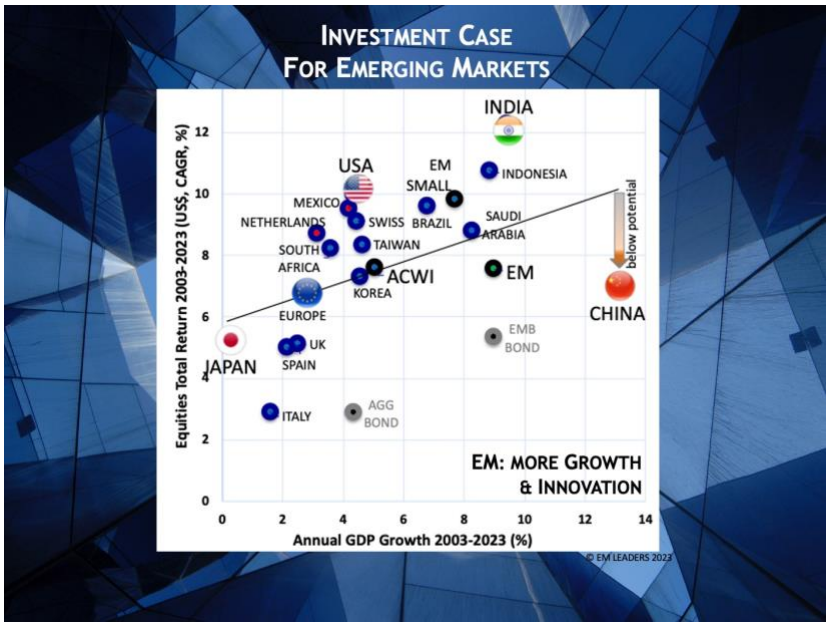


THE INVESTMENT CASE FOR EMERGING MARKETS

Ten Reasons for a new EM Leadership

"An investment in knowledge always pays the best interest." Benjamin Franklin

Benjamin Franklin was a prolific writer and polymath statesman who shared his ideas on "The Way to Wealth" in 1758. He traveled extensively, thought critically, adopted thirteen virtues, and observed that storms do not always travel in the direction of the prevailing wind. Translated to our world of investments, could it be that momentum does not always travel in the direction of mean-reversion? Financial bubbles emerge after excessive momentum which then causes heavy storms during mean-reversion.

True, most investors go with the flow, dance until the music stops, and benefit from momentum over long periods. The current investment cycle has been extended for over a decade, where US stocks, especially the largest technology firms, recorded unprecedented returns. Over the past decade, the Nasdaq annualized 19% returns, Amazon gained 24% per year (8x total), whereas Alibaba returned exactly zero since its IPO in 2014. US investors love Amazon's momentum (current P/E=320) but hate Alibaba (current P/E=26). Can we rule out mean-reversion? No, that would be naive.

Investors always look for investment-conviction from three perspectives: solid historic **fundamentals**, attractive current **valuations**, and promising **momentum or catalysts**.

*Have **emerging markets** now rebuilt conviction on these three perspectives? How are historic EM returns differentiated from other asset classes? How strong are the broader EM fundamentals after the pandemic? How attractively valued are EM equities and currencies compared to longer-term fair-values? How does that valuation align with current asset flows and market sentiment? And what investment themes and catalysts are pointing towards compelling investment ideas?* Looking at these questions in turn, we can make a strong investment case for emerging markets.

<A> **History** reveals that US equities (SPX) had nominal returns of 10% annually, and as shown in chart 1, the SPX returned indeed 10% during the past 20 years (2003-2023). However, returns vary over shorter periods, for example the SPX returned 13% over the past ten years but had zero returns during the 'lost decade'(2000-2009). US bonds had returns of just 3% over 20 years, but zero over the past decade as rates increased. In aggregate, US investors made a healthy return from a 60:40 portfolio averaging 7.5% in nominal of 5% in real terms. But those historic returns will likely be much lower in the future, as we are observing very expensive valuations for US equities.

