Rethinking Emerging Markets

By Tim McCarthy, Daniel Kern, CFA®, and Gerard Cronin, CFA®

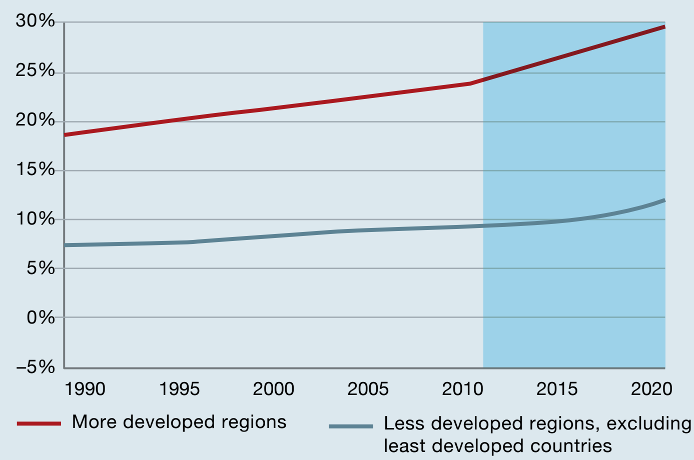
Most U.S. investors invest too little outside their home country. Some of the world's leading companies are located outside the United States, with companies such as Samsung, Taiwan Semiconductor, and Alibaba representing an important part of the global investment universe.

We think that investors should think differently about their approach to investing in emerging markets. Too many investors have been conditioned to think that emerging markets rise and fall in lockstep and that the decision to invest is a binary one—they are either in or out of emerging markets. Going forward, we expect to experience more distinction between winners and losers in normal environments, and we have adjusted our approach accordingly.

Role of Demographics

Demographics are a key element to the growth prospects for emerging markets and are mentioned often by proponents of emerging-market investing and skeptics for the prospects of developed markets (see figures 1 and 2). The importance of demographics was highlighted in McCarthy (2014), and in a recent interview Research Affiliates' Rob Arnott called demographics "the markets' 800-pound gorilla" (Strauss 2014). The demographic argument is a simple one: Aging societies consume less, grow more slowly, and have budgetary constraints tied to the aging population. Japan is the poster child for the demographic burdens of an aging society, though an aging population is far from Japan's only economic challenge. Emerging markets represent the other side of the coin, boasting younger societies with a much lower old-age dependency ratio. From this perspective,

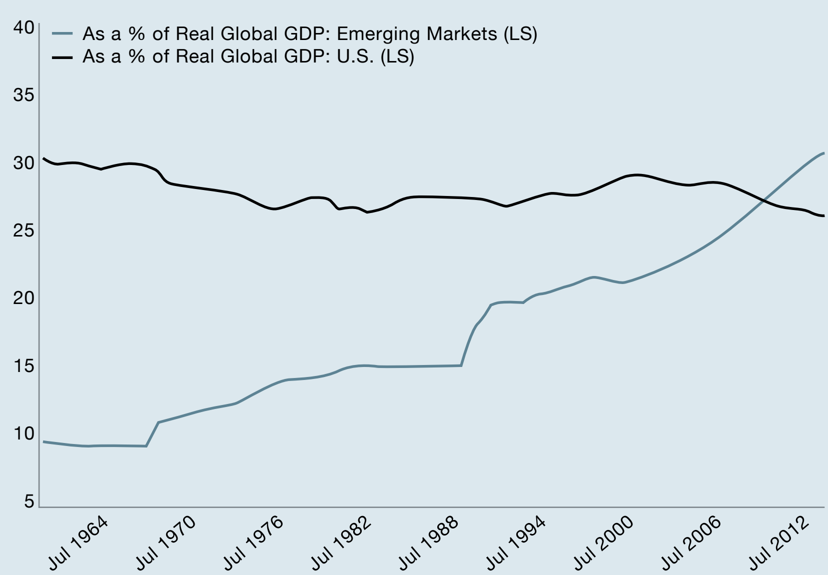
Figure 1: Emerging Markets Have a Lower Old-Age Dependency Ratio*



*Ratio of 65+ year-olds to 15–64 year-olds

Source: UN Population Division. Blue area indicates forecasted data.

