

BIG PICTURE

Emerging Markets: Stepping Into the Spotlight



MACRO INSIGHT | Q4 2022*

In the 2010s, emerging market (EM) equities suffered their worst performance as an asset class since the 1930s (*Display 1*).¹ They returned a mere +49%, compared to an average of +203% in the previous seven decades.² Emerging market countries ran high twin deficits, which led to currency depreciation and forced a cleanup of excesses from their over-leveraged balance sheets, a legacy of loose fiscal and monetary policies. The growth differential between emerging economies and the developed world, historically a key driver of relative equity returns, had also deteriorated in the last decade, a factor which is now turning in favor of EM. After lagging the developed markets (DM), especially U.S. equities which have been dominated by the performance of a handful of stocks, emerging markets are in a much stronger position to outperform developed countries this decade.

¹ MSIM, Bloomberg, FactSet, Haver.

² MSIM, Bloomberg, FactSet, Haver. EM returns based on MSCI EM Index.

* This paper was originally published in Q4 2022, updated with new data as of Q1 2024.

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The headwinds of the past decade that hindered EM economies are becoming tailwinds in several markets that we believe should provide support for the asset class for years to come. Catalysts for a broader EM rally include:

- Relative growth differentials now favor EM equities (*Display 2*)
- EM sovereigns are in healthier shape compared to DM governments with better public debt and fiscal situations
- EM corporates are in a better position compared to DM corporates due to deleveraging
- EM external balances have improved compared to the past decade
- EM equities and currencies are inexpensive and competitive

Relative growth differentials now favor EM equities

Growth in EM used to be seen as dependent on China’s economic performance. However, we think this dependency will lower. Factors such as China’s high debt, declining working-age population growth and falling export contributions are likely to slow its economy. Keep in mind, EM is a heterogeneous asset class—despite the slowdown in China, we expect many other emerging market countries to see an acceleration in their growth, which will drive relative earnings and index market share. EM ex China are expected to grow 4% in 2024 and 3.6% in 2025, versus 2.2% and 1.7% for the U.S. and 1.5% and 1.7% for developed markets.

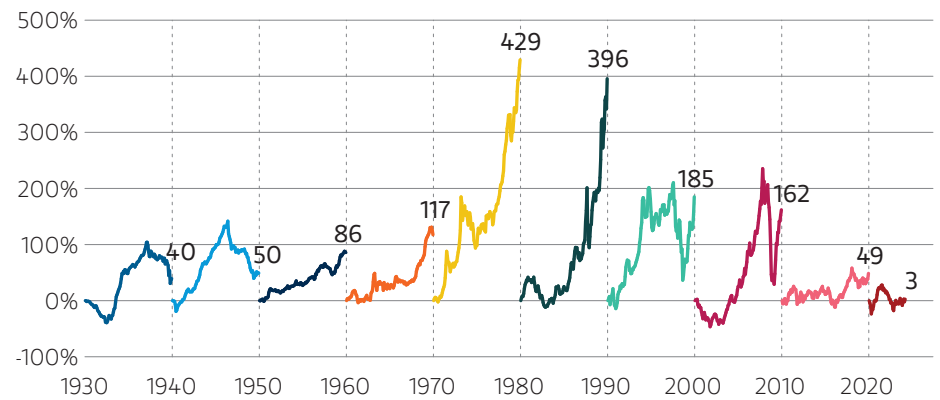
EM’s growth story is underpinned by several factors:

- A manufacturing revival in competitive markets led by a “China plus one” strategy driving reshoring and nearshoring