History also reveals that emerging market equities (EEM) had nominal returns of 7.5% annually in US$ terms over 20 years, identical to 7.5% since inception in 1975. But the majority of emerging markets delivered higher returns over the past 20 years, for example India (12%), Indonesia (11%), Brazil, Mexico, and Thailand (each 9.5%). However, Chinese equity markets underperformed with only 7% total returns, for investors in global exchange-traded funds (ETF like i-shares), versus local vehicles, which would have been up to 2% higher (reflecting legal and convertibility risks). Emerging markets small-cap equities (EEMS, i-shares, total $ returns) would have earned a 2.5% premium and returned 10% annually, similar to US equity returns.

How do emerging market (**EM**) returns compare with developed market (**DM**) returns? Global equity markets (ACWI) delivered total annualized returns of 7.6% in US$ over 20 years, hence EM and DM aggregate returns were quite similar. However, most DM equities performed worse, and the US performed much better. **European** equities only delivered 6.8% total returns, and **Japanese** equity markets barely 5.2%, which both were even worse than Chinese equity markets. In fact, Southern Europe had a very bad decline after the global financial crisis, and Italian equities returned only 3%. Looking ahead, we can expect that international equity returns (EM and DM) will be higher compared to US equities, given that the US cycle is much more extended.

What **asset class** choices do EM investors have? The baseline would be the 7.5% aggregate return in the EEM index. EM external dollar bonds (EMB) would have returned 5.3%, but offered a negative correlation and more attractive Sharpe ratio, especially compared to US bonds (AGG). EM private equity (EMPE) would have returned an average of 10%, with top-quartile managers performing better, although leverage is typically higher, and liquidity is restricted. **EM small-cap equity** (EEMS) as hybrid (between EEM and EMPE) would have returned 10% annually, but with superior Sharpe ratios given its higher quality and lower volatility. Moreover, EEMS managers would also have generated a median 3% return from active management, given higher information asymmetries, in addition to the 2.5% average small-cap premium.

<B> Having looked at solid historic returns for the EM asset class, **fundamentals** also look strong, with superior EM growth and modest EM risk factors as compared to DM. **EM growth** over 20 years averaged 9%, twice the US growth average of 4.5% and three times the European growth average of 3%, besides the zero growth in Japan (chart 1). Economic growth should be correlated with equity market returns at a global level over longer periods, assuming that interest rates and profit shares are constant and translate into earnings growth with constant multiples. However, it is puzzling to compare vastly different equity returns in India and China (12% versus 7%), while both countries had high growth rates (9% and 13%). Three factors may explain that 5% gap:

Structural factors have favored India, as both growth and education of the labor force have increased and the share of state-owned companies with poor returns on capital have been smaller in India. Macro factors have been stronger in India, with capital flows out of China weakening its exchange rate and lowering its valuation multiples. But temporary factors such as China's real-estate crisis and the slow reopening that have been reflected in more recent data may mean-revert in future time periods.

Global risk factors for EM are illustrated on chart 2 (relative to DM, z-scores), along eight dimensions: Political risk is high in Russia and Taiwan; **credit ratings** remain sub-investment grade in Brazil, Turkey, and South Africa. **Debt levels** have increased substantially for DM (black octagon, extended to the right) to above 100% of GDP in the US, also with high levels in Brazil (93%) and India (84%). **Fiscal deficits** in EM are on average similar to DM, about 5% of GDP, but are elevated in India (>9% of GDP). **Current account deficits** have moderated, and reserve coverage has improved for most EM, but remain problematic in Greece and Latin America. EM earlier increased interest rates and controlled **inflation**, with the exceptions of Turkey and Argentina, and EM **exchange rates** remain competitive, with the exceptions of India and Mexico.

