



Emerging Markets: Reward or Risk?

Short-term concerns, but potential for long-term gains.

October 2019

KEY INSIGHTS

- Emerging markets (EMs) have evolved, and investors need to look at them through a different lens. It's important to stay alert to the changes happening in this dynamic asset class.
- The multifaceted nature and higher dispersion compared with other asset classes offers more opportunity to create alpha.
- Trade disputes and slowing global growth are challenging, making the outlook more opaque in the short term. However, fundamentals remain strong and opportunities can be found.

Investing in the emerging world over the last 10 years has provided positive returns in both equities and debt, but far less than the same spectacular returns of the previous decade. Some are questioning if there are still rewards to be found within the developing world.

Strong evidence suggests there is, even though many investors remain structurally underweight the asset class, despite the importance of EMs to the world. Along with many secular drivers, EMs continue to demonstrate a range of growth characteristics that are not easily available in developed markets. This enables higher-quality companies in certain sectors to generate sustainable earnings growth at a much higher rate than the global

average. (Compounding returns can be a powerful driver of future returns.) Meanwhile, in the search for yield, EM debt offers much higher rates than developed markets, many of which now have negative yields. Valuations across the asset class also remain attractive, further supporting investment.

Do the Fundamentals Still Add Up?

Significant headwinds, such as the bursting of the commodity bubble, China's slowdown, weak global exports, and the strong U.S. dollar, have clouded the environment over the last decade. We have also seen a narrowing of the economic growth premium versus developed markets, while corporate earnings growth has been weaker due to a combination of cost pressures (including wage growth) and softening



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41.7%¹

of Global GDP growth will come from China and India in 2020.

¹ Source: IMF World Economic Outlook 2019.

Emerging Middle Class Population

2.6bn²

January 2018

3.7bn²

January 2025
(estimate)

demand. The increasing threat to globalization—only heightened by the trade dispute between China and the United States—is also one of the big challenges EMs now face as global supply chains become more disrupted.

Nevertheless, led by China, EMs are one of the most important drivers of global economic growth. Add to that, longer-term aspects like urbanization, productivity, and for many EM countries, far more attractive demographics, and you get an opportunity set with many interesting and attractive investments.

Past Performance Is Not a Reliable Indicator of Future Performance

In the late 1990s and early 2000s, EMs delivered outsized returns relative to developed markets. Many EM economies were boosted by China's double-digit growth pace and massive investment in resources, leading to what was termed the “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. This has been especially apparent over the last five years as the relationship between commodity prices and EM equities weakened significantly. As seen in Fig. 1, EM equities moved almost in lockstep with energy prices from 2005 to mid-2014, but have since moved with less correlation as the weight of those commodity sectors declined in the index. By contrast, information technology, internet and consumption sectors increased (Fig. 2) and have become more influential.

What we have to recognize is that 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, it is an important one.

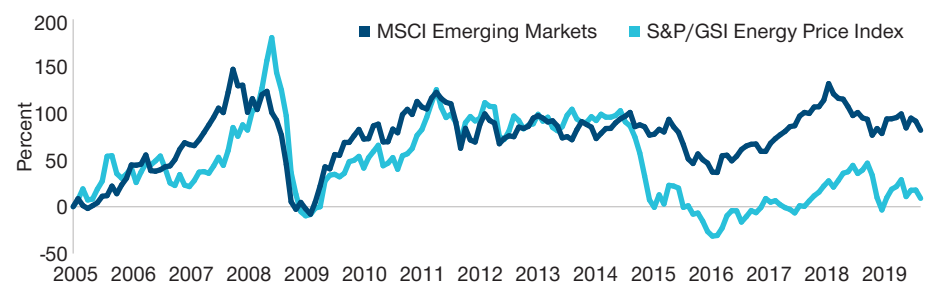
Evolution and Durable Change, With China at the Heart

Economists have long predicted that rising EM incomes would propel a shift from export-led to consumption-led growth, and this shift is well underway

(Fig. 1) EM Equity Performance No Longer Riding the Commodity Cycle

EM equities less correlated with energy prices

Cumulative performance, January 2005 to August 2019



Past performance is not a reliable indicator of future performance.

