A TOP-DOWN PERSPECTIVE ON EMERGING AND DEVELOPED MARKET DRIVERS

23 March, 2021

KEY POINTS

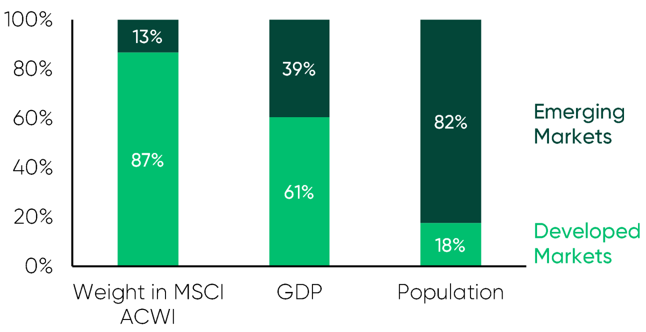
- Relatively stronger economic growth in emerging markets is likely to persist in the coming decades
- A weak US dollar acts as tailwind for emerging markets
- Modest growth and flat yield curves are beneficial to more growth oriented developed markets

INTRODUCTION

As investors weigh the implications of COVID-19 and what the recovery will look like, a global top-down perspective can help investors identify where future outperformance is most likely to come from. Developed and emerging markets represent the two major sub-asset classes within global equities, and over time the two have traded leadership over longer cycles. In the last decade, developed markets have led emerging markets as growth has significantly outperformed value. This paper seeks to explore what factors could influence a transition in leadership from developed markets to emerging markets. Through a top-down lens, we will look at economic, political and sentiment drivers that influence investment returns in each respective category.

Before looking at economic drivers it is useful to get an overview of the investable universe that exists within a global portfolio. As seen in exhibit 1, the MSCI ACWI index which comprises both developed and emerging markets, emerging markets remain underrepresented in equity indices and most investors' portfolios compared to its share of GDP, as well as population. This is likely set to change as emerging markets continue to develop and its public equity markets become more investable.

Exhibit 1: Share of MSCI ACWI, GDP and Population by Region

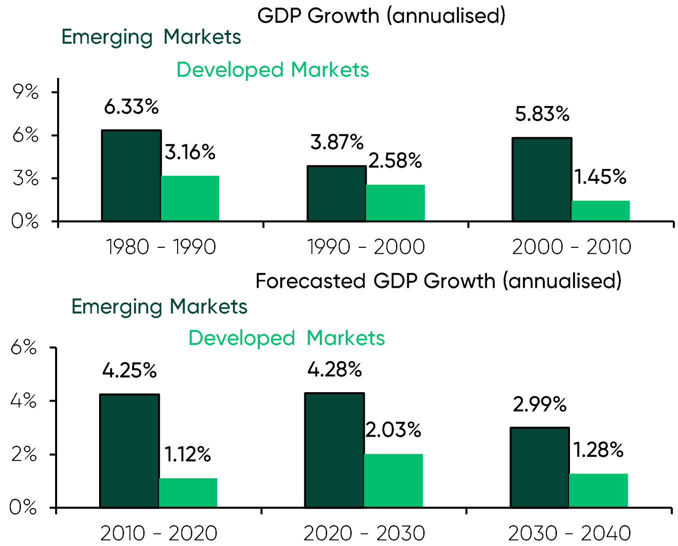


Source: Worldbank for GDP and Population data. As of December 2019. Weight in MSCI ACWI is as of 31/12/2020, as provided by FactSet. Data excludes countries not part of the MSCI ACWI Index.

ECONOMIC DRIVERS

Emerging markets have experienced significantly faster economic growth than developed markets in recent history. As shown in exhibit 2, forecasts show that this trend is likely to persist in the next couple of decades.

