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Investing for a world of change

EM equities: five factors point to a rebound

The environment appears to finally be shifting back in favour of emerging market equities

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Over recent years, the emerging market (EM) equity asset class has seemed to reach a turning point on more than one occasion, only for hopes to be dashed. After several false dawns, this analysis assesses the critical factors that could support EM returns relative to developed markets. First, a look back over the past few decades at how the asset class has performed and why.

Charting the course of EM equity market returns

At the turn of the century, emerging markets were still reeling from the Asian financial crisis – one of the largest economic collapses in the region's history. In stark contrast, euphoria around the 'dot-com' and broader technology, media and telecom sector was boosting developed market equities. Geopolitical tensions and a series of conflicts in the Middle East post 9/11 cast a further shadow over the EM asset class. All against a backdrop of US Federal Reserve (Fed) rate hikes and a strong dollar.

A turning point came in the early 2000s, preceding a 10-year bull market for the EM equity asset class. EM economies had put the troubles of the 90s behind them, restructured debts, floated currencies and appeared to have improved governance. US dollar strength – now recognised as a major headwind for EM assets – had peaked, and as a much looser US monetary policy regime took hold, the dollar declined. This, combined with the China-driven commodity super cycle in a globalising world, propelled the EM equity asset class for the next decade. Investors piled in at lofty valuations, attracted by companies delivering high revenue growth and resilient margins in countries that were quickly building wealth.

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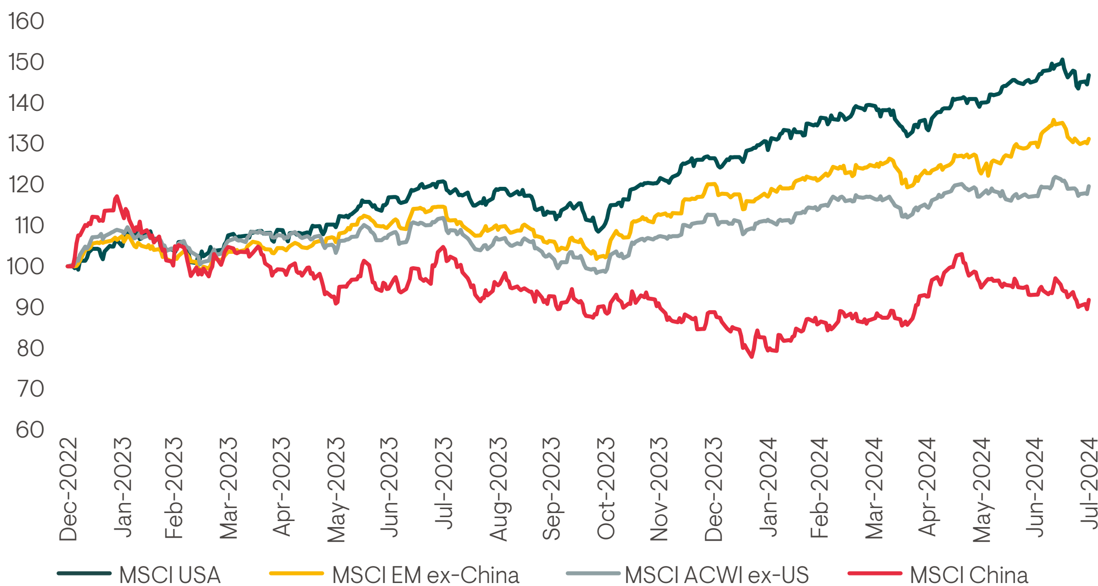
The subsequent decade – from around 2013 – brought an abrupt reversal in fortunes and a decade-long bear market for EM equities. US monetary policy tightened, creating a headwind (especially in the taper-tantrum years of 2013-2016), while the slowdown in China revealed structural fragilities in EM economies.

More recently, a de-rating of the Chinese stock market as well as the fastest tightening cycle in Fed history (accompanied by the US dollar's steady rise) have weighed heavily. Reflecting this, equity markets have seen significant polarisation over the last few years, with the top-performing US market contrasting starkly with the struggling Chinese market, as shown in Figure 1.

Yet excluding China from the EM equity universe, the market has returned 30% over the past 18 months, almost keeping pace with the ACWI's 36%. It appears that the EM risk-asset recovery may already be in motion.

Figure 1: A recovery already underway?



Source: Bloomberg, as at July 2024.

Where next?

After several false dawns, it appears that we are at a turning point. We believe risk is priced in and downbeat sentiment towards the EM asset class (foreign equity investment today is low relative to historical levels) leaves it well-placed to make further progress.