<C> Investors can compare historic asset class returns, relative growth trajectories, fundamentals and risk factors across EM and DM. This provides a birds-eye longer-term perspective on the asset classes and countries. But how can we compare **valuations** at the current time? Let us look at two poignant indicators, namely long-term Shiller P/E ratios (CAPE) and trade-weighted exchange rates (REER). There is an academic debate whether these time series are mean-reverting and hence driven by common factors, with some firms more in favor of mean-reversion and others in favor of momentum.

Despite certain limitations, it appears that both measures, as illustrated in chart 3, are helpful to indicate current valuations, to express relative value comparisons, and to reveal the size of potential bubbles. Cyclically adjusted PE ratios indicate a heavy overvaluation of US equities (CAPE 31, 95%ile), Indian equities (CAPE 30, 85%ile), and Dutch equities (CAPE 27, 88%ile). The mean CAPE for these markets is at least 20% lower than current values, which may also undershoot during the correction phase. On the other hand, Chinese equities (CAPE 10, 3%ile), Polish equities (CAPE 8, 9%ile) and Japanese equities (CAPE 21, 18%ile) are historically cheap and are expected to gain at least 25% during future upward reversion to their mean. In aggregate, **EM equities** (CAPE 13) are historically about 20% cheap compared to developed markets.

The extended outperformance of US equities has historically coincided with an extended strong dollar cycle (2012-2023), which currently is 10% to 15% overvalued compared to its trade-weighted equilibrium. These decade-long cycles (91-01, 01-12, 12-23) typically see swings of 25% to 30% in real exchange rates, and the strong dollar cycle now appears near exhaustion. On the other hand, the Chinese Yuan and the Japanese Yen appear historically cheap, at least 20% undervalued, especially given their strong current account and reserve positions and low current interest rates. Again, in aggregate, **EM currencies** have lost about 15% in real terms against the US$ over the past decade and remain significantly undervalued, except for the Indian Rupee, the Mexican Peso, and the Polish Zloty, which appear somewhat overvalued.

Relative value trades can be spotted from pairs of equity and FX valuations, as illustrated in chart 3. Emerging markets look cheaper than developed markets, especially given their higher earnings growth. China offers more value than India, Brazil more than Mexico, and Malaysia more than Thailand. While it is hard to predict turning points, most experts predict a long-term cycle of outperformance for emerging markets, indicating annual real returns of 8% to 10%, and many Wall Street firms predict that EM equities may become the top asset class over the next decade.

<D> After analyzing fundamentals and valuations, what are other structural factors or catalysts propelling investments into emerging markets? How does economic growth translate into earnings growth? How do labor force dynamics impact overall growth? And what are some strategic themes to drive EM productivity?

Just looking at valuations, it would appear that **Japan** is more attractive (cheaper currency, lower valuation) than **Indonesia**. Well, perhaps there is a new immigration policy to open Japan, or a new investment wave into artificial intelligence, or a big geo-political event like joining NATO which could become great investment catalysts. Otherwise, who would want to invest in an over-indebted economy with zero growth, an aging labor force, slow innovation, declining competitiveness, on an island with lots of trouble around? In contrast, Indonesia is thriving, with a younger dynamic population (twice in size), growth averaging 5%, debt below 40% (vs. 200% in Japan), strong investment, rising urbanization, and capital inflows (including from Japan).

Indonesia is a great example to illustrate that emerging markets are more dynamic, growing faster, offer investment catalysts and are more attractive than developed markets. In fact, Goldman Sachs predicts that emerging markets will overtake the US by 2030 and double to 35% of global market capitalization. Growth and investments are immediate macro factors that positively contribute to earnings growth and higher equity market returns. Let us look at factors that are driving growth models and hence explain differentials between developed and emerging markets:

Growth models are typically driven by three factors: capital, labor, and productivity. **Capital** is critical to support efficient production and growth, both public and private capital, including the quality of capital, as for instance measured by infrastructure. China and India are already heavily investing into infrastructure, whereas Brazil and Nigeria (as proxy for poorer emerging and frontier markets, see table 4) have some way to go, both in quantity and quality. Debt levels in most emerging markets remain much below those of developed markets after the recent spike during the pandemic.

