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Asset Allocation **THE CHANGING FACE OF EMERGING MARKETS**

EXECUTIVE SUMMARY

- Emerging markets have evolved, and investors now need to look at them through a different lens.
- Infrastructure-driven sectors, such as energy, materials, and industrials, have become much less important drivers of performance, while consumer-oriented sectors, most notably information technology, have dramatically increased in importance. This evolution appears likely to continue, as many countries, led by China, transition toward more consumer-driven economies.
- For tactical asset allocation purposes, the outlook for commodity prices is still quite important to the relative performance of emerging markets equities, but it is now part of a much broader mosaic of factors.
- Partially due to the ongoing trend toward more domestically driven economies, emerging market fundamentals are becoming more impacted by country-specific factors, making broad generalizations about the asset class more and more difficult. This makes evaluation more complex for tactical asset allocation purposes, but it also means that the alpha potential for active management is higher.

Emerging markets (EMs) are a different animal to what they were 10 years, or even five years ago. The term “emerging markets” is now more a matter of benchmark classification as opposed to some common fundamental factor. While perhaps sounding like a subtle distinction, the importance is both high and far-reaching for investors, from both a bottom-up stock-picking perspective, as well as from a tactical asset allocation perspective.

TAILWINDS FADE

Emerging economies, led by China, are the most important engine of incremental global economic growth. The dynamics of their economies, their growing share of world trade, and their

increasing importance in global equity markets are trends of fundamental and long-term significance. According to projections by the International Monetary Fund (IMF) released in October 2017, emerging and developing economies will be responsible for 58% of all GDP growth over the next five years, with China alone responsible for 27%. By comparison, the United States is expected to be responsible for 17%.

Add to that the longer-term social aspects like urbanization and dramatically more attractive demographics than developed markets and it is easy to see why, conceptually, emerging markets equities seem as attractive an asset class as ever. Unfortunately, this attractive growth profile has not always translated into superior

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performance results—and in recent years, we have seen some important shifts in the dynamics of when and why emerging markets have outperformed (and underperformed) other regions.

In the late 1990s and early 2000s, EM equities delivered outsized returns relative to developed markets (Figure 1). During this period, many EM economies were boosted by China's double-digit growth pace and massive investment in resources, leading to what was termed a "commodity supercycle." This resulted in a virtuous cycle that benefited EM countries broadly—and several large countries in particular, such as Brazil, South Africa, and Russia, where natural resources are plentiful. It also meant that performance was heavily influenced by the direction of commodity prices.

However, as China began its transition to a more consumer-led economy, that powerful tailwind of rising commodity prices dissipated, and with it came a period of underperformance by EM equities (Figure 1). This caused much angst among investors as they tried to assimilate what had happened to the EM thesis. Were the unique qualities of emerging markets (i.e., superior economic growth and demographic advantages) enough to outweigh the cyclical exposure these markets held? Or had the experience of the 2000s proven they were simply an alternative way to increase exposure to commodity prices and other

FIGURE 1: EM Equity Performance Impacted by Shifting Dynamics

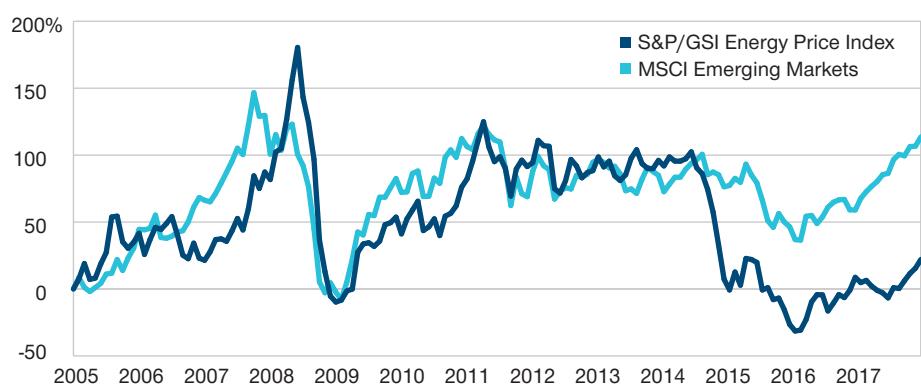
Annualized Total Return in USD	Dec. 31, 2000–Dec. 31, 2010	Dec. 31, 2010–Dec. 31, 2017
MSCI Emerging Markets	16.21%	-1.47%
MSCI World	2.81	5.20

