# AB EMERGING MARKETS MULTI-ASSET PORTFOLIO

## MARKET OVERVIEW

Despite a midmonth pullback, emerging-market (EM) equities finished May well in positive territory. The MSCI Emerging Markets Index gained 2.96% in US-dollar terms for the month and remains up 17.25% year to date. Throughout May, movement among the different regions—emerging-market EMEA (Europe, the Middle East and Africa), the BRICs (Brazil, Russia, India and China) collectively and Latin America ex Brazil—seemed somewhat correlated, though by month-end the BRICs ended up modestly outperforming.

Emerging-market equities were generally boosted by a weaker US dollar, a recovery in the price of oil and a major infrastructure announcement from China. Markets also continued to pin high hopes on the “Trump trade” while playing down tensions with North Korea and chaos from a global cyberattack. By midmonth, however, stocks suffered a sharp reversal on worries that US president Donald Trump’s reform agenda might be bogged down. As the period came to a close, equities recovered as bargain hunters looked past political turmoil to buy on the dip.

From an individual country perspective, Chinese equities surged as investors shrugged off a credit-rating downgrade, focusing instead on new data that underscored robust factory activity. In contrast, Brazilian equities suffered a brutal sell-off when evidence emerged of a bribery scandal embroiling President Temer, who has denied any wrongdoing. Investors feared that Temer’s political capital would be weakened, undermining his ability to deliver pension reform, and would derail the country’s economic recovery. Russian shares also continued to falter—securing Russia’s place as the worst-performing emerging market year to date—as investors worried that extended oil production cuts would hobble its energy companies.

Results at the sector level were mixed. Real estate stocks led on strong underlying demand, while the consumer-discretionary sector also outperformed. At the other end of the spectrum, the energy sector lagged as investors questioned whether OPEC’s ongoing output caps would be sufficient to stabilize oil prices long term. The utilities sector underperformed as well.

EM debt markets continued to deliver strong returns in May. Local-currency EM debt was the best performing segment, as the GBI-EM Global Diversified Index rose 1.96%. US dollar–denominated EM debt, as measured by the EMBI Global Index, returned 1.17%. EM corporates rose 0.48%, per the CEMBI Broad Diversified Index.

## PORTFOLIO PERFORMANCE AND POSITIONING

The Portfolio underperformed the emerging-market equity index in May. The Portfolio’s bond and equity holdings underperformed the broader emerging-markets index. Currency selection detracted from relative returns, particularly our position in the Hungarian forint.

Power Finance in India was the top detractor for the month of May. Political headwinds in Brazil, including the Supreme Court’s investigation of President Temer on corruption charges, weighed on regulated companies such as Portfolio holdings Cemig (Cia Energetica de Minas Gerais) and Itaúsa. Specifically for Cemig, its high financial leverage makes it sensitive to changes in the country’s cost of capital. In addition, the company was unable to issue bonds in the US, providing further evidence of its challenging financial position.

Strong earnings reports benefited the largest contributors to returns. KB Financial’s earnings were ahead of expectations, supported by an improvement in net interest margins, while Hana Financial’s results were driven by lower operating costs.

MOL Hungary oil and gas reported stronger-than-expected quarterly results, driven by improved costs in the upstream segment, the startup of a new butadiene unit in the chemicals division and higher operating uptime in the refining business.

Our fixed-income holdings detracted from performance relative to the broader fixed-income debt market, although US-dollar debt issued by Ukraine and Petróleos Mexicanos (PEMEX) added value.

## OUTLOOK

Emerging-market fundamentals and valuations are very favorable for investors. While growth is firming globally, it is accelerating in EM markets. Brazil and Russia are emerging from recession, and Chinese growth remains strong, defying periodic fears of collapse.

Recent market concerns about the implications of higher rates, a stronger dollar and potential trade policy changes from the US have moderated, and market volatility has begun to stabilize. Consistent with this positive view, we have maintained a tilt toward equity in the Portfolio at 63%.

We believe that higher rates and a stronger dollar reflect expectations of stronger nominal growth, which should be good for emerging markets. The impact of shifts in US trade policy will have more bearing on selecting winners and losers within EM than as a broad-based challenge for EM economies and companies. Energy and raw commodities, for example, have generally held up in the face of these concerns and are unlikely to be substantially affected by tariffs. This underscores the importance of being selective and active when investing in emerging markets. As the actual economic impact of higher rates, a stronger dollar and new US trade policies becomes clearer, we anticipate that many EM assets will rally. The winners and losers will be found across equity and debt, which is why we like the ability to include both in this Portfolio.

We like the balance of exposure to EM equity and debt that we now have in the Portfolio. In the event that economic growth does not accelerate significantly from here, earnings growth to support EM equity capital appreciation will be more modest, though low multiples leave some room for expansion, particularly when compared with developed-market valuations. On the other hand, EM credit spreads are high in relation to the yield on comparably rated US credit, which has historically been a signal for strong future relative returns. Moreover, to the extent that the global economy remains in a muddle-through growth mode, EM debt could generate returns comparable to equity with considerably less volatility. The bonds we select are generally either higher-yielding securities with equity-like return potential or higher quality securities that trade more in sync with Treasuries and that should therefore offer significant diversification from equities, and downside protection.

EM equities trade at about 12.6 times estimated 2017 earnings, versus 19.3 times for the US and 16.2 times for Japan. Consensus earnings growth for EM is 20.0% this year versus 14.4% for global. As earnings growth materializes, we believe that EM price-to-earnings multiples could expand in the direction of developed-market levels, which underpin very strong returns.

However, the path is far from certain. This is precisely why we believe that the Emerging Markets Multi-Asset Portfolio is a great way to get exposure to EM right now. Our goal is to smooth out the inherent volatility of EM and participate in the upside as EM recovers. If it takes longer than anticipated, our aim is still to generate a positive yield.

As a reminder, EMMA isn’t simply an asset-allocation strategy. We build the Portfolio in an integrated process as a single team, drawing on the best EM investment ideas from across the firm. Ultimately, much of the success will be driven by how our research into companies and countries surfaces opportunities that are different from standard benchmarks.

Thank you for your support,

Morgan Harting

*Please see overleaf for important disclosures.*

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