Exhibit 2: Historical and Forecasted GDP Growth

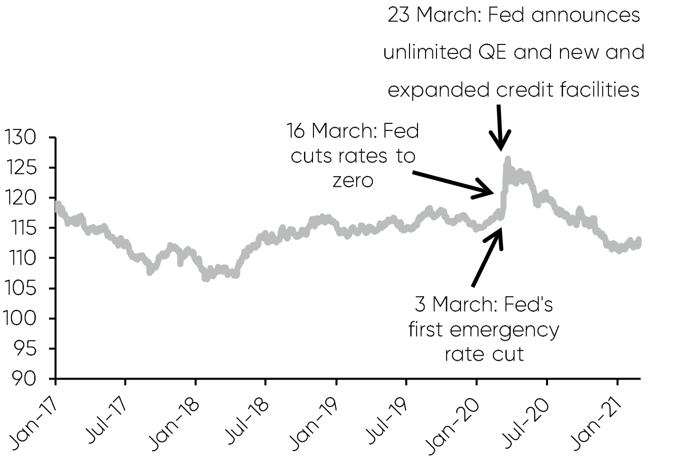


Source: Oxford Economics, World Bank, FactSet. Years after 2019 are a forecast/estimation as 2020 GDP figures have not been released by the World Bank.

As economic growth in emerging markets continue to outpace that of the developed world, this should help boost per capita income and spending levels, benefiting companies exposed to EM economies. Further, expected gains in per capita GDP have an outsized impact on aggregate consumption, as hundreds of millions of EM households are graduating into the middle class. Meanwhile penetration rates in EM for both basic and discretionary goods and services remain much lower than those of developed peers. This should provide companies with exposure to growing EM economies a structural tailwind as untapped demand for these goods and services increase. This long-term structural backdrop with higher relative economic growth, paired with a recovering global economy and easing trade tensions should provide a boost to growth in EM over the next 12-18 months.

The sharp downturn in global equity markets in March 2020 led to a spike in the US dollar as market participants fled to safety in a widespread risk-off trade. As the volatility escalated, the US Federal Reserve took quick action, cutting the fed-funds rate to zero in two stages and restarting its quantitative easing program. The Fed also launched new programs to support corporate bond markets, and initiated other measures to boost liquidity to banks, businesses and global central banks running short on dollars. Since global equity markets bottomed out on 23 March, there has been a steady reversal of the risk-off trade as global markets have recovered. As seen in exhibit 3, the trade-weighted dollar index peak coincided with the market bottom on 23 March when the Fed announced unlimited quantitative easing and expanded its credit facilities. Since then the US dollar has weakened significantly signaling a return of the risk-on trade as the global economy recovers from the COVID-19 crisis.

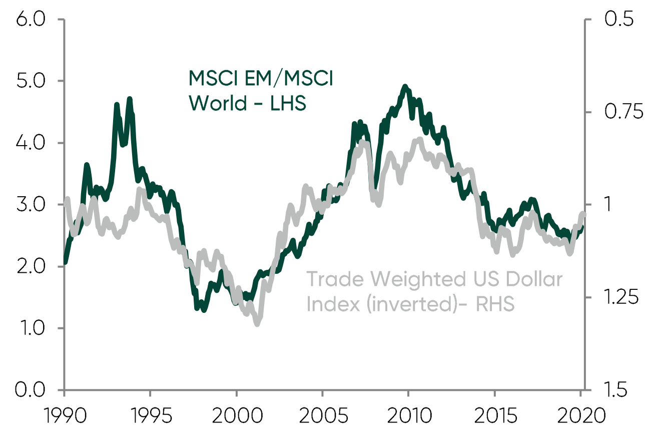
Exhibit 3: Nominal Trade-Weighted USD Index



Source: FactSet, indexed to 100 from January 2006, data shown from January 2017 to February 2021.

Historically a weaker US dollar has been a tailwind for emerging markets. As seen in exhibit 4, EM outperformance shows a high negative correlation to a trade weighted US dollar index.