Past performance cannot guarantee future results.

Sources: MSCI and FactSet.

FIGURE 2A: EM Equity Performance No Longer Riding Alongside the Commodity Cycle

EM Equities vs. Energy Prices, Cumulative Performance to December 2017

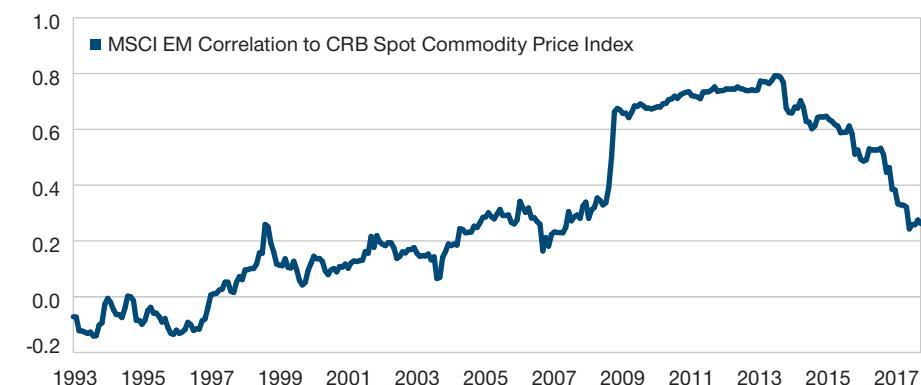


Past performance cannot guarantee future results.

Sources: MSCI and FactSet.

FIGURE 2B: MSCI EM Correlation to CRB Spot Commodity Price Index

Five-Year Rolling, in USD, as of September 30, 2017



Sources: MSCI and Credit Suisse research.

cyclically driven elements of the global economy? Recent evidence points to the former rather than the latter.

