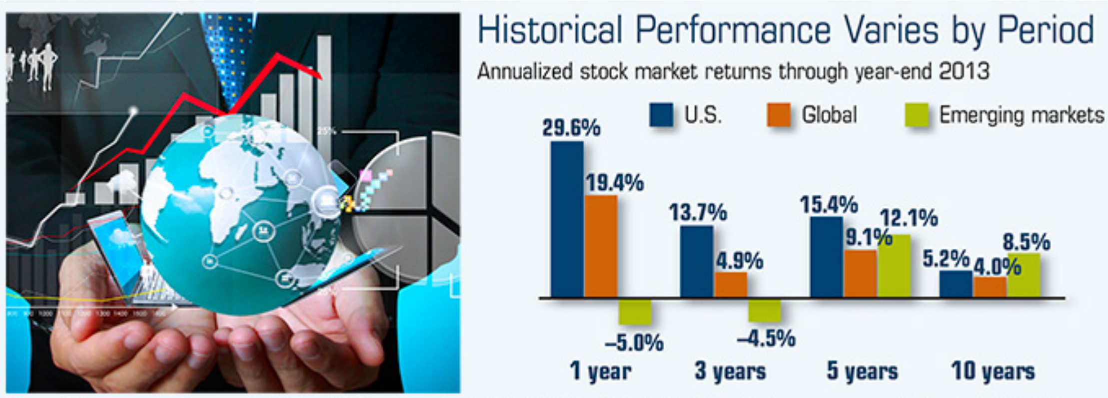
Turbulent Times in Emerging Markets

The term “emerging markets” refers to developing nations that show signs of progress, such as significant growth in gross domestic product (GDP) and infrastructure. Altogether, developing nations account for about 40% of global GDP, compared with about 18% two decades ago.[1]

Morningstar data suggests that emerging market stocks are about 50% riskier than U.S. stocks, which is why any decision to invest in emerging market stocks should begin with a thorough examination of your risk tolerance.[2] For investors who can handle the bumpy ride, emerging market investments may have the potential to generate higher average returns over the long term.



Source: Thomson Reuters and MSCI, 2014, for the period 12/31/2003 to 12/31/2013. U.S. stocks are represented by the S&P 500 Composite Price Index. Global stocks are represented by the MSCI EAFE Price Index. Emerging market stocks are represented by the MSCI Emerging Markets Index. The performance of an unmanaged index is not indicative of the performance of any specific security. Individuals cannot invest directly in an index. Past performance is no guarantee of future results. Actual results will vary.

The return and principal value of stocks fluctuate with changes in market conditions. Shares, when sold, may be worth more or less than their original cost. Investing internationally carries additional risks that often result in greater share price volatility. Many of these risks (such as differences in financial reporting, currency exchange risk, as well as economic and political risks) tend to be more pronounced in less developed nations.

U.S. stocks have experienced a lengthy bull market in recent years, but a tightening of global monetary conditions has taken a toll on the performance of emerging market investments.

Capital flight. In the wake of the 2008 financial crisis, the Federal Reserve began pumping liquidity into the global economy, and much of it flowed into booming emerging markets. The 2013 decision to begin tapering bond purchases pushed up Treasury yields and strengthened the dollar. The prospect of higher interest rates in the United States and elsewhere caused many investors to pull money out of emerging markets in favor of more stable advanced economies.[3]

Vulnerable currencies. To keep their currencies from depreciating rapidly against the dollar, a number of nations — including Argentina, Turkey, and South Africa — raised interest rates sharply in early 2014. Higher rates may attract foreign investment, but they also threaten to spur inflation, raise borrowing costs, and hinder economic growth.[4]

Slowing growth. The Chinese economy expanded 7.7% in 2013 and 2012 and 9.3% in 2011. Chinese officials have set a 7.5% growth target for 2014 as part of a plan to restructure the economy by increasing consumption and reducing the nation’s dependence on exports. However, the International Monetary Fund has warned that China’s slowdown could also affect growth in emerging market economies.[5]

Political problems. Some nations such as Thailand, Turkey, and Ukraine have unstable governments and/or suffer from social unrest. Russia's annexation of Crimea in Ukraine prompted Western nations to impose sanctions, and rising borrowing costs threaten to send the world's eighth-largest economy into a recession.[6]

Ready to Rebound?

Many emerging market economies will remain the world's fastest growing, even if they don't expand as fast as they did in the past.[7] Disciplined investors may have the opportunity to add emerging market shares to their portfolios at attractive prices. At the end of the first quarter of 2014, the MSCI Emerging Markets Index traded at a price-to-earnings ratio of about 10, well below the historical average of about 14.[8]

Taking a diversified approach and investing across many nations and sectors may help reduce your exposure to isolated events and keep you from reacting emotionally. But remember that diversification does not guarantee a profit or protect against investment loss; rather, it is a method used to help manage investment risk.

1) Bloomberg, January 27, 2014
2) *Kiplinger's Personal Finance*, November 2013
3–4) *Forbes*, February 3, 2014
5) Bloomberg, April 3, 2014
6, 8) *The New York Times,* April 4, 2014
7) *The Wall Street Journal,* August 12, 2013