Exhibit 4: USD and EM Negatively Correlated



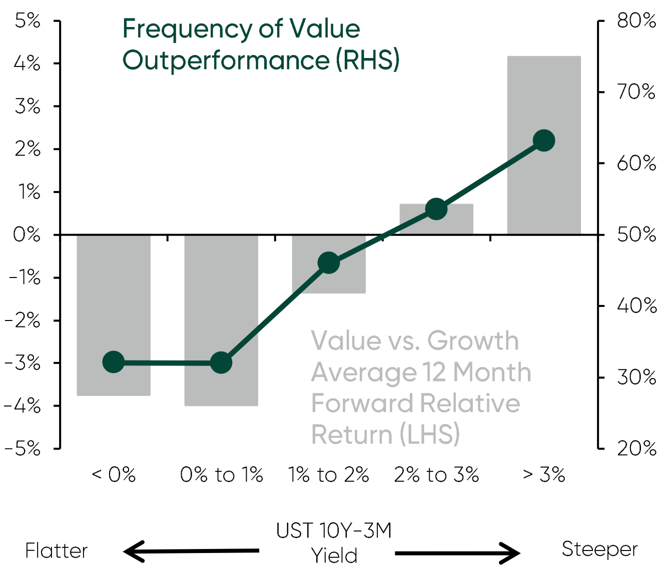
Source: FactSet, MSCI EM/MSCI World and Trade Weighted US dollar index both rebased to 1 on 31/12/1990. Data as of 26/02/2021.

While emerging markets have evolved over the last decade with growth in sectors like Information Technology and Consumer Discretionary, many emerging market countries still have a high sector concentration, with one or two sectors making up a majority of countries' publicly traded equities. These countries tend to have a high concentration to Financials, as well as resource heavy sectors like Energy and Materials. Therefore, emerging market countries overall are more influenced by natural resources and oil prices than developed markets and responds more to expectations of economic growth. In contrast, developed markets have a higher concentration of growth companies, which typically thrive in modest-growth environments.

With Energy and Materials among the leading sectors in early 2021, talks of sustained commodity price inflation has started to pick up steam. We think this thesis is only partially correct. In our view, metals prices should continue benefiting from the economic recovery from last year's lockdown-induced contractions, which boosts demand. With supply relatively slow-moving, that bodes well for metals and mining profits. Energy supply is much more nimble, however. Several key producers have already announced plans to increase output, which likely keeps a cap on supply, as well as prices, even as demand recovers.

Emerging markets' significant exposure to Financials makes it more sensitive to economic growth and yield curve spreads relative to developed markets. As seen in exhibit 5, growth on average outperforms value in a flat yield curve environment. As spreads rise, value outperforms growth as value sensitive sectors such as Financials are more likely to outperform. With challenging lending conditions in recent years, what matters for banks going forward is fundamental improvement in their lending environment. If the recent rise in long-term rates were to persist and yield spreads widen further, this could provide a tail-wind for emerging market and developed market countries that are more value oriented with large financial sectors as rising long-term rates would aid banks' loan profitability.

Exhibit 5: Narrow Yield Spreads Favor Growth



Source: FactSet as of 31/12/2020. Shows Russell 3000 Value vs Russell 3000 Growth forward 12 month relative performance starting 28/12/1978. Relative performance shows as an average for different levels of the US yield curve spread

Further, if US dollar weakness were to persist, this could also help boost emerging market demand for commodities as relative prices in EM currencies decrease. In addition, if a global recovery with accelerating economic growth takes hold, as the world emerges from the COVID-19 crisis, this could have a positive influence on the value oriented sectors that make up a large portion of emerging markets.

POLITICAL DRIVERS

When looking at political drivers, developed and emerging markets face different issues and challenges. For developed markets with well-developed political systems, strong property rights and a history of democratic governance, equity markets tend to favor political gridlock over sweeping legislation. In the short term, potential major legislative and regulatory changes with uncertain outcomes tend to increase volatility as equities price this uncertainty and the potential effects on businesses.