Figure 2: Emerging Market GDP as Large as the United States



* Includes China, Korea, Poland, Turkey, India, Philippines, Thailand, Indonesia, Mexico, Brazil, Malaysia, Chile, Russia, Colombia, Czech Republic, Hungary, Vietnam, Venezuela, Peru, Singapore, Middle East and Africa

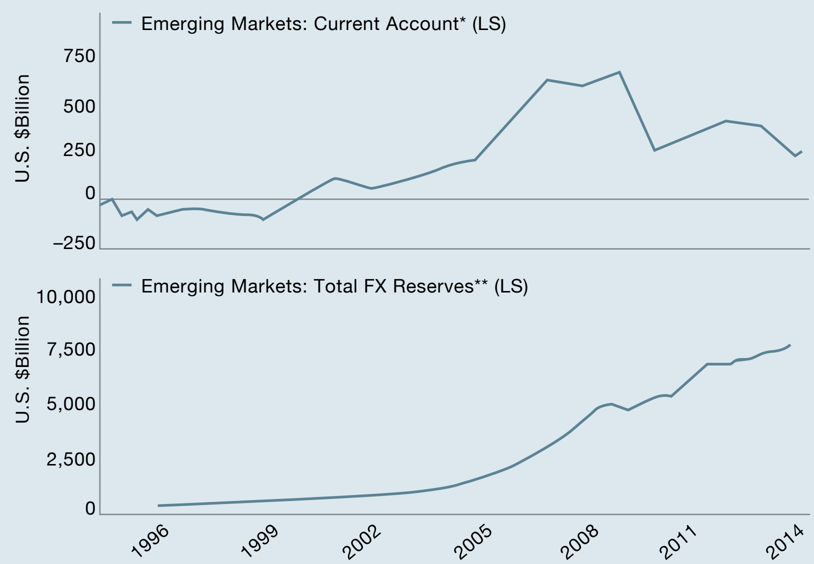
Source: World Bank

emerging markets may offer faster growth, more consumption growth, and favorable budgetary trends.

Fundamental Changes

Many of today's investors came of age in the 1990s, observing cycles in which emerging markets alternated between explosive growth and spectacular collapse. These boom/bust cycles were a function of immature economic development and governance, coupled with strains associated with the rapid growth enjoyed by many emerging economies. Fueling the turbulence were current account deficits, pegged exchange-rate regimes, limited foreign currency reserves, and a reliance on unstable sources of funding from foreign investors (see figure 3). The International Monetary Fund (IMF) and developed markets' central banks lectured emerging-market leaders from a soapbox, championing a variety of fundamental changes that in many cases became conditions tied to bailout programs. Emerging markets have made substantial progress in recent years, e.g., they have lowered inflation (see figure 4), while developed markets in many respects have deteriorated. The financial crisis awakened investors to how much has changed in emerging markets as well as the demographic challenges awaiting much of the developed world. Many investor conversations during 2008 and 2009 highlighted the reversal of fortune: a new reality in which the developed world faces high budget deficits, unstable banking systems, and unsustainable public finances. Emerging markets were arguably the biggest beneficiaries of quantitative easing, as generous liquidity conditions combined with the reversal of fortune between developed and emerging markets to fuel explosive rallies in emerging-market stocks and bonds. This rally ended in 2013, a function of slowing growth in emerging markets and the threat of tightening liquidity as quantitative easing comes to an end.

Figure 3: Improvements in Current Account and Reserves

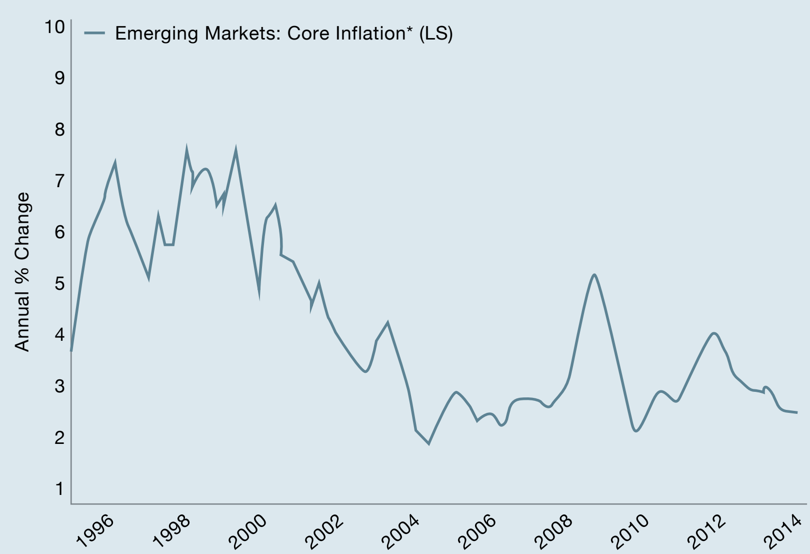


*Includes forecast for 2013. Source: International Monetary Fund

**Source: International Monetary Fund

Source: BCA Research Inc.