We see five main reasons that point to a more favourable outlook for EM equity returns moving forward.

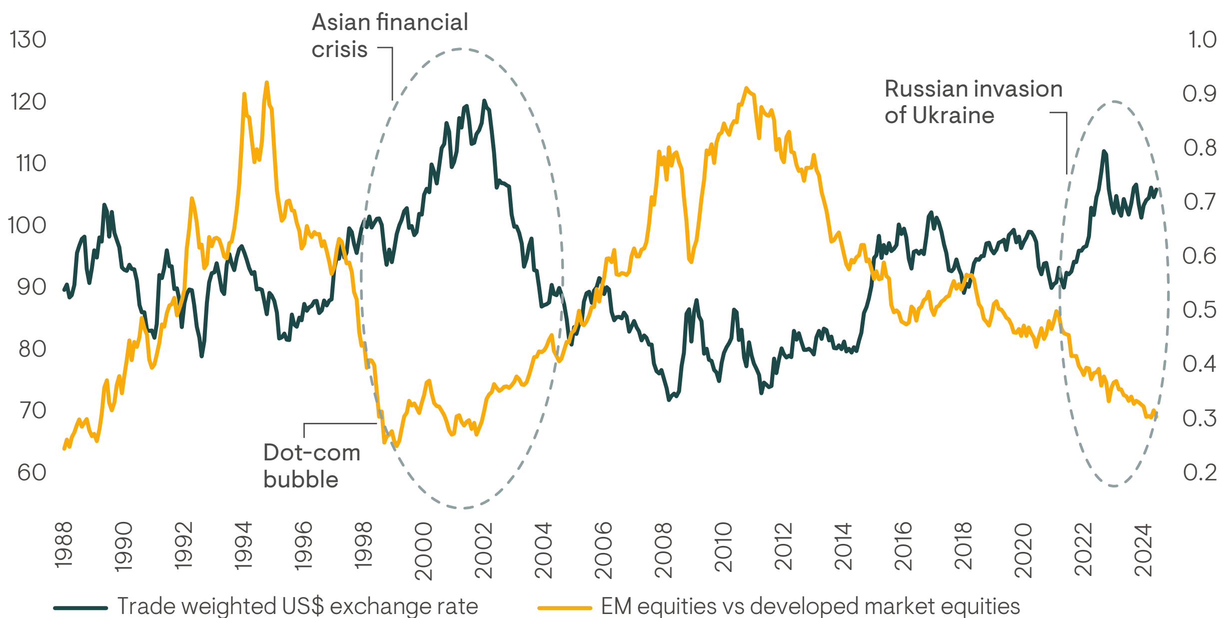
1 A powerful headwind is set to wane

It is now abundantly clear that there is a strong inverse relationship between the US dollar and the performance of EM equities. A strong dollar is bad for the EM asset class as it makes servicing US dollar-denominated debt more expensive, and vice versa. The situation today closely resembles the period highlighted on the left-hand side of Figure 2, where the US dollar peaked in the early 2000s, preceding a stellar run for EM equity returns, as discussed earlier.

However, we don't need the US dollar to fall for the EM equity asset class to succeed, we just need it to stop rising as steadily as it has over the past 10 years. With loosening in the US money supply and Fed rate cuts on the horizon, we may see easing in the one-way dollar trade.

While its future path is unclear and unlikely to be linear, the scope for further dollar upside may be more limited than previously.