DISPLAY 1

2010s: Worst Decadal Returns for EM Since the 1930s

Emerging Markets Cumulative Total Returns Each Decade



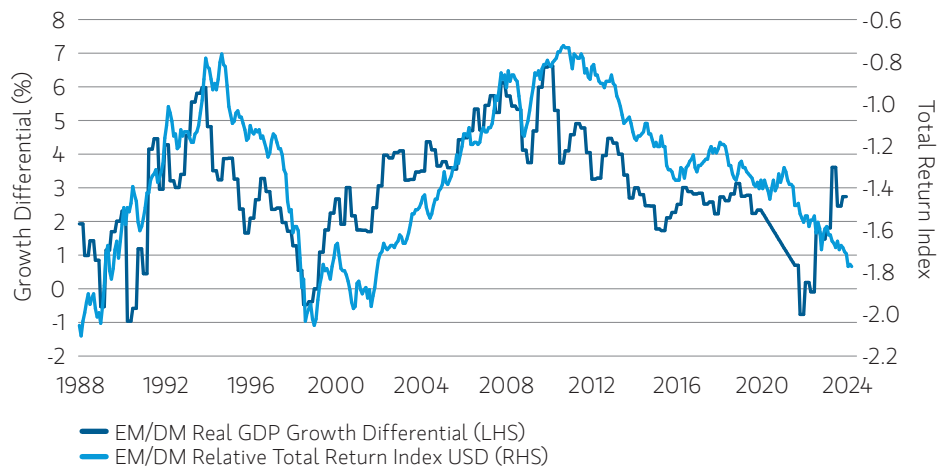
Data as of March 31, 2024.

Source: MSIM, Bloomberg, FactSet, Haver. Equity Total Returns, USD.

DISPLAY 2

Relative Growth Differentials Favor EM

EM vs DM Real GDP Growth Differential and Relative Equities Performance



Data as of March 31, 2024. GDP-weighted.

Source: MSIM, Bloomberg, FactSet, Haver. Forecasts = Bloomberg consensus private sector estimates. Forecasts/estimates are based on current market conditions, subject to change, and may not necessarily come to pass.

- A commodity upcycle driven by supply constraints and increased demand for green metals and minerals supporting decarbonization, benefiting resource-rich economies
- A digitization-led productivity boost across most EM regions
- A favorable political cycle in several emerging market economies

EM sovereigns are in healthier shape compared to DM governments with better public debt and fiscal situations

Emerging markets’ fiscal restraint has helped the region maintain lower inflation compared to the developed world. Historically, fiscal spending and money printing was done by EM governments and central banks, which

Themes Driving Emerging Market Growth



SUPPLY-CHAIN DIVERSION LEADING TO RESHORING AND NEARSHORING: Under this era of deglobalization, countries feel a greater need to become more self-reliant and less dependent on China. This has led to the so-called “China plus one” strategy, a manufacturing revival and spreading of production to other countries to diversify supply chains away from China. Countries where wages are low and relatively high skills are appealing—such as India, Indonesia, Vietnam and Mexico—are benefitting from this supply-chain diversification.



DECARBONIZATION BENEFITS COMMODITY EXPORTERS: The global push to build a greener economy has increased the demand for energy and raw materials while green politics have made it increasingly difficult to invest in new oil fields, aluminum smelters or copper mines. This imbalance provides support for commodity prices of energy and green metals that are benefitting from increased demand at a time when supply has been cut and curtailed. Commodity exporting countries like Brazil, South Africa and some GCC countries will benefit from these decarbonization tailwinds.



DIGITIZATION HAS A POSITIVE GROWTH IMPACT: The pandemic accelerated the digital revolution across the globe, but its impact will be felt more in emerging economies than developed ones. Consumers in emerging economies are moving quickly to adopt mobile internet services, from digital payments to online education and shopping. In many cases this is due to a lack of legacy infrastructure. Digital revenue growth averaged 28% in emerging economies—more than double the 11% rate seen in developed ones.³



POLICIES AND POLITICS IN EM ARE MORE FAVORABLE: Several countries have undertaken key economic reforms in recent years, such as the privatization of inefficient state-owned enterprises and tax changes in India and labor reforms in Indonesia, which will help benefit the quality of growth in these economies. The new red tide in Latin America, brought on by a surge of anti-incumbent voting as well as demands for social justice in some countries, is different from an earlier era. Today’s socialist governments in LatAm countries are more inclined to be fiscally conscious and maintain an independent central bank to keep their economies humming along.

inevitably stoked inflation and led to currency crises. But this time it was the Fed, and other developed world central banks, that resorted to printing money during the pandemic.

