
DISCUSSING ASIA AND THE PANIC IN EMERGING MARKETS

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Last week's "Behind the Markets" podcast highlighted two of the more beaten-down regions on a pure asset price and [valuation](#) basis today: Japan and emerging markets. The overlap between the two is that Japan, in local currency terms, trades with [volatility](#) levels not so different than standard emerging market countries, with a large [beta](#) to global growth prospects given two-thirds of the country's profits come from global markets. Edward Cole, portfolio manager at Man GLG, and Jesper Koll, CEO of WisdomTree Japan, were on the show to discuss these topics.

My friend and co-host Wes Gray sent in skeptical questions about the marginal portfolio diversification benefits of emerging markets, and Professor Jeremy Siegel started the case with this opinion:

- Yes, emerging markets have a beta to global equities and growth greater than 1 such that they are riskier, but that is reflected in their price—and they have an 11 to 12 [price/earnings ratio](#) and therefore a 9% [earnings yield](#), which means you are paid for taking those risks compared with, say, the U.S. markets and developed markets at higher prices.
- Further, the developed world is growing at 1% to 2% at the boundary of prospects for growth while the emerging markets are playing catch-up with the developed world and can grow faster. This does not mean the per capita catch-up will happen in a smooth line, but Siegel sees this benefiting companies that serve emerging market consumers during the catch-up period.

One of the big questions and risks for global markets has been the global trade war dynamics between the U.S. and China. The China [A-shares](#) market was down 30% year-to-date ahead of Friday's conversation and move. Cole pointed out that many Chinese companies with more than 50% revenue abroad were down for entirely "domestic" factors despite being levered to the U.S. housing cycle.

Panic in A-Shares Market Creates Opportunity

Cole believes it would be a struggle to find a market more inefficient than the China A-shares market—which is why he believes it is such a ripe source of opportunity. But in these emerging markets when panic sets in, there is no regard for valuations or fundamental prospects—there is just panic and investors fleeing.

In exploring the reasons China has sold off—Cole pointed out that Xi Jinping, after being confirmed essentially as president for life, has started some deleveraging

policies, and that has been reflected in both a slowdown in growth characteristics and pressure on cyclical company earnings. There are further fears that the Chinese state is going to creep further into the affairs of companies. And, of course, there are also the trade war fears.

Good Timing Indicator: Cole has looked at the percentage of down days over trailing three-month periods and found there have been eight times in history during which over 60% of trading days were down. If markets trend up over time, having close to two-thirds of days being down is a large outlier. Cole's work suggests forward returns are bright after such panic sets in, as we've seen.

Case for Japan Today: Koll believes the case for Japan is robust earnings and shareholder value driven by better corporate governance structures. Japan used to have large conglomerate groups, and information about them was very limited. Twenty years ago, cross-shareholding was 50% of [market capitalization](#), but today it is only 4% of total market cap. This has made managers much more capitalistic. Further, even just five years ago, the average age of an executive director in listed Japan was 72, but today it is 52. This is a radical change for management that is not tied into the old keiretsu management structures, and we see record levels of dividend payouts with robust buybacks.

Some other topics we covered included research and development spending and competitive dynamics for Chinese companies trying to compete at the highest levels of the global supply chain.

Japan and China Coming Together: At the political level, there are developments with China and Japan coming together, and they are starting to do joint bidding for upcoming infrastructure projects, leveraging each of their strengths. There is also the first bilateral summit with Xi and Japan's Shinzo Abe—and Koll believes there are more opportunities to collaborate and not just compete with each other.

This was a great conversation on the opportunities in Japan and emerging markets. Please listen to the full conversation below.

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DEFINITIONS

Valuation: Refers to metrics that relate financial statistics for equities to their price levels to determine if certain attributes, such as earnings or dividends, are cheap or expensive.

volatility: A measure of the dispersion of actual returns around a particular average level.

Beta: A measure of the volatility of a security or a portfolio in comparison to a benchmark. In general, a beta less than 1 indicates that the investment is less volatile than the benchmark, while a beta more than 1 indicates that the investment is more volatile than the benchmark.

Price-to-earnings (P/E) ratio: Share price divided by earnings per share. Lower numbers indicate an ability to access greater amounts of earnings per dollar invested.

Earnings yield: The earnings per share for the most recent 12-month period divided by the current market price per share. The earnings yield (which is the inverse of the P/E ratio) shows the percentage of each dollar invested in the stock that was earned by the company.

A-share: shares traded on the Shanghai and Shenzhen stock exchanges. This is contrast to Renminbi B shares which are owned by foreigners who cannot purchase A-shares due to Chinese government restrictions.

Market Capitalization: Market cap = share prices x number of shares outstanding. Firms with the highest values receive the highest weights in approaches designed to weight firms by market cap.