

# Emerging opportunities



## Summary

- Emerging markets (EM) covers a wide spread of countries, as diverse as China, Brazil, UAE and Greece.
- EM did extremely well in the noughties, outperforming the developed world.
- The 2010s brought lows, with EM underperforming significantly.
- China – the biggest influence on EM – has reopened and lifted its zero-Covid policy, bringing new potential to the space.
- But with ongoing global economic and geopolitical uncertainty, caution is still a watchword.

Emerging markets (EM) have brought impressive returns in the past, but challenges caused by global events over recent years have seen the sector struggle. So, what's next for this potentially dynamic investment space?

## What are 'emerging markets' anyway?

According to the International Monetary Fund (IMF), the main criteria used when dividing the world into developed or advanced economies and emerging markets are 'per capita income level,

'export diversification' and 'degree of integration into the global financial system'. According to the *Financial Times*, the result seen on indices is "a haphazard collection of countries with varying economic sizes and growth rates".

Indeed, some argue that the very term 'emerging market' is outdated, but it is nonetheless still very much in use, although the states

that count as emerging are up for debate. The MSCI Emerging Markets Index shows large and mid-cap representation across 24 EM countries, including Brazil, China, Colombia, Egypt, Indonesia, Malaysia, Greece and United Arab Emirates.

## Highs and lows

Broadly speaking, for investors the appeal of EM is the harnessing of potential, as a country moves from earlier stages of development (or emerges from a crisis) and on to a greater level of economic maturity. When the sector performs well, the rewards can be significant – but in times of turmoil, EM can be severely shaken. "Emerging markets assets did extremely well in the noughties and outperformed more or less everything, including US assets," says Mercer head of asset allocation, Rupert Watson. "And then in the 2010s, it was the exact opposite, with US equities outperforming, and emerging market assets underperforming."

As a result, Aon asset allocation specialist, Lucinda Downing, says: "EM assets have been unloved for many years." After all, she adds: "EM equities have underperformed developed equities for the past decade as the emerging

## Sandra Haurant explores the investment opportunities in the dynamic world of emerging markets

region's economic growth advantage over developed markets has narrowed."

And for much of last year, EM continued to face significant challenges. As GQG Partners managing director, Mark Barker, says: "The MSCI EM Index lost 20 per cent in 2022, with every sector down for the year." Particularly hard-hit sectors included IT, communication services, and 'consumer discretionary' – that is to say, companies providing goods and services that people want but can manage without. In terms of geographical areas: "Losses were led by China, Taiwan, and South Korea," says Barker.

## Changing tides

Most of 2022 was tough, but the end of the year did bring signs of a shift in EM's fortunes. While both equities and bonds fell last year, says Downing, "they held up quite well relative to their developed counterparts in a year when global growth slowed and the US dollar and US interest rates rose strongly, which are typically negative for EM assets".

Cardano senior multi-asset strategist, Ross Barr, agrees: "Despite several years of underperformance, EM [assets] have been the clear outperformers in the equities space through the fourth quarter of 2022 and into the beginning of this year."

Arguably the most significant factor in this shift is one very big country, says Downing: "China is the largest region in emerging equities and a dominant influence on the whole index." Over recent years the country's problems and

policies have had an enormous impact on the markets. “The Chinese economy last year was very weak, in contrast to the rest of the world,” says Watson. “And the Chinese economy was very weak because it was locked down because of Covid.”

The recent change in China’s Covid policies, and the opening up of that country, suggest a change in the fortunes for the EM space is possible. “We see the reopening of the Chinese economy as an important catalyst for this and the pace of withdrawal from zero-Covid has accelerated quicker than anticipated,” says Barr. “As a result, growth expectations have risen and the market’s pessimism, which was embedded into 2022’s depressed valuations, is fading.”

There is already evidence of an upturn, Watson says. “Chinese growth this year is going to be very strong, not only because of the ‘Covid Bounce,’ but also because [*the Chinese state*] has put in supports for the property sector, which was very, very weak last year, and more generally, a favourable policy mix that should lead to trends above average growth this year, in contrast to soft growth in the US and soft growth across Europe.”

Nevertheless, others are more cautious. “We are currently less constructive on China and Taiwan,” Barker says. “We believe when economic activity normalises in China following the relaxation of its zero-Covid policy, the pace of growth in that country may be slower for longer than investors currently expect. President Xi’s recent consolidation of power may result in an even more unpredictable regulatory environment, in our opinion, while his emphasis on common prosperity may have a negative impact on the profitability of certain businesses. We believe this dynamic reduces earnings visibility.” What’s more, tensions between China and Taiwan, he says, could elevate “the risk profile of both countries”.

Barker does, though, see potential in other parts of the developing world. “In India, for example, select banks

are generating nearly five-year highs for return on assets, while also seeing non-performing loans fall.” The recent growth in mortgages in Indian cities beyond the major metropolises is also “a good barometer of robust, sustainable economic growth”, according to Barker, while wider issues related to the Russian invasion of Ukraine have led to “unintended consequences”, with India being able to accumulate increasing amounts of oil at a discount, he adds.

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### **Benefits in bonds**

EM bonds – fixed income debt issued by countries within the EM sphere, and companies within those countries – bring with them their own pros and cons. Being generally higher risk than bonds in the developed world, they pay higher yields. And, says Barr: “EM bonds can also be useful within a growth investment strategy, particularly given their potential to perform well in periods when the US dollar is cyclically weakening.”

Essentially, says Watson: “If you’re a bond holder, you care about whether countries default or whether they don’t. And they either do or they don’t, and if they do, you get back all your money and make a decent return. And if they don’t, well, you will lose a certain amount of money, depending on how the default works.”

If today’s positive predictions by some parties play out, Watson says, “the chances are that both equities and bonds will do well. But equities will do

better than bonds”. However, he adds that, in the same scenario, it’s likely that “developed world corporate bonds and high yield bonds could do better than developed world equities”.

### **Looking forward**

While EM has had something of a rollercoaster ride since the start of the millennium, it has nonetheless remained part of the mix. “Pension schemes never divested completely away from emerging markets,” says Watson. “But trustees, of course, are aware of the swings and roundabouts in financial markets and are very cautious not to be aiming to put too many of their eggs in one basket. What schemes are looking to do is to diversify as broadly as possible, which includes an allocation to emerging markets.”

When developed markets are not doing well, emerging markets may fair better – and this lack of correlation is beneficial. “EM is a diversifying equity market investment,” says Barr. “Often, as is the case now, economies and markets operate within cycles that are not synchronised with developed markets.”

What’s more, says Barr: “The long-run risk premium that can be achieved within EM is higher, and this can be a valuable component of a pension fund’s growth investment strategy. However, the volatility of returns within EM is higher too.” As a result, Barr argues that EM risk must be actively managed, within a multi-asset investment approach.

Economic and geopolitical uncertainties remain prevalent across the world, whether ‘developing’ or ‘developed,’ and predicting the future for EM is a difficult game to play. But some argue that there is scope for cautious optimism. As Watson says: “I think it’s possible, looking forward over the next decade, that emerging market assets will outperform US assets across the equity – and probably in the debt space as well.”

**Written by Sandra Haurant, a freelance journalist**