EMERGING MARKETS

The Start Of A New Leadership Period?

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Our Emerging Markets Allocation Model triggered a BUY signal at the end of August after 5 1/2 years in bear mode (Chart 1), and we've responded by boosting the EM position in the Leuthold Core Portfolio to 5.5% of assets, up from 3%.

No, the model did not bottom-tick the January lows in EM stocks… but bottom-fishing is not inherent in the model's design. And we'd emphasize that the model sidestepped perhaps half a dozen putative relative strength lows in EM stocks over the past few years.

Chart 1

*Buy Emerging Markets when Total Return Ratio breaks above upper (GREEN) band, and remain positioned there until Ratio drops below lower (RED) band, triggering a switch into the MSCI World Index.

The model's upgrade is consistent with a *cyclical* leadership run of perhaps one to four years in EM equities relative to their Developed country counterparts. Historically, the Allocation Model has outperformed the Emerging Markets Index by 440 bps and the MSCI World Index by 670 bps on an annualized, total return basis. Volatility of the strategy (19.2% annualized) has been exactly halfway between that of the World Index and the EM Index (Table 1). The model dictates a shift once every 27 months, on average, with the big winners usually lasting considerably longer.

Table 1

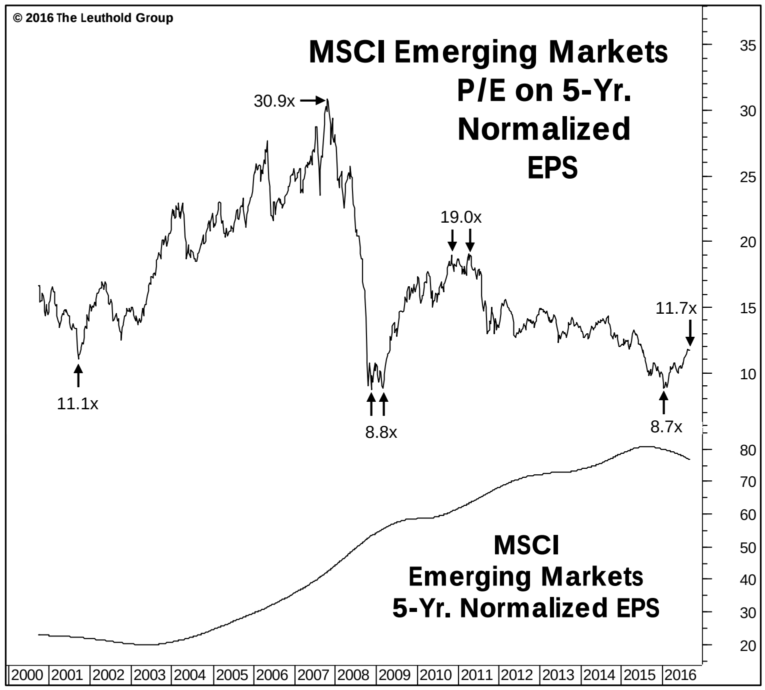
EM Allocation Model Performance, 1989 To Date

© 2016 The Leuthold Group	Annualized Return	Annualized Standard Deviation	Trades Per Year
MSCI World Index	7.0 %	15.0 %	-
MSCI Emerging Markets Index	9.3 %	23.4 %	-
EM Allocation Model	**13.7 %**	**19.2 %**	**0.44**

Our *secular* opinion on EM equities is agnostic. **We've never held the view that superior GDP growth in the Emerging Market economies would necessarily translate into superior outcomes for *shareholders*.** Dilution via share issuance and an EM obsession with market share over profitability are key economic risks, and political risks are too numerous to mention. But the EM Model has triggered, and it has done so with the MSCI Emerging Markets Index trading at a relatively cheap 11.7x 5-Yr. Normalized EPS (Chart 2).

- With the benefit of hindsight, the best time to buy EM was at the January lows when the Normalized P/E briefly undercut its 2008-09 "double bottom" of 8.8x. But **the current figure of 11.7x is nonetheless down a third from the 17.6x prevailing at the Allocation Model's last SELL signal (February 2011)**, and is on par with the valuation low that immediately followed the 9/11 attacks. And today's reading occurs with EM 5-Yr. Normalized EPS in a *downtrend*. In other words, EM earnings results have been so weak for so long that even our Normalized figure looks compromised.