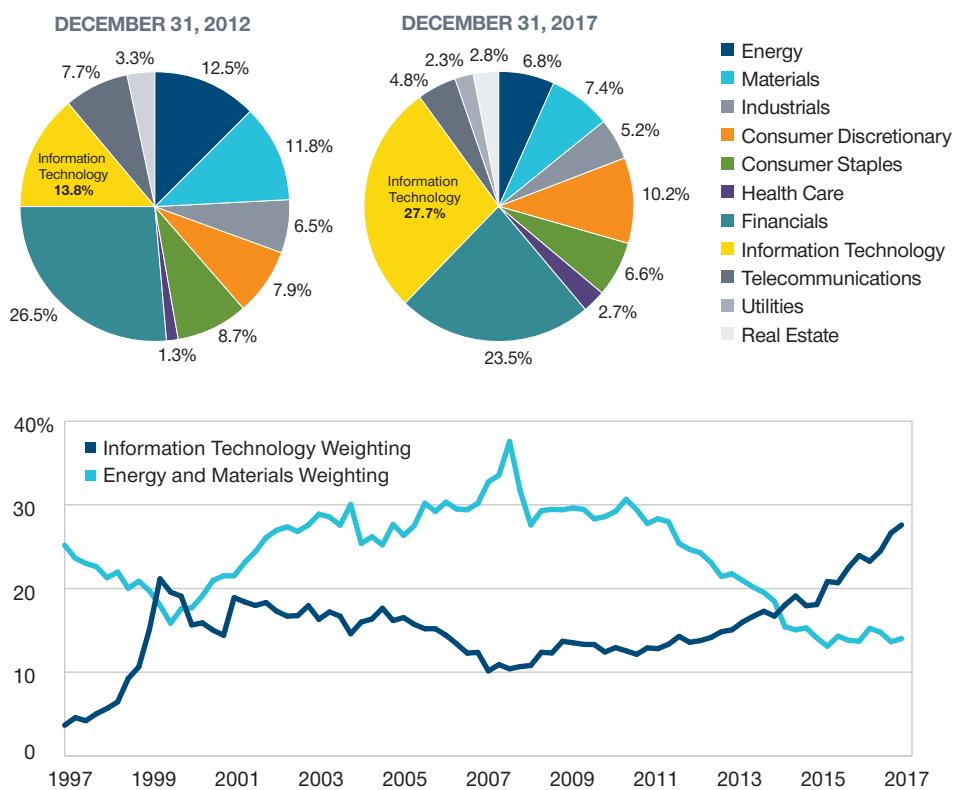
CHANGING DRIVERS

A look back over the last three years reveals that the relationship between commodity prices and EM equities has

weakened significantly. EM equities had moved almost in lock step with energy prices from 2005 to mid-2014, but from 2014, they have moved much more independently (Figure 2A). This raises two questions: (1) Why did this relationship weaken and (2) Should we expect this to continue?

FIGURE 3: Technology—The New Driving Force Within Emerging Markets

MSCI Emerging Markets Index—Sector Composition, as of December 31, 2012, and December 31, 2017



Sources: MSCI and FactSet.

A key factor in the change has been the sector composition of the MSCI Emerging Markets Index, where there has been a marked shift away from commodity and manufacturing areas into consumer-driven ones. Most notable is the growth of the information technology sector, while energy and materials sector weights have fallen dramatically.

Since 2012, the IT sector's size within the MSCI Emerging Markets Index has doubled to almost 28% of the index (Figure 3). That's bigger than the technology weighting in the S&P 500 index at around 24%.¹ Importantly, much of the change has been driven by digital companies (i.e., "new tech").

At the same time, the constituent weighting of the energy sector has almost halved, while the materials weighting

has fallen to single-digit levels within the index. Elsewhere, index sector weights have evolved less dramatically, but in a similarly thematic fashion. Those sectors in infrastructure-driven areas of the economy—industrials, utilities, and telecommunications—have trended lower. Meanwhile, the sectors driven by domestic consumption—consumer discretionary, health care, and financials—have trended higher.

OPPOSING DRIVERS, MIXED RESULTS

In addition to falling representation within the index, the performance of commodity areas has also been poor during the current cycle (Figure 4). As we have witnessed the slowdown in the demand for resources, we have seen sectors exposed to this trend underperform the wider market. Meanwhile, consumption

areas have provided relatively strong performance, led by the technology sector. This dynamic has exacerbated the ongoing decrease in correlation between commodity prices and EM equities, as not only have energy and materials become smaller constituents, but returns for the sectors have been negative, while the majority of the benchmark has performed positively, particularly the technology sector.

EVOLUTION AND DURABLE CHANGE, WITH CHINA AT THE HEART

These trends in benchmark composition are unlikely to reverse anytime soon given the ongoing wealth creation and the organic rise in demand within local economies over time. Economists have long predicted that rising emerging markets incomes would propel a shift from export-led to consumption-led growth, and this shift is well underway across most areas of the advancing world. The rising middle class consumption story (Figure 5) shows few signs of stalling, with China alone having lifted more than 600 million people out of poverty over the past three decades.

China's industrialization phase is clearly and intentionally fading, and as the economy has shifted away from an infrastructure and fixed asset investment-led growth model, the consumption and the services sectors have generally picked up the slack. When looking at the data, we see clear evidence of this change, with services as a percentage of GDP growing (Figure 6).