Figure 4: Emerging-Market Core Inflation



*Market-cap weighted average of 20 emerging economies; shown as a three-month moving average.

Source: BCA Research Inc.

Growth Countries

As we enter a period in which global liquidity conditions are less likely to support a "rising tide that lifts all boats," a group of countries within the emerging markets may be set for long-term success in the future. McCarthy (2014) calls these "growth countries." Demographic advantages are just one factor that may allow the economies of growth countries to outperform. Other factors include stable economic and political systems. These countries benefit from a business-focused population segment that has built companies that take advantage of a relatively stable domestic business climate. Some of these companies have produced successful products or services that compete globally.

The roster of growth countries changes over time, but many people would agree that Mexico, the Czech Republic, Hungary, Poland, South Africa, China, Indonesia, Malaysia, the Philippines, and Thailand meet the definition of growth countries. Another group of "advanced growth countries" such as South Korea and Taiwan are further along the development path and may no longer have as rapid long-term growth prospects as the growth countries.

Slowing Growth, Mounting Challenges

Although the long-term prospects for emerging markets are compelling, the near-term outlook is far from rosy and the "bear case" for emerging markets has prevailed for much of the recent past. Gross domestic product (GDP) growth and margins, which were so strong leading into the financial crisis, have declined. Ample liquidity from developed markets fueled the boom in emerging markets subsequent to the financial crisis, but with the gradual tapering of quantitative easing in the United States, the liquidity boost is no longer as supportive of risk taking. Last year's "taper tantrum" shook investors out of complacency, and the rotation away from emerging markets was striking. Within emerging markets, liquidity conditions are far tighter than in developed markets, as is earnings momentum.

Our caution about the near-term outlook informs our conclusions about the need to approach emerging markets in a more selective manner. For much of the history of emerging markets, broad-based rallies and crisis-driven crashes were mostly top-down phenomena. As emerging markets mature, we expect emerging countries to increasingly decouple from one another, and we also expect some degree of decoupling within countries. Emerging market countries have differing demographics, less-synchronized economic cycles, and varying levels of political and economic maturity. Although emerging markets exited the financial crisis in better fiscal shape than developed markets, some of that advantage has been squandered through poor economic or political decisions.

Some emerging-market countries are entering the ranks of mature countries, e.g., South Korea and Taiwan. Others historically considered as growth countries, such as Brazil and Malaysia, may be caught in the middle-income trap, with plateauing growth a function of inefficient investment, poor labor market conditions, or populist and anti-capitalist policies. Frontier countries such as Saudi Arabia and Qatar appear on the verge of graduating, and other frontier markets represent the scariest of opportunities, offering potential growth that is a multiple of the investment outlay while simultaneously providing the risk of permanent loss of capital.

Table 1: Top Country Weights in MSCI Emerging Markets Index

Country	Percent Weight in Index
China	18%
South Korea	16%
Taiwan	12%
Brazil	11%
South Africa	8%

