranking companies in the MSCI EM index from most to least liquid after adjusting for market cap, those in the top quintile have outperformed the index by more than 9 percent. The second quintile have outperformed by more than 5 percent. In contrast, less liquid companies have done much worse: the fourth quintile has underperformed by more than

DISPLAY 1

Emerging Markets Now Cluster At Two Extreme Poles

Outperformers with high valuations, and underperformers with low valuations



Source: MSIM, Bloomberg, FactSet, Haver.

3 percent, and the bottom quintile has underperformed by more than 7 percent. Since larger caps tend to be the most liquid, they have continued to thrive in this environment.¹

Clearly a market driven by fear of the pandemic has a logic all its own, with this intense focus on the familiar, the safe and the liquid. But that logic will very likely evaporate as the spread of the coronavirus starts to slow.

If the latest forecasts are correct, the world economy is headed for only its eighth recession of the last century, on track to contract by three percent this year.² That would be worse than the contractions that accompanied the Spanish Flu of 1918-1920 and the global financial crisis of 2008, and much still depends on the course of the pandemic. The latest forecasts still assume that a sharp collapse in growth during the first half of 2020 will be followed by a sharp recovery in the second half, as the spread of the virus slows, and nations begin to lift the lockdowns.

We remain wary of any particular pandemic scenario, when real epidemiologists are deeply divided, but it does appear that investors are intensely focused on one number—the rate of growth in new cases. China's stock market started to rebound when that number peaked in mid-February, and South Korea's started to bounce back after the spread of the virus peaked there two weeks ago.

The hope has been that the contagion would soon reach a similar turning point in other markets, and latest reports have offered some potentially good news. Worldwide, the growth rate in new cases slowed to under 10 percent for two days in a row, with growth in both new cases and fatalities falling in the European hotbeds of the contagion, including Italy, Spain and Germany.³

Eventually, investors will start looking beyond the pandemic, return to the broader fundamental picture, and recognize that many of the countries,

² JP Morgan. As of March 20, 2020.

³ MSIM, Haver, JHU, WHO. As of April 1st 2020.

sectors and companies that were left behind during the mega-cap driven bull market of the last decade are even more attractively valued now. Indeed, many emerging markets are now so cheap, so deeply ignored in a liquidity-obsessed environment, the snap back could be both very fast, and nearly as extreme as

the fall has been. Ten emerging markets, including Brazil, Mexico and Poland, are now at or below their lows during the global financial crisis of 2008.¹

If over the next five years emerging markets simply climb back to (not above as usually happens in bull

markets) their long-term trend line, it implies annualized dollar returns of 12 percent on average, and much more for the economies that experience the strongest rebound.¹ There will be great opportunity in emerging markets in the After Coronavirus world, and as long-term investors, we are positioning for it.

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