A young, growing, and educated **labor** force is differentiating the most successful emerging markets (table 4). Clearly, India and Nigeria have a young labor force and the most potential gains from urbanization, starting from a low level. However, both health and education expenditures in both countries remain inadequate, limiting future improvements in competitiveness. China's life expectancy is higher than in the US, it has heavily invested into education, and some additional progress from ongoing urbanization is possible, but China's competitiveness is already near European levels.

Total factor **productivity** has stalled in most developed markets, which are expected to grow by barely 2% in the near future, according to the IMF, but emerging markets are forecast to grow faster, by over 4%. Productivity improvements can be obtained by technological change, innovation, efficiency improvements, returns to scale, and institutional transformation. China has most heavily invested in these areas and has focused on three industries in particular: **energy transition, artificial intelligence, and aerospace innovation**, where growth effects could become exponential. These are three examples of catalysts that could become most relevant for EM investors:

Policies in China and India will be crucial to succeed in the **energy transition**, both countries are by far the largest emitters with the largest growth rates, and the majority of their emissions are from coal and oil. Meanwhile, China is producing more than 80% of the world's solar panels, its manufacturing cost is 10% lower than in India and 35% lower than in Europe. China also is producing more than 60% of the world's electric vehicles, after doubling production in 2022. India already has the largest solar farms in the world and is expected to become the world's second-largest PV producer within three years, leapfrogging Europe. Meanwhile, European carmakers are heavily growing their investments in Latin America, and Japanese carmakers are investing in EV production in South-East Asia. Emerging markets may well replace established car industries in developed markets, according to one industry group, Japan risks to lose 50% of its exports or 14% of GDP if it does not accelerate its energy transition.

Artificial intelligence could be as transformative as the industrial revolution. It could become a new arms-race between the United States, Europe, and China. However, arms are typically not greatly adding to a country's growth potential, whereas AI could exponentially alter growth curves. Although the US starts this race as presumed front-runner, China does already account for over half of world robotics, 40% of the world's patents, and the largest contribution to science journals (30% more than US). PWC predicts that AI could boost Chinese GDP by 26% by 2030, as compared to a 15% boost expected for North America. Super-computing may turbocharge AI development and the early market leaders may dominate this space. This factor alone could be decisive for the outperformance of technology firms in the US as compared to Asia.

The **aerospace industry** could be primed to become a rapid growth area, which now accounts for 4% of GDP in Europe and 2% in the US. Nuclear fusion could become a catalyst for space exploration, and already Japan, China, India, and the UAE have substantially upgraded their investments in this area. Sustainable aviation has become another recent focus, and the aircraft industry is becoming more competitive with the entry of the China into the large aircraft industry and further growth in Brazil. Investors need to have a more thorough understanding of these three catalysts that could drive major industries where historical data and partial valuations are useless.