At the same time, more subdued economic growth in the developed world continues to erode the secular export theme within the whole of the emerging world. This leads us to suspect that EM fundamentals have evolved, and will continue to evolve, in a more self-reliant direction over time. China's economy will not be the only one migrating toward a more consumption-oriented model.

¹Information technology weighting in the S&P 500 Index was 23.8% as of December 31, 2017.

FIGURE 4: Change of Fortunes as the Commodity Supercycle Fades

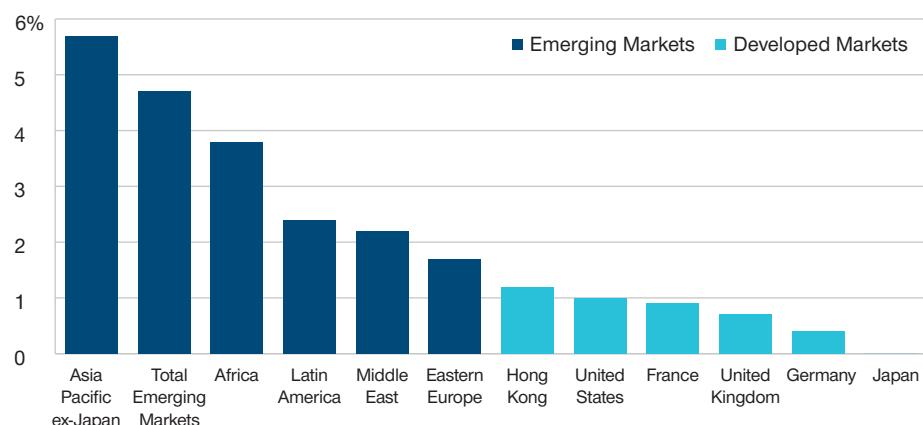
2001–2010		MSCI Emerging Markets			2011–2017		MSCI Emerging Markets		
		Port. Average Weight	Port. Total Return	Port. Contrib. to Return			Port. Average Weight	Port. Total Return	Port. Contrib. to Return
Total		100.00%	349.98%	349.98%	Total		100.00%	18.63%	18.63%
Materials		14.82	679.41	78.43	Information Technology		16.70	141.22	23.90
Energy		12.19	718.73	58.08	Financials		22.47	21.13	5.18
Financials		17.88	359.17	55.59	Consumer Discretionary		8.27	38.96	4.06
Information Technology		14.13	177.15	34.69	Consumer Staples		7.15	34.05	1.83
Consumer Discretionary		5.53	481.27	27.02	Health Care		1.81	52.50	0.87
Consumer Staples		5.75	522.92	23.18	Real Estate		2.16	28.66	0.61
Industrials		5.94	365.99	18.27	Telecommunication Services		6.52	3.36	-0.29
Telecommunication Services		9.60	197.08	12.86	Utilities		3.24	-33.61	-1.99
Health Care		1.99	359.26	9.25	Industrials		6.39	-27.15	-3.01
Utilities		3.41	333.71	8.83	Materials		9.03	-27.52	-4.29
Real Estate		0.95	152.16	1.16	Energy		15.21	-80.44	-43.65

Past performance cannot guarantee future results.

Sources: FactSet, MSCI, and data analysis by T. Rowe Price.

FIGURE 5: Wealth Creation and Urbanization a Powerful Tool

Superior growth in middle class households 2015–2020 estimate. As of March 2016



Sources: Euromonitor International and CLSA.

An examination of the trade balance data shows that, indeed, many EM countries are seeing their trade balances narrow. Of the 10 largest emerging economies (based on GDP), the balance of trade for goods has narrowed over the last decade (Figure 7), except for Mexico. Net importers are generally importing less, while net exporters are also generally exporting less.

