Emerging Markets: Time to Buy, Sell, or Neither?

After a long hiatus, emerging market stocks have recently hit new highs. But their risks and track record call for caution on the part of potential investors.

The MSCI Emerging Markets Index increased 86% between March 23, 2020 and January 25, 2021.

Emerging market stocks have been on a tear. The MSCI Emerging Markets Index (MSCI-EM) grew by a whopping 70% between March 23 and December 31, 2020, and, as of January 25, was up another 9% in 2021.

The dramatic rally reflects, in part, the positive outlook for the global economy, as governments across the globe prime their economies with fiscal spending and loose monetary policy in an effort to counteract the fallout from the coronavirus. As vaccines are approved and distributed, many economists predict a boom that will touch all corners of the globe, particularly suppliers of raw goods and commodities, which include many emerging market countries.

Performance at a Glance[1]

Annualized returns for emerging markets, developed countries, and U. S. stocks.

		Periods Ended December 31, 2020			
	YTD 2021*	**1 Year**	**5 Years**	**10 Years**	**20 Years**
MSCI Emerging Markets Index	9.2%	18.69%	13.22%	4.00%	9.94%
MSCI EAFE Index (developed countries)	1.8%	8.28%	7.97%	6.00%	4.96%
S&P 500 Index	2.6%	18.40%	15.22%	13.89%	7.47%

*As of January 25, 2021

But the emerging market picture needs to be viewed in its historical perspective. The recent rally follows a 12-year stretch during which emerging market stocks were range bound. Although seesawing up and down, the MSCI-EM did not fully regain the ground lost during the financial crisis until November 2020. In contrast, the S&P 500, considered an indicator of large-cap domestic stocks, surpassed its pre-financial crisis peak by March of 2013, and as of January 25, 2021, it had increased over 400% from its financial crisis low in March 2009.

This recent history serves as an apt illustration of the risks of investing in emerging markets. Anyone considering emerging market investments will want to first consider several factors.

Risks

The high return potential of emerging markets investing comes with high risk, and many factors can trigger trouble. Politics, regime changes, governmental policies and laws -- all pose risks for the investor in foreign markets. It is especially important to note that the fortunes of one nation can increasingly affect those of another, as trading ties become tighter between most nations. As one nation devalues its currency, others may be forced to do so in order to keep their exports competitive.

Currency risk can present another risk factor for emerging market investors. As the currency exchange rate fluctuates, so does the value of your investment in U.S. dollar terms. Fortunately, many emerging countries have their local currencies pegged to the dollar, which can result in a relatively constant exchange rate, but they are still subject to volatility.

An Asset Class for the Long-Term Investor

Emerging markets can be volatile; they are considered appropriate only for suitable long-term investors with an investment time frame of 10 or more years. With such high risk potential, why invest in emerging markets at all?

To answer this question, you should first look at the economic fundamentals, which are the underlying support for any country's financial market. Many emerging markets have economic growth rates that greatly exceed those of developed countries.

Emerging markets also offer diversification benefits. Because these markets tend not to move in tandem with those of developed countries, they may be rising while other markets are falling. Hence, they can help reduce the overall risk of a portfolio.

Before considering investing in emerging markets, make sure to consult a financial professional, who can help gauge how well they may suit your investing goals and risk profile.

[1]Source: DST Retirement Solutions, LLC, an SS&C company.