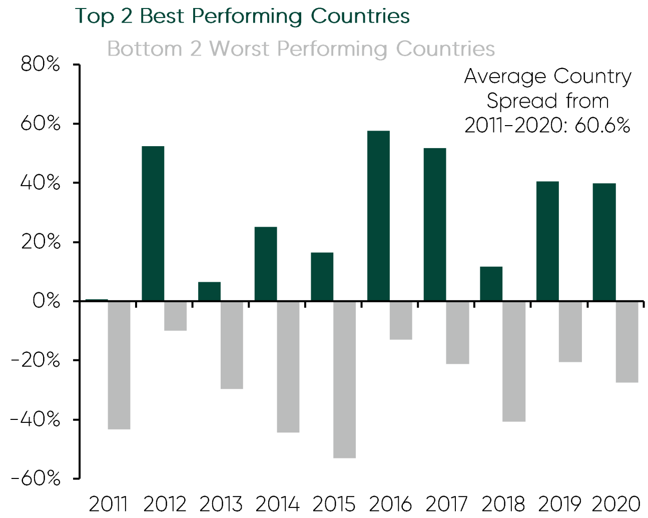
Looking ahead, the political roadmap for the developed world in 2021 should be much quieter than what we saw in 2020. With the US elections behind us and with Britain finally exiting the EU on 31 December, the political backdrop for 2021 looks relatively uneventful in comparison to 2020. Nonetheless, there are a few national elections scheduled for 2021, including Germany and Japan, that we will monitor closely, although at this point, none look poised to deliver big change.

Contrary to developed markets, many emerging markets have less developed political systems and require more sweeping legislation to address issues like property rights, access to foreign direct investments and other pro-growth reforms that can help stimulate economic growth. What can be seen now is that many emerging market countries are enacting pro-growth oriented reforms, such as lowering taxes, liberalising financial markets and opening state-run industries to private competition.

An example of this is Brazil, where political reform hopes fueled by President Jair Bolsonaro and Minister of the Economy, Paulo Guedes' lofty reform agenda set aim to make Brazil more business-friendly and to open up opportunities for outside investors. Proposals included pension reform, which was successfully passed in 2019, an overhaul and simplification of the tax system, privatisation of state-owned companies and a reduction of the budget deficit. With the pandemic, remaining reforms have been largely delayed or moderated. As the reform agenda stalls, recent political news coming out of Brazil has been a cause of concern for investors, headlined by President Bolsonaro's ousting of Petrobras' CEO Roberto Castello Branco. The heightened political uncertainty in Brazil is an example of how market-friendly reforms in emerging market countries can get derailed as the political landscape and sentiment changes quickly. Nonetheless, the economic agenda in Brazil still has the potential to provide a positive catalyst if Congress can successfully resume its efforts to overhaul the country's tax system and improve the fiscal situation in Brazil by keeping the budget contained within the spending ceiling.

EM countries successfully enacting measures like the ones proposed in Brazil's reform agenda should help drive future economic growth through more efficient allocation of resources. Important to note however, is that drastic political changes can be very fragile in countries in which governments lack well-established institutions with a track-record of consistent policymaking. Positive reform agendas enacted under the rule of one administration can see its progress diminished a few years later as a new administration takes hold and rolls back previously enacted legislation. This lack of political stability in many EM countries contributes to the significant country spreads seen between the top performing countries and worst performing countries in emerging markets as seen in exhibit 6. By utilising a top-down view and evaluating political risks on a country level, investors can significantly improve relative returns by minimizing exposure to countries where political instability is deemed to have a negative effect on equity markets as well as increasing exposure to countries adapting more market-friendly legislation likely to have a positive impact.

Exhibit 6: MSCI EM Country Return Spreads



Source: FactSet as of 31/12/2020. Data shows the arithmetic average of the performance of the top 2 countries in the MSCI Emerging Markets Index that outperformed the overall MSCI Emerging Markets Index for a given year. The same concept is applied for bottom 2 countries. The "Average Country Spread" is the arithmetic average of the yearly spread between the two. Price returns in USD.

SENTIMENT DRIVERS

Although recent EM outperformance has narrowed the valuation spread between EM and DM, looking at forward earnings the MSCI Emerging Markets Index still trades at a wider spread to the MSCI World Index compared to its three- and five-year averages.

