Geopolitical Risks in Emerging Market Equity ETFs

Last week included several dramatic examples of unexpected geopolitical developments in emerging markets: Two nuclear powers in South Asia, India, and Pakistan, clashed and appeared to be on the brink of full-scale war; and the US-North Korea summit in Hanoi ended badly, with Trump walking out.

Also, unsettling markets were some negative signs about the state of US-China trade negotiations which, later in the week, were offset by some positive signs. With country-specific emerging-market equity ETFs, the risk of such geopolitical shocks is always present. It is interesting to look at how the respective national equity markets reacted to last week's developments.

The India-Pakistan clash intensified last Tuesday, February 27, when Indian warplanes dropped bombs on a suspected terrorist camp inside Pakistan in response to a deadly terrorist attack on Indian soldiers earlier. Pakistan shot down at least one Indian plane and captured the pilot. Artillery barrages across the border followed, and thousands of troops converged. Pakistan Prime Minister Imran Khan then announced on Thursday that his country would release the captured Indian pilot, “In our desire of peace … and as a first step to open negotiations.” This move appeared to calm matters for the moment, but the situation remains tense. India’s stock market dropped sharply at first but later recovered as the situation eased. The iShares MSCI India ETF, INDA, finished the week up 0.4%. Clearly, should fighting resume, the market would tumble.

The long-standing India-Pakistan dispute over Kashmir is one of the most dangerous geopolitical risks. This clash is a reminder to investors that this risk should not be ignored. Indian stocks have been trending downward for fundamental economic reasons. Economic growth slowed to 6.6% in the fourth quarter of last year from 7% in the third quarter, which in turn was slower than the second quarter’s 8% growth rate. The ETF INDA is down 5% for the last twelve months ending March 1st and is down 2.3% year-to-date. Other emerging markets were also down last year. However, unlike Indian equities, most other emerging markets have rallied so far this year. The iShares MSCI Emerging Markets ETF, EEM, is up 8.8% year-to-date. Our International and Global ETF Portfolios are overweight in emerging markets, but we are not holding any India-specific positions.

The unpredictable North Korean regime and its nuclear capabilities constitute another dangerous geopolitical risk overhanging markets, particularly that of South Korea. The failure of the Hanoi summit appears to have resulted from inadequate preparations at a lower level and failure to recognize that the very complex and difficult issue of denuclearization could not be settled prematurely by a “deal” between two heads of state. There now is the risk that, following this humiliation for Kim, he will respond by moving to add to North Korea’s nuclear capabilities. Hopefully, seasoned diplomats on both sides will seek to restore the negotiations.

As was the case for India, South Korea's stock market dropped in response to the bad news, with the iShares MSI South Korea Capped ETF, EWY, losing 2.2% over the week. But unlike the case for Indian stocks, the South Korean market has participated in the emerging-market rally so far this year. Despite last week's losses, EWY is up 7.12% year-to-date as of March 1st. We are maintaining our South Korea positions in our International and Global Portfolios, while monitoring further developments closely.

The South Korean economy is strong, with close ties to the US economy. It is quite advanced and is considered by many to no longer be an emerging-market economy. The Korean equity market is large, accounting for 14% of the iShares MSCI Emerging Markets ETF, EEM, and is exceeded only by Hong Kong's 23% share. China's share in EEM is only 8%, but that does not yet include most of the Mainland China stocks. South Korea's equity market is heavily weighted (40%) with technology stocks. Samsung Electronics alone accounts for 23% of the holdings. Long-term investors in South Korea's equity market using EWY have done well: The annualized total return over the past 10 years is 12.37%.

Last week was also a volatile one for Chinese stocks, which lurched down and back up with each press comment and tweet hinting at the state of US-China trade talks or the severity of the moderation in the growth of China's economy. In the end, the broad-based iShares MSCI China ETF, MCHI, was little changed for the week, with an increase of 0.5%.

There was a definite plus for Chinese stocks announced before the market opened on March 1st. The index publisher MSCI announced that it will quadruple the weight of Mainland China shares in its benchmarks. The benchmarks are the basis of many ETFs and funds. It is estimated that this quadrupling will lead to new passive inflows into Mainland China's stock markets of some $US 80 billion. Chinese equities are also participating in the emerging-market recovery. MCHI is up over

16% year-to-date.

Investors who wish to limit exposure to the country-specific risks inherent in emerging-market stocks can invest in highly diversified ETFs that include stocks from a number of national markets. Two good examples are the ETFs EEM, mentioned above, and the Vanguard FTSE Emerging Markets Index Fund, VWO. Investors in individual-country ETFs need to monitor developments closely and seek to separate the noise in the daily news flow from developments that signal meaningful and lasting changes in the prospects for a market. Often events that capture the headlines for several days or more have little lasting market impact. At Cumberland Advisors we sort key signals from the noise by bringing together fundamental economic and financial analysis, technical market analysis, and geopolitical expertise.

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Exchange traded funds may not correlate to designated indices and have additional fees and expenses, including the duplication of management fees.

Sources: Financial Times, Wall Street Journal, CNBC.com, ETF.com

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