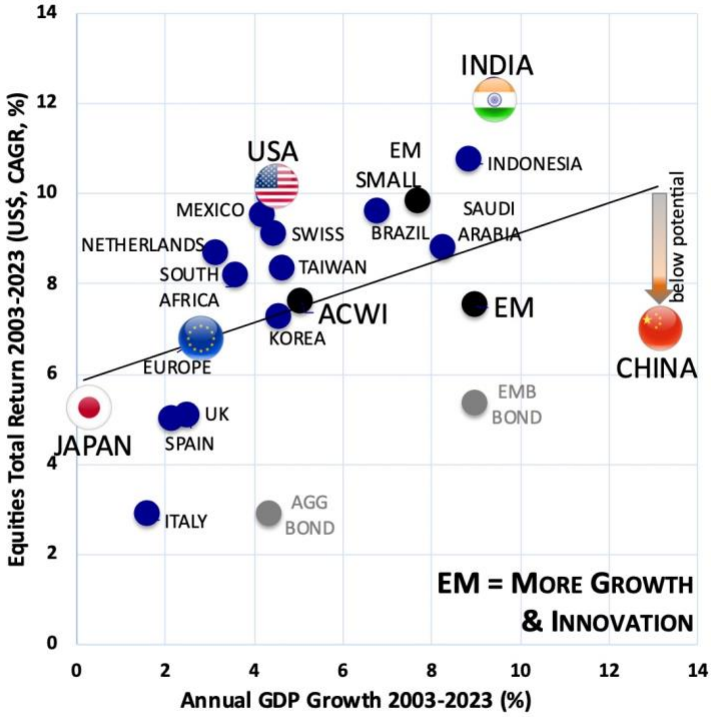
Coincidentally, Walter Isaacson, who had published an impressive Kissinger biography back in 1982, is now completing a new biography on Elon Musk, which focuses on these three areas of innovation: Musk has heavily invested into the energy transition, especially electric cars, and Tesla now sells 50% of its vehicles in China. Musk is also investing into artificial intelligence and is concerned that the "out of control" AI race could lead to "civilization destruction". And Musk founded SpaceX back in 2002, with strong US investment focus, including NASA, which is now valued at $150bn.

<E> **Emerging markets** are more than a niche, they already are leaders in critical industries and drive the energy transition and the innovation in artificial intelligence. Their market share is expected to double in the next six years. Their historical returns have been very much aligned with developed markets, and their fundamentals have been improving. Emerging market valuations today are attractive, at the tail end of an extended US dollar cycle. To summarize, there are ten reasons why emerging markets could soon transition from laggard to leader:

1. EM stand to benefit from a geo-political rapprochement and likely trade rebound;
2. EM extend beyond China, with competition from India, East Asia, LAC and EMEA;
3. EM potential growth is twice of DM, with half of DM debt, and rising productivity;
4. EM equity markets have grown by 7.5% and EM small-cap by 10% (2003-2023 CAGR);
5. EM equity valuations are two standard deviations cheap compared to US equities;
6. EM currencies are 10% to 20% below fair value at the end of an extended US$ cycle;
7. EM technology firms may benefit from the AI revolution and rising hardware needs;
8. EM commodity producers may enjoy a super-cycle driven by the energy transition;
9. EM outperformance may focus on smid-cap quality-growth innovative companies;
10. EM may become more differentiated in a multi-polar world with shifting alliances.

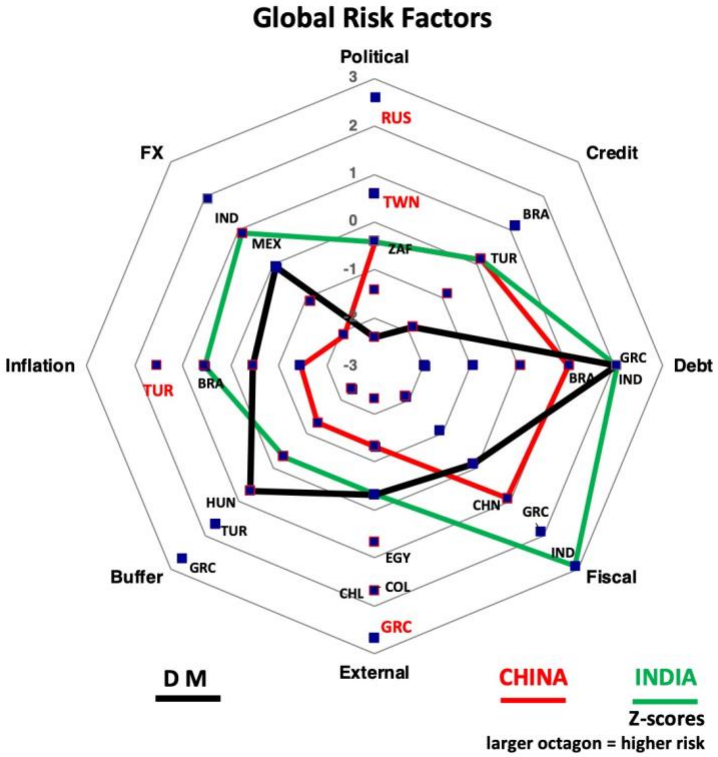
http://www.emleaders.com/pdf/em-turning.pdf