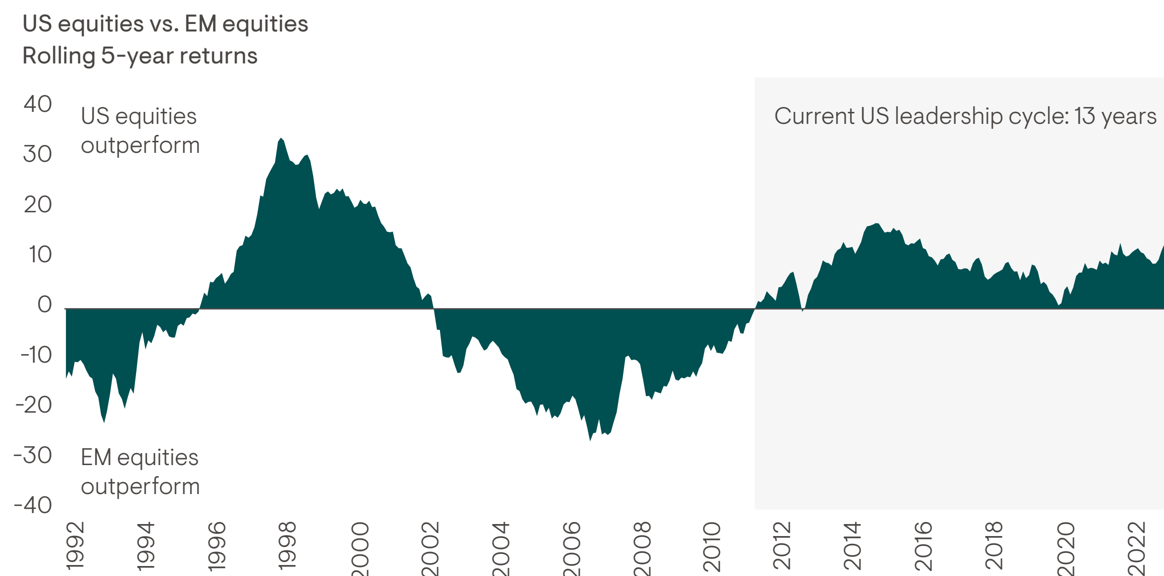
Figure 2: A strong dollar is a powerful headwind and the dollar is now close to 20-year highs



Source: Bloomberg, Emerging markets equities = MSCI Emerging Market, Developed markets equities = MSCI World. June 2024.

In a similar vein, we have analysed the relationship between market cycles in US and EM equities and how they tend to move in multi-year cycles. Without getting into a debate on the current health of US equities, we simply point out that the average market cycle tends to last for around eight years and the current US leadership cycle is now in its 13th year. (Figure 3).

Figure 3: US and EM equities move in multi-year cycles



Source: Bloomberg, Ninety One. As at May 2024.

2 Stronger fundamentals

Substantial progress has been made on the macroeconomic front – both monetary and fiscal - and in corporate fundamentals in recent years.

At the macro level, it is widely recognised that many EM central banks have skillfully navigated the recent hiking cycle, moving proactively to tackle inflation ahead of their developed market counterparts. Thanks to benign inflation dynamics, the prospect of further rate cuts for emerging markets (both absolute and relative to developed markets) provides a cyclical tailwind for EM equities. The reduction in cost of capital should also help stimulate economic and business activity in EM economies.

Turning to EM corporate quality, an important trend that's taking hold is Chinese companies becoming more shareholder friendly, and more investable as a result. Yet as China's dominance has receded, as discussed in our paper here, this is a market where rock-bottom sentiment means even good businesses appear to be trading at attractive valuations.

The increased levels of share buybacks and dividends paid out paints a positive picture (Figures 4 and 5) and signals that management teams

believe their shares are undervalued by the market and see better growth prospects and cashflow generation in the coming years. This improvement in corporate governance, along with higher standards of operating performance, has been evident in the broader EM equity asset class.

Figure 4: Chinese companies' annual buybacks (Rmb bn)

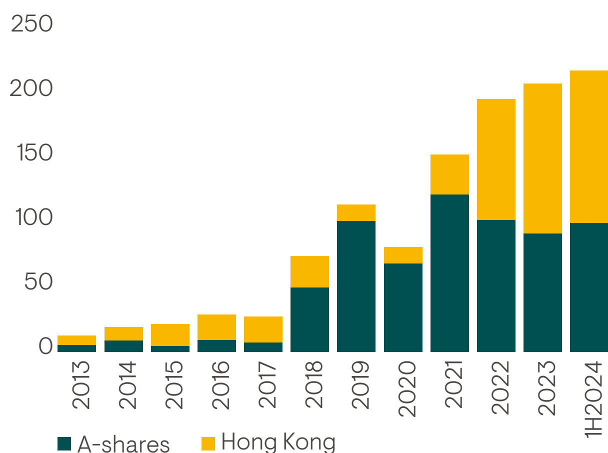
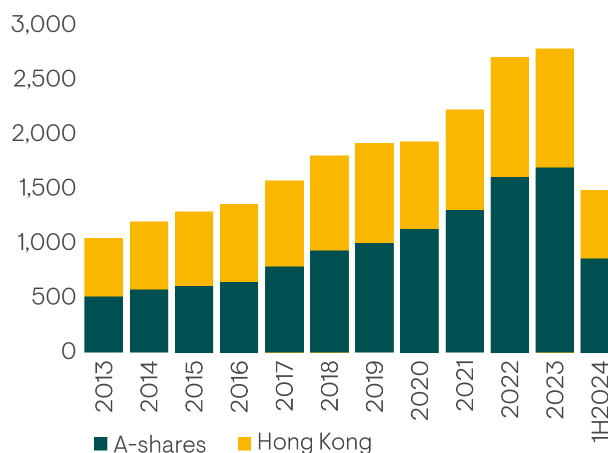


Figure 5: Dividends paid out by Chinese companies (Rmb bn)



Source: Wind. CICC, June 2024.