RISING DISPERSION

Partially due to this ongoing trend toward more domestically driven economies, emerging markets fundamentals are becoming more dispersed, making broad generalizations about the asset class more and more tenuous. You only need to look at performance on a country-by-country basis to see that they cannot be viewed under one singular homogenous banner any more (Figure 8).

This is not a surprise to us given the ongoing economic and financial maturation within these countries. Few investors would group Japan, the UK, France, the U.S., and Australia together under a single banner, but since the emergence of emerging markets as an asset class 20 years ago, the fundamentals of India and Brazil have nonetheless been commonly associated with the fundamentals of the Philippines or Turkey, for example. However, the point of maximum fundamental correlation (remember the days of the BRICs ascending as one) was reached some time ago and has likely passed, leaving a more complex, and often confusing, situation in its wake.

A current view of sector weights further reveals the broad dichotomy of exposures by both country and region. Among the 10 largest countries by weight in the MSCI EM benchmark, information technology exposure ranges from over 60% (Taiwan) to 0% (South Africa, Russia, Mexico, Malaysia, and Indonesia). Meanwhile, energy weights range from 48% (Russia) to 0% (Mexico) (Figure 9). This dichotomy

is also present on a regional basis, with information technology being the largest weight in Asia but barely represented in EMEA and Latin America (Figure 9).

Dispersion is also rising on a more granular level than just on a regional or country basis. An examination of rolling 90-day intra-stock correlation of the MSCI EM index shows that stock correlation has been gradually falling, after peaking in November 2008 (Figure 10). This means emerging markets stock movements have been gradually becoming more independent for almost nine years, insinuating that getting choices right at the stock level is becoming even more important.

IT'S COMPLICATED

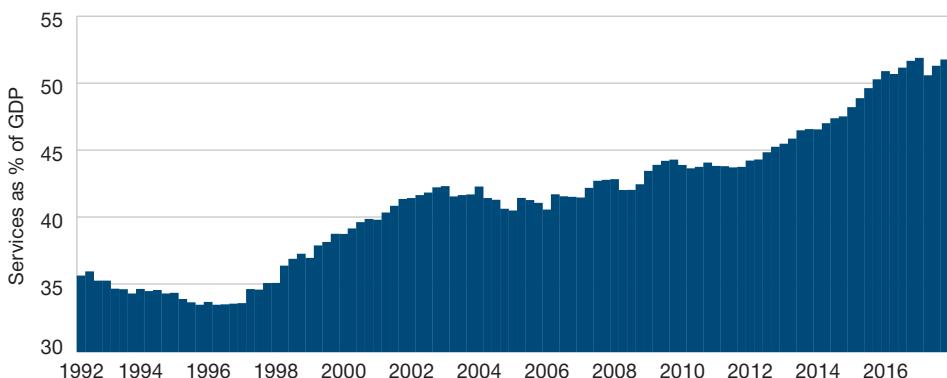
From an asset allocation perspective, the rise in dispersion means that we need to adjust our assumptions about what environments will be most beneficial, while also recognizing that the experience of active investors in EMs may be markedly different for passive investors.

Falling oil prices may be a catalyst for poor performance within Brazil or Russia, but it may mean that consumers in China and India have more disposable income to spend on food, travel, or entertainment—areas that are now more heavily represented within EMs. Meanwhile, numerous country-specific variables, such as the actions of central bankers and politicians, cultural trends, demographics, and even weather within each country, can have considerably more impact on each individual domestic economy.