While total EM government debt/GDP (Gross Domestic Product) has risen, EM ex China government debt has in fact declined to 45.2%, due to improving fiscal deficits and higher nominal growth.⁴ EM borrowing has shifted to local funding, with about 85% of EM government debt now funded from domestic sources, reducing past vulnerabilities related to outflows and currency pressures during Fed hiking

cycles.⁵ For example, in 2017, 40% of Indonesia’s government securities were owned by foreign investors. Today that figure has fallen to 14%.⁶

Smaller frontier economies like Egypt, Pakistan, Nigeria and Argentina have had their backs against the wall. They are addressing their excesses of fiscal profligacy, high inflation and twin deficits by raising interest rates, implementing orthodox monetary and fiscal policies and utilizing International Monetary Fund (IMF) programs to bring down vulnerabilities. For example, in March 2024, Egypt devalued its currency and hiked

interest rates by 600 basis points (bps), to help secure an IMF loan.

EM corporates are in a better position compared to DM corporates due to deleveraging

In 2022, the private sector debt/GDP ratio of emerging economies excluding China decreased by 4.5% to 85.8% of GDP.⁷ The deleveraging was led by a fall in domestic corporate borrowing and household credit. Although private external debt rose by \$1 trillion over the previous five years—reaching \$7.4 trillion in 2021—this acceleration reflects debt growth in China alongside

³ MSIM, Statista. Data as of March 2021. Includes 9 largest emerging and 11 largest developed digital markets.

⁴ MSIM, J.P. Morgan, IMF.

⁵ MSIM, J.P. Morgan, IMF.

⁶ MSIM, Bloomberg, FactSet, Haver. Data as of November 2022.

⁷ J.P. Morgan, IMF.

borrowing by the Hong Kong and Singapore financial centers to fund Asian entities.⁸ Elsewhere, external private sector borrowing has flatlined and is falling as a share of GDP, suggesting corporate-sector balance sheets are generally healthy across EM. Several EMs are starting a credit cycle buoyed by robust domestic liquidity, a healthy banking sector and high-quality assets. Credit availability could support higher growth in these markets going forward.

EM external balances have improved compared to the past decade

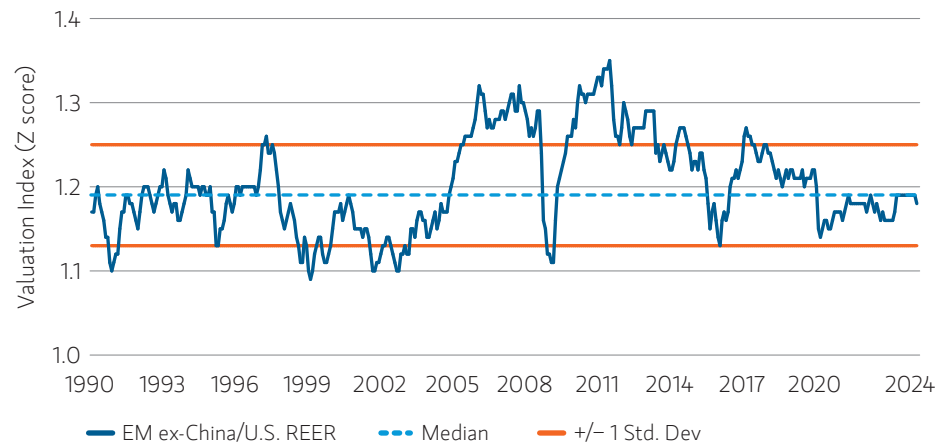
A better macro environment with stronger sovereign, corporate and household balance sheets along with lower external vulnerabilities has helped improve the current account balances for several emerging markets. Commodity tailwinds are helping the external accounts of resource-rich countries and lowering their reliance on foreign capital. Reserves in EM are higher than where they were at the beginning of the last decade.⁹ In contrast to the past, EM economies now exhibit healthier balance-of-payments accounts and balance sheets. This should support currencies in emerging economies that, excluding China, are trading at historical lows.