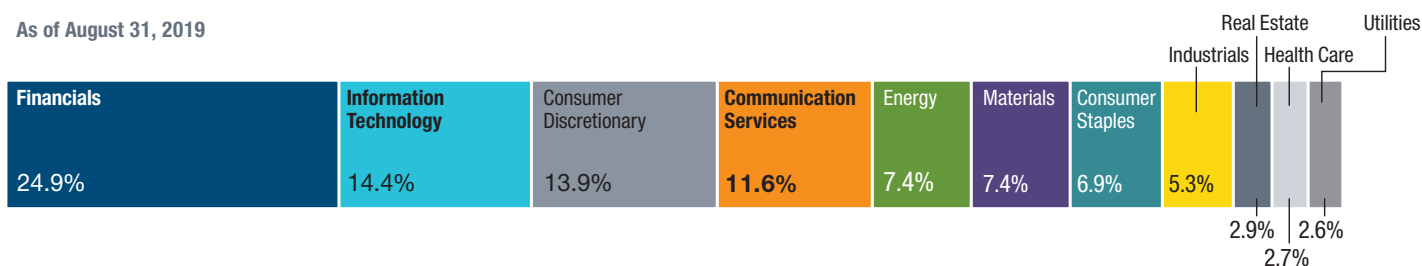
Sources: FactSet (see Additional Disclosures), and MSCI (see Additional Disclosures).

²Sources: World Data Lab/Market Pro and HSBC.

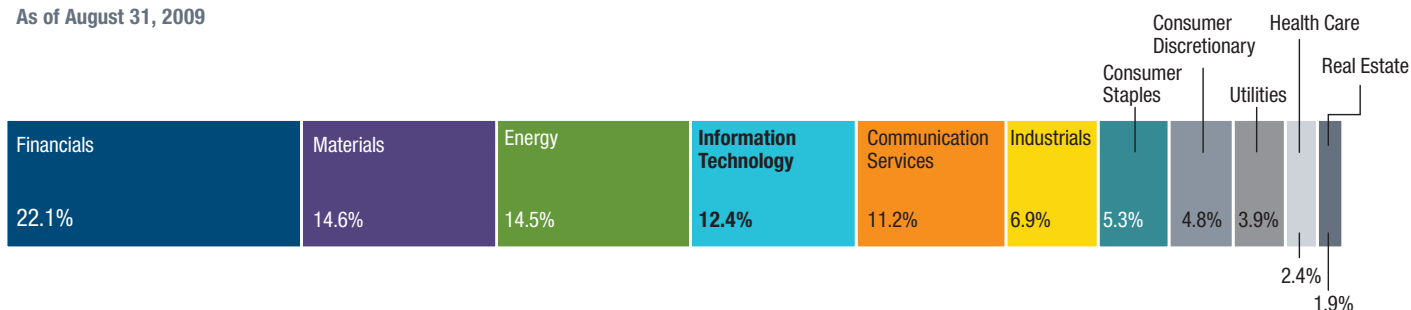
(Fig. 2) The New Driving Force Within Emerging Markets

Consumer and technology sectors rise in importance to the detriment of commodity-related areas
 MSCI Emerging Market Index Weightings

As of August 31, 2019



As of August 31, 2009



Sources: FactSet (see Additional Disclosures), and MSCI (see Additional Disclosures).

Services as a Percentage Share of Chinese Economy

33.5%³

March 1996

51.7%³

September 2017

in many emerging markets. China is at the heart of this, with its industrialization phase clearly and intentionally fading, while consumption and services sectors have become far more important.

Other EM economies are similarly having to adapt to this lower-growth world. Many are becoming more self-reliant and increasing trade among themselves, reducing their dependence on developed markets, and the U.S. in particular. This is a marked shift and should further spur their own development.

Rising Dispersion

With this ongoing trend toward more domestically driven economies, EM fundamentals are becoming more localized, making broad generalizations about the asset class even more tenuous. One only needs to look at performance on a country-by-country basis to see

that they cannot be viewed under one homogenous banner anymore.

This dispersion also means that we need to adjust our assumptions about what environments could be most beneficial. Falling oil prices may be a catalyst for poor performance within Russia or the Middle East, 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.

This ongoing change represents both a challenge and an opportunity. The playbook for allocating to EM equities and bonds is no longer solely cyclically driven. In the past, we used to ask questions like: Do you think global growth will be healthy? Do you think commodity prices will be strong? Do you think EM currencies will be stable? If the answer to all these questions was yes, then EMs were very likely to

³Sources: National Bureau of Statistics of China/Haver Analytics, IMF, and data analysis by T. Rowe Price.

“For investors searching for yield, EM debt offers very attractive rates.

— Andrew Keirle
Portfolio Manager,
Emerging Markets Local
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outperform other regions. Now one must concede that it is much more complicated. Macro factors like global growth, commodity prices, and currency markets are still important, but they are now part of a much broader mosaic.