One implication of this increasing dispersion within the asset class is we should expect EM equities to have a more muted reaction to specific macro forces going forward and, therefore, moderate our conviction regarding tactical allocations to EMs based on specific macro factors. Another is that

FIGURE 6: China: An Evolving Story

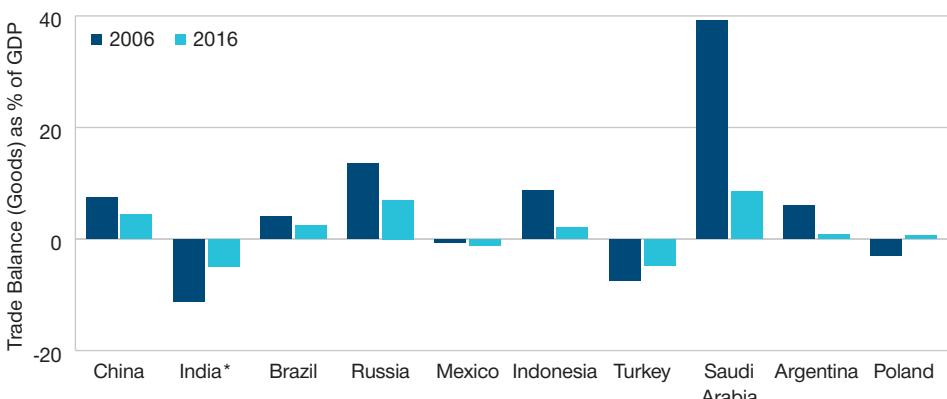
China: Services Share of the Economy, 1992 to 3Q 2016



Sources: Haver Analytics, IMF, and data analysis by T. Rowe Price.

FIGURE 7: Trade Balances Narrowing

As of December 31, 2016

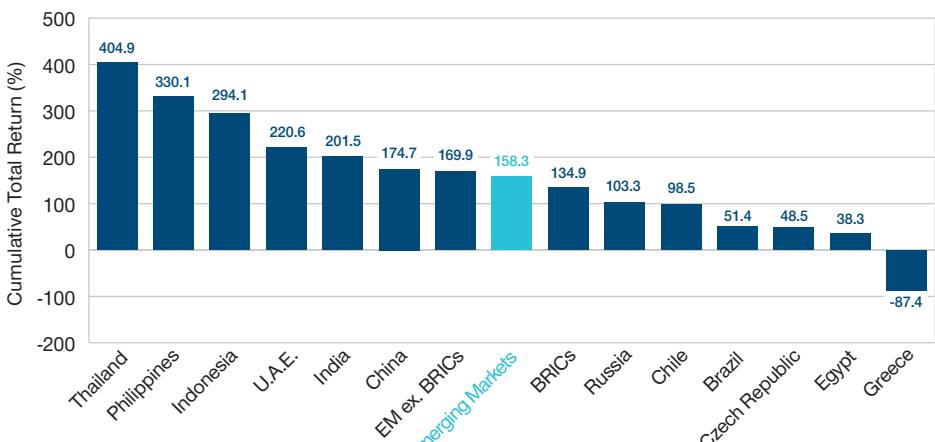


Source: FactSet.

* Data for India are unavailable prior to 2012, so 2012 number is shown.

FIGURE 8: Emerging Markets Return Dispersion

March 2009 to December 2017



Past performance cannot guarantee future results.

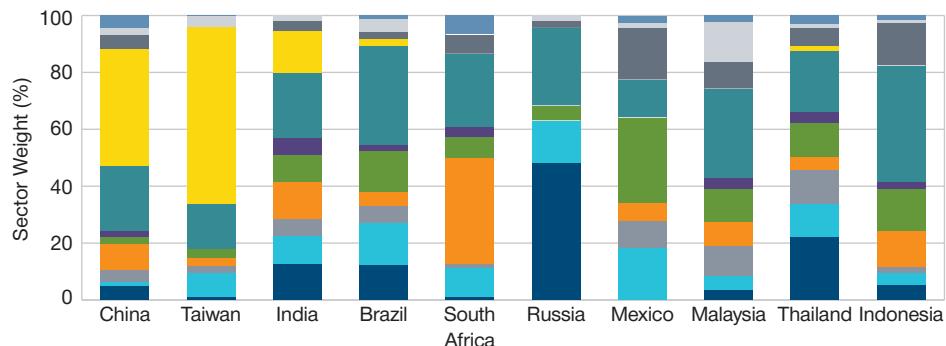
Sources: MSCI and FactSet.