3 Structural tailwinds

Supportive tailwinds that are strengthening for the asset class include rising income levels in emerging markets, along with the associated increased demand for consumer products and services. Global economic momentum is shifting away from advanced western economies towards emerging markets, as they constitute a larger share of economic activity and are forecast to deliver higher GDP per capita growth than the developed markets.

Furthermore, the shift to a new multi-polar world economy means some emerging markets, such as Mexico, Vietnam and India, are already starting to benefit, returning an average 20% since the start of 2023[1].

Other multi-decade structural themes that have the potential to generate sustainable value for EM equity investors include the drive towards net zero, efforts to enhance supply-chain resilience, government stimulus and infrastructure expansion. Together, these have heralded a new capex super-cycle. We believe the companies that win in this environment are likely to look very different from the technology leaders of the last cycle, creating rich alpha opportunities for investors in the EM equity asset class.

1. Cumulative MSCI Index returns from 1 January 2023 to 30 June 2024, Bloomberg.

4 Robust earnings growth

Emerging markets are expected to deliver higher earnings growth than most other major regions over the short- to medium-term, with around 20%+[2] earnings growth forecast in forward year 1 and high teens in forward year 2. That's significantly higher than what's on offer in DM equity markets (e.g., 10.9% and 14.6% for MSCI USA; 5.5% and 9.9% for MSCI Europe, for FY1 and FY2, respectively).

This trend is also evident in our latest Capital Markets Assumptions, where we present our long-term return forecasts for asset classes. There, we note the most promising return opportunities are found in emerging markets, driven by earnings growth.

5 Compelling valuations

EM equity valuations have been attractive for some time now with metrics like Price/Earnings ratios among those that have not changed much in 10 years. This is, in part, driven by Chinese companies that are high quality, now trading on depressed multiples, as noted earlier. Valuation alone is not a signal, but it sets the right starting point for other conditions to drive a re-rating, especially as the gap between emerging markets and the US is now near its widest in 40 years following the exceptionally strong run in US equities.

	Price/earnings ratio	Price/book ratio
MSCI EM	15.2x	1.7x
MSCI EM ex-China	17.7x	2.0x
DM	20.4x	3.4x
US	24.0x	4.9x

Source: Bloomberg estimates, 30 June 2024.
For further information on indices, please see the Important information section.

2. Source: FactSet, as at June 2024, for all earnings growth forecasts listed in paragraph.

Risks to navigate

While we believe the investment case for the EM equity asset class is strong, we are mindful of various risks that could lead to market volatility, delay a turn in the cycle, or both. These include the US election outcome in November and resulting implication on global markets; higher-for-longer rates in the US should inflation prove to be stickier than expected; policy missteps; and further lacklustre economic growth from China despite recent fiscal and monetary stimulus.

Short-term fears and souring sentiment from further geopolitical headwinds could overshadow longer-term considerations, delaying a turnaround for the asset class while also providing short-term mispricing opportunities for bottom-up stock pickers.

While political uncertainty prevails and the economic outlook is mixed, we believe much of the risk is already priced into EM equity valuations. Furthermore, the divergence in sector, country and stock performance is high, creating a favourable environment for stock-pickers.

In summary

EM equities have been in a more-than decade-long bear market relative to developed market stocks. With a caveat that timing inflection points is difficult, the building blocks for a turnaround are falling into place, with parallels to the period some 20 years ago that preceded a bull-run.

In addition to the strong cyclical case for the EM equity asset class (valuations at 20-year lows, high expected earnings growth, rate-cutting cycles with capital costs falling), there are structural, longer-term trends that are transforming emerging markets. Performance ex-China has already turned positive over the past 18 months, and there are encouraging indicators presently with respect to relative valuations and the US dollar. While timing will always be uncertain and various macro and geopolitical risks will need to be navigated carefully, a market regime shift does appear to be on the horizon.

General risks. The value of investments, and any income generated from them, can fall as well as rise. Past performance is not a reliable indicator of future results. Environmental, social or governance related risk events or factors, if they occur, could cause a negative impact on the value of investments.

Specific risks. Emerging market (inc. China): These markets carry a higher risk of financial loss than more developed markets as they may have less developed legal, political, economic or other systems.

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