Chart 2



- We often note that "Forward" P/E ratios will frequently make a market or stock look artificially cheap. But in a rare turn of events, we think the EM "Forward" P/E—though nominally low at 12.6x—*overstates* the true level of EM valuation (Chart 3). Current Emerging Market EPS—Trailing, Normalized, and Forward—all strike us as cyclically depressed. And asset-based valuation readings support this view: despite its big rebound off January lows, **the MSCI Emerging Markets Index trades at 1.55x book value—about 50% below the 2007 peak**.

Chart 3

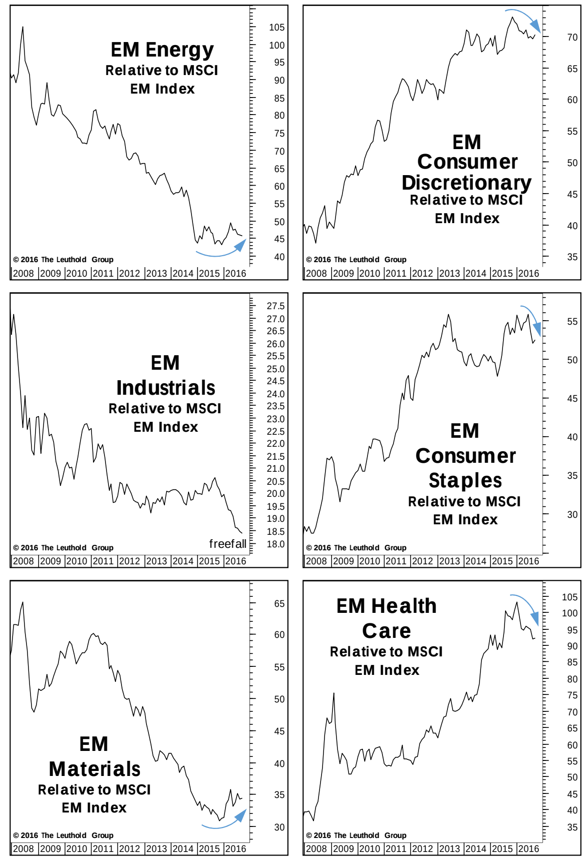
Leadership trends *within* Emerging Markets confirm that 2016 could represent a major inflection point. Consumer-oriented groups (Consumer Discretionary, Staples, Health Care) had been the market leaders for years, a trend Jun Zhu has exploited in our own EM equity portfolio (now 5.5% of the Leuthold Core Portfolio). But the leadership pendulum may have begun to reverse (Chart 4). All three consumer-oriented sectors appear to have formed relative strength peaks, while both the EM Energy and Materials sectors appear to be bottoming on a relative basis.

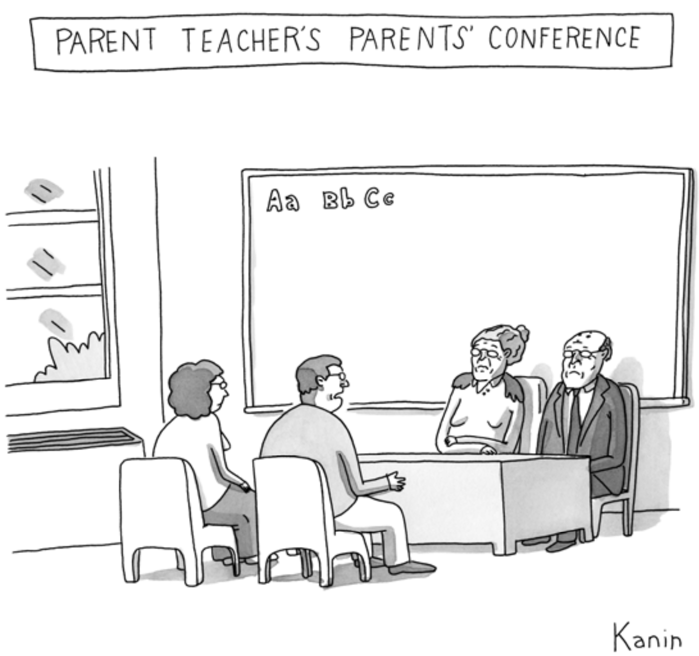
The EM Industrials, however, have yet to show any sign of reversal. The latest print, in fact, is an all-time relative strength low for the sector dating back to the inception of the data series in 1995.

We'd point out that sector and industry trends are not (yet) part of the EM Allocation Model. But **longer-term market inflection points are frequently accompanied by a major disruption in existing leadership trends, and the accompanying charts suggest the disruptive process is well underway**. This upheaval, in fact, increases our confidence that the new EM leadership phase is for real.

Chart 4

A Turn In EM Leadership Away From Consumer-Led Groups?





"Your son is teaching third grade at a second-grade level."