FIGURE 9: Sectors by Country and Region

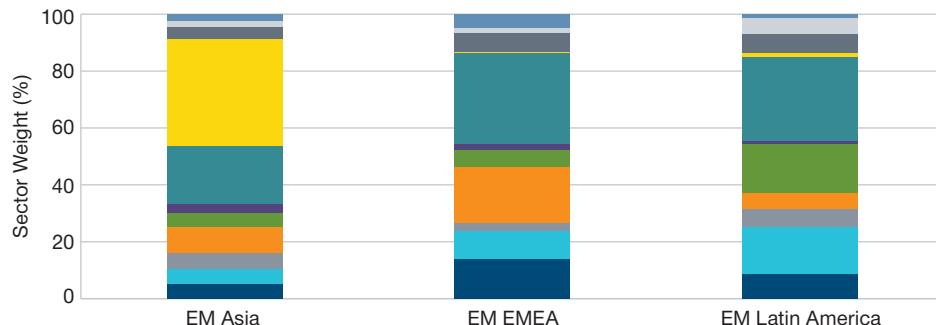
Sector Weights by MSCI Country, as of December 31, 2017



SECTOR WEIGHTS BY MSCI COUNTRY



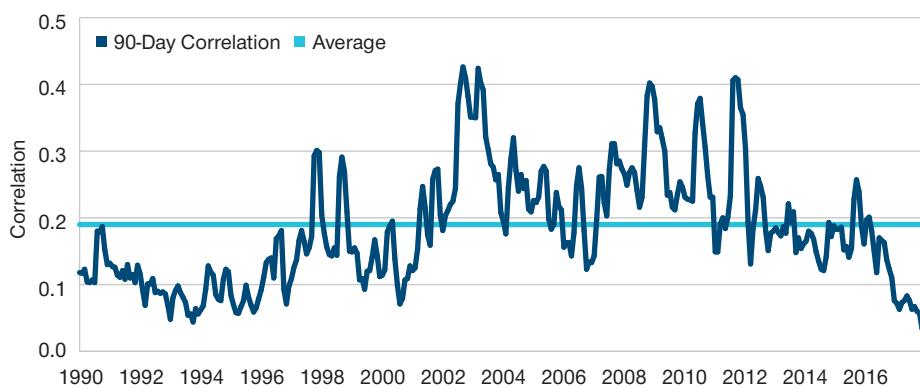
SECTOR WEIGHTS BY MSCI REGION



Sources: MSCI and FactSet.

FIGURE 10: Stock Correlations Falling

Intra-Stock Correlations* in the MSCI Emerging Markets Index, December 1990 to December 2017



Sources: MSCI and FactSet.

*Intra-stock correlations represent the average pair-wise correlation of returns over monthly rolling 90-day periods.

we should expect falling correlation among equities within the EM universe and, therefore, should expect underlying stock selection to have a greater effect on portfolio performance.

For asset allocators, this ongoing change in emerging markets represents both a challenge and an opportunity. The playbook for allocating to emerging markets equities used to be more cyclically driven. In a nutshell, it went something like: Do you think global growth will be healthy? Do you think commodity prices will be strong? Do you think emerging markets currencies will be strong? If the answer to all these questions was yes, then EM equities were very likely to outperform other regions. Now one has to concede that it is much more complicated. Macro factors like global growth, commodity prices, and currency markets are still quite important, but they are now part of a much broader mosaic of factors.

The opportunity lies in the recognition of two important realities: (1) Emerging markets may continue to offer stronger economic growth trajectories than developed markets and (2) Emerging markets now include a much greater representation of country-specific influences.

Point one argues for the need to have exposure to EMs in portfolios with long time horizons, while point two argues for the need to gain this exposure through an active manager that is well equipped to identify the best opportunities within emerging markets.

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