Equity Returns and Growth (20 yrs) Chart 1



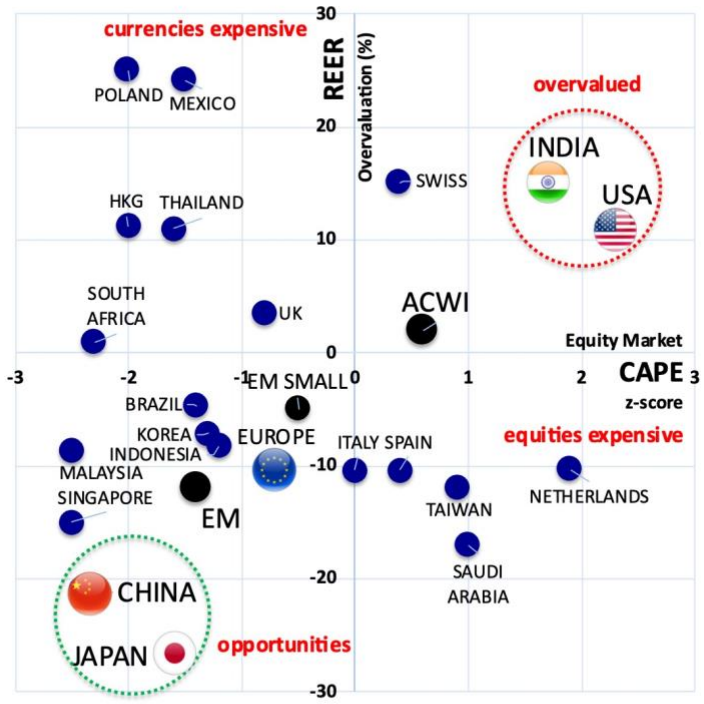
Sources: IMF, I-shares, Local Exchanges, EM Leaders (2023)

Country Risk Factors (2023) Chart 2



Sources: IMF, IIF, Bloomberg, Reuters, EM Leaders (2023)

Currency & Equity Valuations (2023) Chart 3



Sources: IMF, IIF, Research Associates, Brookings, EM Leaders (2023)

Advantages for Emerging Markets Table 4

<A> HIGHER GROWTH	USA	EU	CHINA	INDIA	BRAZIL	NIGERIA
GDP (% world PPP)	15	15	19	7	2	1
GDP per cap ($)	80,000	40,000	13,720	2,600	9,670	2,280
GDP growth (20yrs)	4.4	2.8	13.1	9.4	6.8	4.9
<B> HIGHER INVESTMENT						
Debt/GDP (%)	128	92	72	84	92	37
Infra Invest/GDP (%)	2	2	6	5	3	4
Infrastructure quality	88	90	78	68	65	40
<C> YOUNGER POPULATION						
Population (+10yrs)	336+16	446+0	1412-15	1437+87	215+18	222+41
Life Expect (yrs)	76	81	78	67	73	53
Old/Population (%)	26	35	20	10	14	6
Urban (%)	83	78	64	36	88	54
<D> QUALITY OF LABOR						
Health/GDP (%)	19	13	6	3	10	3
Education/GDP (%)	6	5	4	5	6	1
High School (%)	97	95	59	43	62	40
Competitiveness (rank)	10	15	17	37	59	99
<E> STRATEGIC PRODUCTIVITY						
Science Articles	16	16	23	5	2	0
IT exports (%)	20	15	30	10	9	6
Aerospace exports (%)	40	39	2	1	1	0
EV Sales (% global)	8	21	29	2	1	0
Carbon emissions (%)	13	7	31	7	13	0

Sources: IMF, World Bank, IIF, GIHub, IEA, Brookings, EM Leaders (2023)