The opportunity lies in the recognition of two important realities: (1) EMs may continue to offer stronger economic growth trajectories than developed markets and (2) EMs now reflect a wider range of country-, sector-, and stock-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 exposure in a more active way to identify the best opportunities within EMs now.

Misconceptions About EM Debt

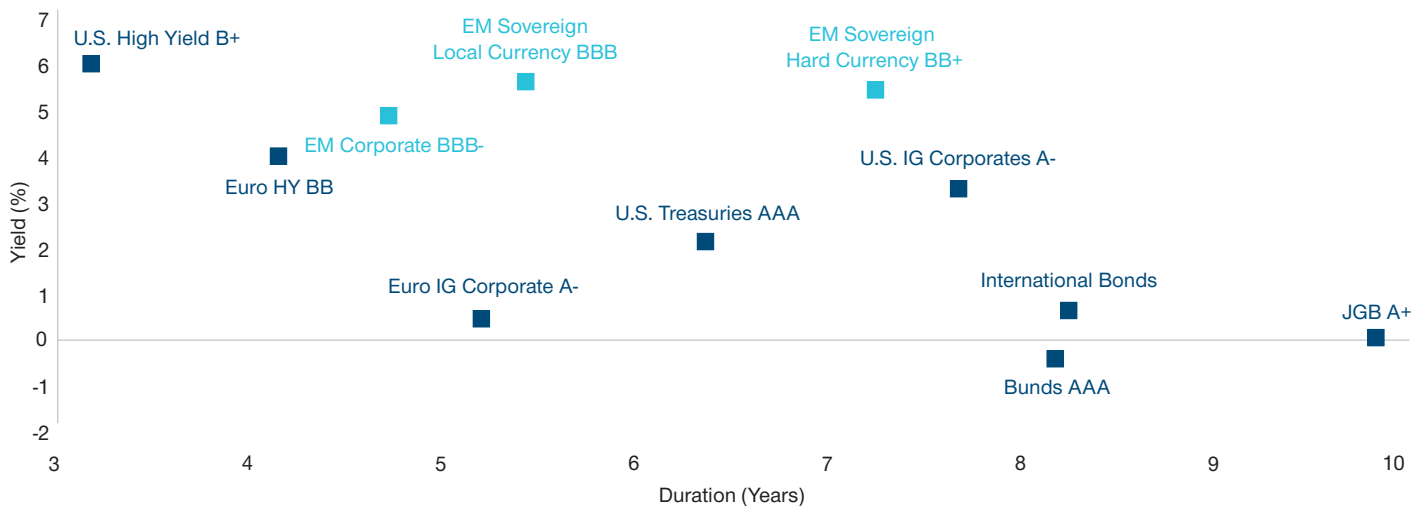
What about debt markets? Contrary to popular belief, EM debt is not the volatile and high-beta asset class that some may believe. Many regions and sectors offer defensive qualities that can outperform other asset classes during periods of risk aversion. EM corporates stand out as a particularly defensive sector due to their strong fundamentals. EM corporate debt is now a larger market than U.S. high yield or EM sovereigns, with over USD 2 trillion in bonds across 50 countries. Default rates are also at cyclical lows.

A huge factor is also the yields on offer. EM debt offers much higher rates than developed markets. At the same time, because of broad market diversification, the yield is more consistent. For example, EM local currency bonds⁴ have recorded

(Fig. 3) Looking for Yield?—Turn to EM Debt Markets

EM Debt offers investors much higher rates of yield than other areas.

As of July 31, 2019



Past performance is not a reliable indicator of future performance.

Sources: Bloomberg Index Services Limited (see Additional Disclosures), J.P. Morgan (see Additional Disclosures). Returns are in U.S. dollar terms. Data analysis by T. Rowe Price.

Benchmarks: EM Sovereign Hard Currency: J.P. Morgan EMBI Global; EM Sovereign Local Currency: J.P. Morgan GBI – EM Global Diversified; EM Corporate: J.P. Morgan CEMBI Broad Diversified; Euro High Yield: Bloomberg Barclays European High Yield; US High Yield: Bloomberg Barclays U.S. High Yield; US Investment Grade: Bloomberg Barclays U.S. Corporate Investment Grade; Euro Investment Grade: Bloomberg Barclays European Corporate Investment Grade; U.S. Treasuries: Bloomberg Barclays U.S. Aggregate – U.S. Treasury; International Bonds: Bloomberg Barclays Global Aggregate ex U.S.; Bunds: Bloomberg Barclays Global Aggregate – German Bund; JGB: Bloomberg Barclays Global Aggregate – Japanese Government Bond.