Exhibit 7: MSCI World vs MSCI EM, Price-to-Earnings Spread

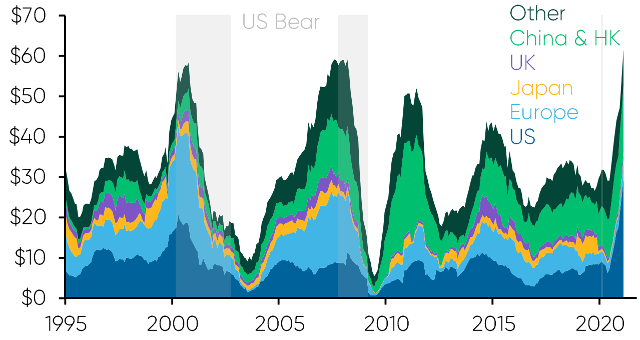
Source: FactSet as of 26/02/2021. MSCI World and MSCI EM forward price-to-earnings ratios with valuation spread shown as MSCI world forward P/E-MSCI EM forward P/E.

In addition to valuations, an important sentiment driver that we monitor to gauge sentiment is IPO activity and levels of aggregate equity supply. Recently, developed markets issuance has been driven mostly by the US. The US aggregate equity supply has been growing rapidly in the last 12 months, driven primarily by IPOs and follow-on issuance. A big part of this fast growth has been the growing share of special purpose acquisition companies, also known as SPACs. In the last 12 months, US SPACs made up roughly 60%[i] of total proceeds from US IPOs. Although the aggregate equity supply has been growing quickly and is approaching previous historical highs, in our view, we have yet to reach aggregate equity oversupply.

Second to the US in global IPO issuance is China, which has seen its own IPO boom recently with the launch of ChiNext and StarMarket boards driving a surge in listings. China makes up a dominant portion of emerging markets issuance and in the last twelve months roughly 25%[ii] of all global issuance. Adding to the recent surge in China and Hong Kong listings, the US passed a bill requiring foreign companies to submit their financial audits to US regulators to retain their listings on US exchanges. China presently bars mainland firms from complying with this requirement, which will likely push some companies to return to Hong Kong and local listings.

The recent IPO boom is one place where we see froth right now, both in emerging and developed markets. As seen in exhibit 8, the US and China have been the primary drivers of the recent heightened levels of global IPO issuance, with Europe and other parts of the world making up a smaller portion than seen in previous years. Although we have yet to see this lead to aggregate equity oversupply, we think that monitoring the quality of IPOs will be key in the months ahead.

Exhibit 8: IPO Gross Proceeds by Country/Region ($Bil)



Source: Thomson Reuters & DataStream. Data shows gross inflation-adjusted IPOs, in 1971 billion $ from 1/1/1995-28/2/2021

CONCLUSION

Developed markets have led emerging markets over the last decade, largely attributed to the relative outperformance of growth over value. However, during this period emerging markets have evolved and now consist of a more diverse equity universe that now represents attractive opportunities for growth oriented investors. Despite this, many investors still view emerging markets as a homogenous category. While many EM countries still have a significant value tilt due to large exposure to quintessential value sectors such as Financials, Energy and Materials, sectors with more growth exposure such as Information Technology and Consumer Discretionary are becoming a larger part of many EM countries' public equity markets.

Among the potential tailwinds for emerging markets are a weakening US dollar, rising commodity prices and political reforms aimed at liberalising financial markets and stimulating economic growth. Possible headwinds include lower than expected economic growth, political instability and continued challenging lending conditions for banks. On the contrary, for developed markets with a more growth oriented sector composition, tailwinds include modest economic growth, political gridlock and a flat yield curve. Whereas a strong growth environment with rising rates and a steepening yield curve would tend to benefit more value oriented countries, making developed markets less attractive on an aggregate relative basis.

By utilising a flexible top-down view when analyzing future sources of return for developed- and emerging markets, investors can position themselves to take advantage of country and sector tailwinds, and by doing so, put themselves in a good position regardless of when a transition in leadership between developed- and emerging markets occurs.

[i] *Source: Thomson Reuters & DataStream. TTM US SPACs proceeds as % total of US IPOs as of 28/02/2021.*
[ii] *Source: Thomson Reuters & DataStream. China and Hong Kong TTM IPO proceeds as % of total global IPO proceeds as of 23/02/2021.*

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