

Reasons to be optimistic

Broader emerging markets exposure enhances diversification and reduces volatility, writes **Pedro van Gaalen**

Before the US and Israel attacked Iran, markets were optimistic about global growth prospects across developed and select emerging markets.

The S&P 500 had closed out another strong earnings season in early March, with roughly 74% of constituents beating or matching expectations, supporting the view that US equity exposure remains an important component in offshore portfolio allocations.

However, the US-Israel incursion into Iran roiled global markets, driving crude oil prices past \$100 a barrel, fuelling inflation fears and triggering a sharp sell-off in global equities.

The conflict increased safe-haven demand for the US dollar, bolstered defence stocks and heightened risks of a long-term disruption to energy supply chains.

However, signs that the US is looking for an offramp to the conflict shifted sentiment, supporting a relief rally. Should sense prevail, markets will likely experience a significant, though potentially incomplete, return to pre-conflict conditions.

Warren Buys, senior wealth manager and investment committee member at Private Client Holdings, explains that the global landscape was already steadily transitioning towards a more multipolar structure, with economic and



Bastian Teichgreeber.

geopolitical influence increasingly distributed across several major powers.

"Recent policy actions from the Trump administration, such as challenging the Fed's independence and a European country's sovereignty, accelerated this shift. This has contributed to a decline in international confidence in the US, which was exerting pressure on the trade-weighted dollar, an effect amplified by lower real interest rates."

The ever-mounting US debt pile, inflation and questions about AI-linked capex and revenue models have also prompted investors to look outside the US when allocating capital.

When adjusting offshore portfolio exposure, Bastian Teichgreeber, chief investment officer at Prescient Investment Management, says the first principle is conceptual hygiene.

"Separate the asset class decision from the currency risk decision – they are different risk premia. A view on global equities is not automatically a view on the US dollar, euro or Japanese yen."

Among developed markets, the eurozone is poised for growth, with huge stimulus on the way in Europe beyond the Ukraine rebuild project, along with wider deregulation, and a

watershed moment in Germany with unprecedented fiscal loosening.

However, while developed markets appear safer than emerging markets, Stefan Magnusson, who leads the Emerging Markets investment team at Allan Gray's offshore partner Orbis, says extreme valuations and concentration in US mega-cap tech mask hidden risks.

"History shows that starting valuations at today's levels have delivered only low single-digit returns over the following decade."

Teichgreeber adds that developed market equities screen as expensive on multiple valuation metrics, including forward price-to-earnings, cyclically adjusted earnings yields, and equity risk premia.

"As such, the economic backdrop starts to look more positive in global emerging markets. Earnings revisions breadth has improved, and financial conditions have stabilised in several key emerging market economies."

Numerous other factors are aligning to create what Buys believes will be a favourable environment for emerging markets.

"A key driver is the prospect of a structurally weaker US dollar over time,



Stefan Magnusson.

which historically provides a tailwind for commodity prices."

According to Buys, higher commodity prices would benefit many emerging market currencies and listed companies, translating into stronger earnings growth and improved relative performance across these equity markets. "This dynamic is reinforced by the significant underinvestment in commodity supply over the past decade, particularly among major miners. Constrained supply alongside firm demand creates the conditions for sustained strength in commodity markets," he says.

Magnusson adds that emerging markets account for more than 80% of the world's population and more than half of its GDP, but less than a tenth of typical global equity portfolios.

"With cheaper valuations, weaker currencies and lower correlations to developed markets, selective exposure to emerging markets can add diversification and resilience when it matters most."

With emerging markets nearly 60% cheaper than the US, coupled with undervalued currencies, Magnusson says the attractive discounts offer a positively skewed return potential despite the risks.

"From these starting points, history suggests forward returns ranging from low single digits to more than 15% a year."

Given this potential, Magnusson believes avoiding emerging markets may be the greater long-term risk right now. "Broader emerging markets exposure enhances diversification and reduces volatility. Less coverage, inefficiencies and overlooked compounders also create fertile ground for active managers to generate alpha." ●