⁴ EM Local Currency Bonds are represented by J.P. Morgan Government Bond Index -Emerging Markets Global Diversified.

“ Emerging markets offer a fertile ground for finding quality, well-managed companies with the potential to grow their earnings consistently, year after year.

— Eric Moffett

*Portfolio Manager, Asia
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an average yield of 5.5% to 7.5% over the last eight years. Meanwhile, hard currency sovereign bonds⁵ boast absolute returns double that of EM equities⁶ over the past 25 years. With roughly USD 15 trillion in developed market debt offering negative yields, EM debt provides an attractive yield and duration profile with a compelling history of long-term risk-adjusted returns (Fig. 3).

Of course, there is always idiosyncratic risk involved with EMs, but the positive reforms in many EM countries mean that most are no longer just one or two bad decisions away from a crisis. Bottom-up, on-the-ground research can identify countries that are committed to consistent, market-friendly policy directions and reduce investors' exposure to policy error and those countries that are taking the wrong direction.

Even when significant sell-offs do hit certain EM countries, we don't believe this constitutes a systemic risk to the wider asset class. For example, Turkey and Argentina dominated the headlines for much of 2018 and 2019 as markets quickly lost confidence in their ability to manage their currencies and fiscal accounts. Some investors pulled out at the height of these crises, seeking safety in more familiar core developed market assets. However, this sell-off was short-lived and created better long-term opportunities.

Sudden downturns can provide opportunities to go against the grain and buy cheap assets. By uncovering when to reenter a distressed credit or sector, investors can improve their potential for long-term gains.

Where Are We in the Current Cycle?

Trade tensions between the U.S. and China, and growing concerns about global growth have reduced investors' risk appetite. Therefore, the prospects

for weaker growth and a flight to safety set a challenging backdrop for EMs in the short term.

An abrupt slowdown in China would weigh on global growth, but its heaviest impact would be on other EMs. We see this as unlikely, however, as Chinese policymakers have the monetary and fiscal policy tools to stimulate growth. The trade situation could also provide further motivation for China to boost its economy.

Meanwhile, pressure from the U.S. dollar on EM currencies should be more muted with the Federal Reserve on an easing path. Low inflation also gives scope for many EM central banks to lower interest rates, which has historically been a strong driver for these markets.

Valuations over the near and long term are appealing relative to history and to developed markets, while corporate earnings should also begin to improve. Weaker economic growth has led to negative revisions to earnings for 2019, but assuming global economies do not contract dramatically, EM earnings should likely recover heading into 2020.

It is important to state, however, that the past trajectory of EMs and winners at the individual stock and country levels will not be the same going forward. What will matter over time is the individual investments you own and whether they are growing and undervalued.

Overall, EMs look in good shape, but we expect more volatility in the near term as the trade situation plays out. We need more clarity on this, so we advise EM equity investors to bide their time, using periods of volatility to add to their exposure on a measured basis. For EM debt, however, the case for investing now seems more straightforward due to positive fundamentals and much higher yields on offer compared with developed markets.

⁵ Hard currency sovereign bonds are represented by J.P. Morgan Emerging Markets Bond Index Global Diversified.

⁶ EM Equities represented by MSCI Emerging Markets Index.

A Global View: Challenges and Opportunities as a Non-EM Dedicated Investor

—Scott Berg, Global Growth Equity Strategy

Casting the net wider is hugely advantageous for me as a global equity manager. I believe that EMs are of huge importance to the global economy and have a range of growth characteristics that are not easily available in developed markets, allowing higher-quality companies in certain sectors to generate sustainable earnings growth at a much higher rate than the global average. Banks are a great example, with the return on equity for EM banks being far higher than their developed market counterparts.

These markets are difficult and tend to be less efficient than in the developed world, but that makes them a more fertile hunting ground for investors like me with enough resources to identify the best opportunities. One of the core tenets of our investment philosophy is that quality growth stocks are frequently mispriced because the market underappreciates the durability of long-term earnings stream. This is especially true in EMs where the demographic and secular drivers are very long term in nature.

Another fundamental principle is that stock-specific factors are the key drivers of stock prices over the long term. Ultimately, we look to invest in companies that offer high-quality, growing businesses in good industries, but that also offer a valuation

opportunity that gives high-conviction upside potential. There are many such companies to be found within EMs.

Banks are a great example, with the return on equity for EM banks being far higher than their developed market counterparts.

— Scott Berg
*Portfolio Manager,
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