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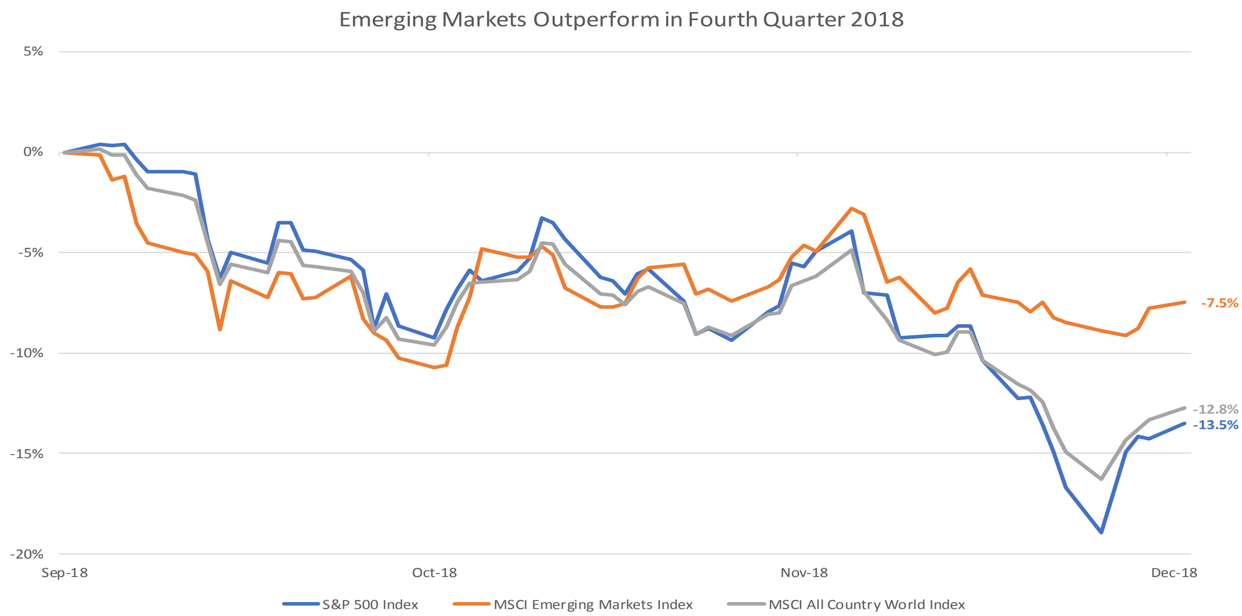
A Brighter Outlook for Emerging Markets in 2019

Michael Kass, Portfolio Manager of [Baron Emerging Markets Fund](), discusses recent emerging markets equities performance and his outlook for 2019.



Source: Morningstar

During the fourth quarter of 2018, emerging markets equities outperformed the U.S. and global indexes for the first time in several quarters.

We believe this mean reversion in leadership was a result of several catalysts that came into play in the quarter.

These catalysts included indications of a credible truce between the U.S. and China on trade, market recognition that U.S. corporate profits and equities were exposed to disruption from escalating tariffs and foreign policy tensions, and finally, a peak in unconstrained executive privilege, or what we termed "peak Trump political currency." We believe such outperformance is a welcome precondition to forming a durable bottom and a return to positive absolute returns for EM stocks.

Our expectation was that the above conditions would increase the likelihood that the U.S. would seek a compromise in trade relations with China and perhaps a return to more conventional foreign policy, and/or help coerce Federal Reserve behavior to become less restrictive, either of which would also reduce risk premium associated with EM assets and equities. We also believe the U.S. midterm elections in November that resulted in the Democrats taking control of the House of Representatives might represent an important inflection point where going forward we begin to see constraints on U.S. executive privilege.

We now enter 2019 with various risks to U.S. corporate earnings increasingly priced in and speculative and leveraged positioning in equities, bonds, and oil having corrected and normalized. Our conclusion is that much that could go wrong has now been priced in, particularly in mid-cap growth stocks globally, which suffered an outsized correction during the fourth quarter.

Looking ahead, in the near term, we believe a rally in global equities is more likely than a further decline, as markets begin to anticipate a de-escalation of protectionist measures and improving global trading conditions, as well as a more flexible Fed mandate. Such a development would likely suggest a peak in the U.S. dollar and further outperformance by EM equities.

While this is our base case expectation for now, we remain cautious because global capital markets remain exposed to the elevated risk of policy error. Risks include:

- **U.S.-China trade tensions** Will the U.S. and China reach a credible compromise by the imposed March 2 deadline?
- **Interest rates** Will the Fed follow through in tempering expectations of future tightening if trade relations improve? Could a shift to positive global economic news in the aftermath of a large decline in oil and long-term government bond yields force the Fed to return to a more restrictive bias?
- **Mueller investigation** Indicative of a market environment where non-economic risks may ultimately "overwhelm the fundamentals," what can we expect in the coming months from the ongoing Mueller investigation and what sort of unpredictable response could it provoke?

Although we believe unconventional U.S. foreign policy initiatives have driven international and EM equity risk premium higher and earnings multiples lower in the short term, we are encouraged by several emerging bright spots, including:

- **Brazil** Brazil has demonstrated market leadership and material positive returns as the incoming Bolsonaro administration has articulated a market-friendly doctrine emphasizing material privatization activity and a commitment to enhanced fiscal orthodoxy.
- **U.S. dollar** While certain Asian equity markets remain closely correlated to the outlook for China's economy and policy direction, many markets such as Indonesia, Thailand, South Africa, and much of Latin America remain more sensitive to the outlook for the U.S. dollar and Treasury yields, where recent developments suggest we have already entered a bottoming phase.

Conclusion

Should the outlook for foreign and trade policy reduce pressure on China, and Fed policy shift to a marginally more accommodative stance, we believe many EM equities could offer material upside from current levels.

Investors should consider the investment objectives, risks, and charges and expenses of the investment carefully before investing. The prospectus and summary prospectuses contain this and other information about the Funds. You may obtain them from the Funds' distributor, Baron Capital, Inc., by calling 1-800-99BARON or visiting www.BaronFunds.com. Please read them carefully before investing.

RISKS: In addition to the general stock market risk that securities may fluctuate in value, investments in developing countries may have increased risks due to a greater possibility of: settlement delays; currency and capital controls; interest rate sensitivity; corruption and crime; exchange rate volatility; and inflation or deflation. The Fund invests in companies of all sizes, including small and medium sized companies whose securities may be thinly traded and more difficult to sell during market downturns.

S&P 500 Index measures the performance of 500 widely held large-cap U.S. companies. **MSCI Emerging Markets Index** is an unmanaged float-adjusted market capitalization index designed to measure equity market performance of large and mid-cap securities in the emerging markets. **MSCI ACWI Index** measures the equity market performance of large and midcap securities across developed and emerging markets, including the United States. The index performance is not fund performance; one cannot invest directly into an index.

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