EM equities and currencies are trading at crisis-level valuations (Displays 3 and 4)

Despite better growth prospects, improved external balances and sustainable sovereign and private debt, the relative valuations of currencies and equities have dropped to lows last seen in 2000.¹⁰ That was when

DISPLAY 3 EM ex-China Currencies

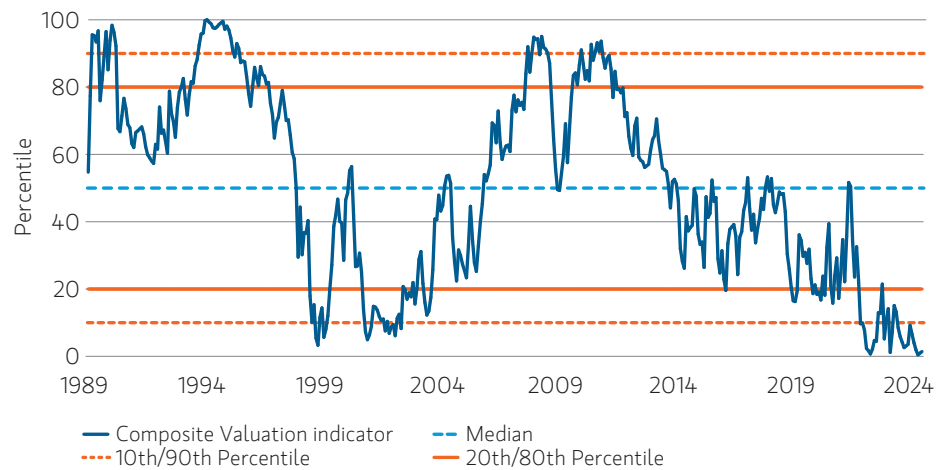
EM Currencies ex-China REER Valuations Still Competitive



Data as of March 31, 2024. Market Cap Weighted.
Source: MSIM analysis, Bloomberg, FactSet, Haver.

DISPLAY 4 Relative EM Equity Valuations Are Also at Crisis-level Lows

Emerging Markets vs the U.S. Composite Valuation Indicator



Data as of March 31, 2024.
Source: MSIM, Bloomberg, FactSet, Haver. Composite measure of 6 valuation metrics: price/book, 12m-fwd. P/E, P/E, price/sales, price/cash earnings, dividend yield.

several markets were only beginning to recover from a series of crises—from the Mexican Tequila Crisis in 1994 to the Asian financial crisis in 1997 and the Russian debt default just a year later.

Crisis-level valuations have been great starting points for EM outperformance in the past. Currency moves, on average, have contributed to one-third of total returns historically for dollar investors.¹¹

⁸ J.P. Morgan, IIF.

⁹ MSIM, Bloomberg, FactSet, Haver.

¹⁰ MSIM, Bloomberg, FactSet, Haver.

¹¹ MSIM, Bloomberg, FactSet, Haver.

Navigating beyond China

The Chinese economy and markets have also followed a decadal cycle. In the 2000s China became the manufacturer to the world, and in the 2010s, China's economy grew fueled by consumer internet giants. The focus this decade will be on green technology and science-based industries like semiconductors, artificial intelligence, and high-end manufacturing. The 2020s will be the decade of "China 3.0"—with the government prioritizing hard science-based technologies. Although China represents 25% of the MSCI EM Index, we do not think passive investing can capture these thematics, given a large part of the index is still made up of Old and New China companies. Currently, China 3.0 is a small part of the index, with only a few companies in the index positioned for this decade.

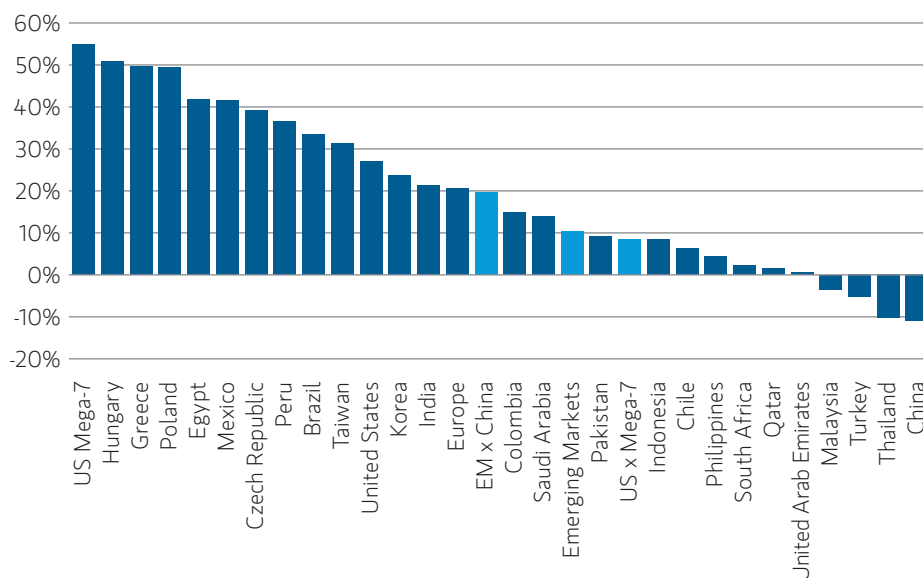
China's correlation with the rest of emerging markets and the rest of the world has steadily declined in recent years, a sign of its decreasing dominance.¹² While EM equities ended 2023 with a +10% return in dollar terms, China marked its third straight year of underperformance. Excluding China, the MSCI index rose +20%. It's time to look beyond China and seek markets, sectors and companies with strong structural tailwinds (*Display 5*).

Evolution of the EM Index

The composition of the MSCI EM Index has continuously evolved since its inception in 1988. In the beginning, Malaysia made up 30% of the index, followed by Mexico, which became the top country also with a 30% share in 1992.¹³ Over the years China's share in the index grew gradually, peaked at 43% in 2020 and has since fallen to 25% today.¹³ We think China's share will

DISPLAY 5

In 2023 EM and EM ex China Outperformed the U.S. ex Mega-Cap 7

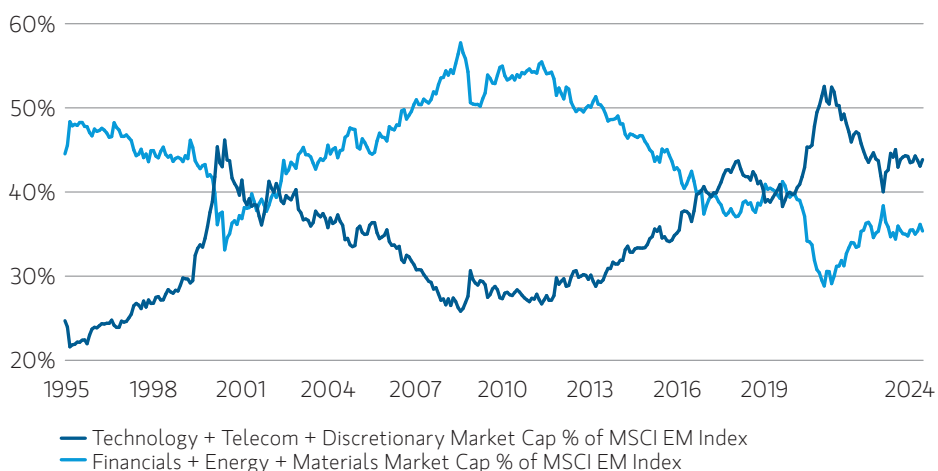


Source: MSIM, Bloomberg, FactSet, Haver. As of December 31, 2023. Index definitions can be found in the disclosure section. The index performance is provided for illustrative purposes only. **Past performance is no guarantee of future results.** The indexes do not include any expenses, fees or sales charges, which would lower performance. The index is unmanaged and should not be considered an investment. It is not possible to invest directly in an index.

DISPLAY 6

Changing Fortunes: New Economy vs Old Economy

Sector Weights in the MSCI EM Index Over Time



Data as of February 29, 2024

Source: MSIM, Bloomberg, FactSet, Haver.

continue to fall as other economies grow faster, allowing for increased representation from markets like India, Southeast Asia and Latin America.

Leadership has also changed at the sector level (*Display 6*). Old economy sectors like commodities and financials accounted for 57% of the index in

¹² MSIM, Barra, FactSet.

¹³ MSIM, Bloomberg, FactSet, Haver.

2008 and halved to a low of 29% in 2020. New economy sectors like tech, telecom and consumer platforms made up 46% of the index in 2000 at the height of the global dot com boom and again peaked at 52% in 2020, with a sharp increase in the first year of the pandemic when all activity turned online.¹⁴ Now we are seeing another change in the fortune of the two with a convergence in the index weights of the new and old economy sectors

in EM as old economy drivers like credit, manufacturing and commodities propel growth in several EMs. Last decade's winners have to give way to new leaders.

Conclusion

Even with higher growth, reduced debt and lower inflation, emerging market equities are trading at crisis-level valuations. We believe that most

investors are under-allocated to EM, considering the potential catalysts that can drive returns for the asset class in this decade. The environment for investing in EM will never be easy. But by taking an active approach and focusing on country and stock selection as well as structural themes, we believe investors can reap the rewards of buying into these markets particularly at this stage of their economic and market cycle.

Risk Considerations

There is no assurance that a portfolio will achieve its investment objective. Portfolios are subject to market risk, which is the possibility that the market values of securities owned by the portfolio will decline and that the value of portfolio shares may therefore be less than what you paid for them. Market values can change daily due to economic and other events (e.g. natural disasters, health crises, terrorism, conflicts and social unrest) that affect markets, countries, companies or governments. It is difficult to predict the timing, duration, and potential adverse effects (e.g. portfolio liquidity) of events. Accordingly, you can lose money investing in this portfolio. Please be aware that this portfolio may be subject to certain additional risks. In general, **equities securities'** values also fluctuate in response to activities specific to a company. Investments in **foreign markets** entail special risks such as currency, political, economic, market and liquidity risks. The risks of investing in **emerging market countries** are greater than the risks generally associated with investments in foreign developed countries. Stocks of **small-capitalization companies** entail special risks, such as limited product lines, markets, and financial resources, and greater market volatility than securities of larger, more-established companies. **Derivative instruments** can be illiquid, may disproportionately increase losses and may have a potentially large negative impact on the Portfolio's performance. **Illiquid securities** may be more difficult to sell and value than public traded securities (liquidity risk). **Non-diversified portfolios** often invest in a more limited number of issuers. As such, changes in the financial condition or market value of a single issuer may cause greater volatility. **Cryptocurrency (notably, Bitcoin)** operates as a decentralized, peer-to-peer financial exchange and value storage that is used like money. It is not backed by any government. Federal, state or foreign governments may restrict the use and exchange of cryptocurrency. Cryptocurrency may experience very high volatility.

¹⁴ MSIM, Bloomberg, FactSet, Haver.

DEFINITIONS

Gross Domestic Product (GDP) is the monetary value of all the finished goods and services produced within a country's borders in a specific time period. It includes all private and public consumption, government outlays, investments and net exports.

INDEX DEFINITIONS

The **MSCI Emerging Markets Index (MSCI EM)** is a free float-adjusted market capitalization weighted index that is designed to measure equity market performance of 23 emerging markets.

The **MSCI World Index** is a free float adjusted market capitalization weighted index that is designed to measure the global equity market performance of developed markets. The term "free float" represents the portion of shares outstanding that are deemed to be available for purchase in the public equity markets by investors. The performance of the Index is listed in U.S. dollars and assumes reinvestment of net dividends.

The **S&P 500® Index** measures the performance of the large cap segment of the U.S. equities market, covering approximately 75% of the U.S. equities market. The Index includes 500 leading companies in leading industries of the U.S. economy.

The **CRB Continuous Commodity Index (CRB)** is an index made up of a broad grouping of different commodity futures, which is a benchmark of performance for commodities as an investment.

The **US Dollar Index (DXY)** is an index of the value of the United States dollar relative to a basket of foreign currencies, often referred to as a basket of US trade partners' currencies.

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