Source: msci.com, as of April 30, 2014

Table 2: Top Company Weights in MSCI Emerging Markets Index

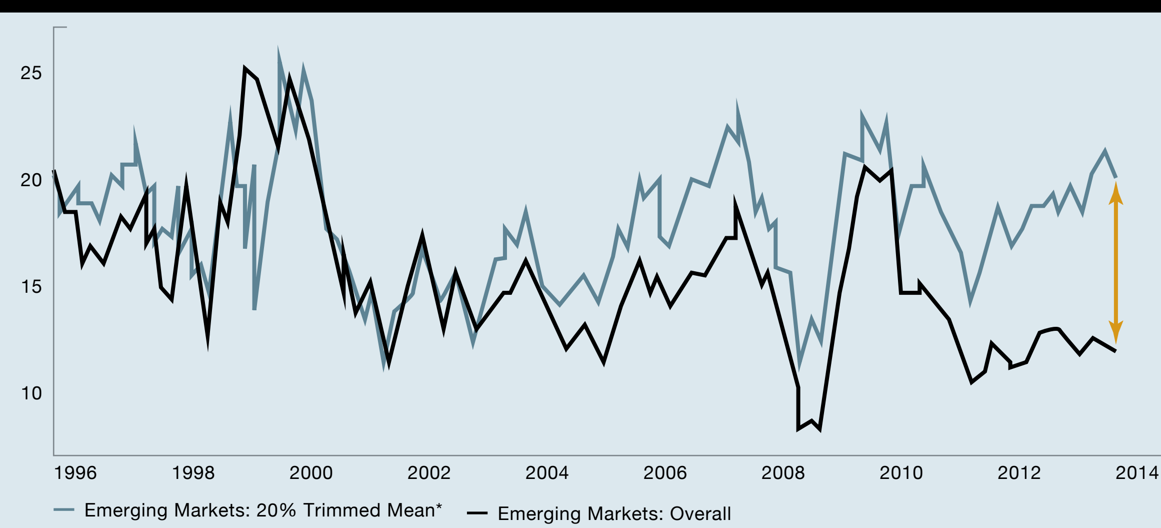
Company (Country)	Percent Weight in Index
Samsung Electronics (S. Korea)	3.8%
Taiwan Semiconductor (Taiwan)	2.6%
Tencent Holdings (China)	1.7%
China Mobile (China)	1.5%
China Construction Bank (China)	1.3%

Source: msci.com, as of April 30, 2014

Selectivity

Now more than ever, the outlook for emerging markets is nuanced and selectivity is critical. Although we've relied mostly on passive equity investments in recent

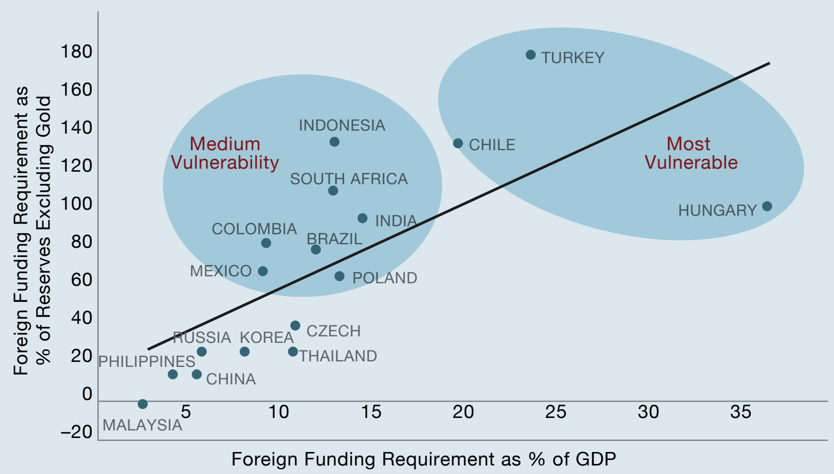
Figure 5: Trends in Price-to-Earnings Ratios



*Includes 47+ industry groups

Source: BCA Presentation March 13, 2014

Figure 6: Some Countries Would Have More Trouble Replacing Foreign Funding



Source: BCA Presentation March 13, 2014

years, a stance supported by our review of past performance and risk, we've been revisiting our approach to investing in emerging-market equities.

Investing in emerging markets requires more selectivity as well as awareness that market sentiment can change rapidly with each new element of incremental information. For much of the past decade, certain countries were beneficiaries of the commodity supercycle, i.e., the boom in commodities fueled by demand from China, a falling dollar, and rapid economic growth. The commodities boom favored commodity-rich countries such as Brazil and South Africa. The boom in Internet services and mobile telephony was another megatrend, with South Korea and Taiwan the big winners (see tables 1 and 2).

Opportunities in coming years are likely to be much different, with themes including the rise of the emerging markets consumer, urbanization, and structural reform. Commodity consumers rather than producers may be winners, a reversal of the fortune that favored commodity-rich companies. Asset-light companies, big winners in recent times in the developed world, may replace the asset-rich firms that have been the big winners in emerging markets. We think that tomorrow's opportunities lie outside the countries and companies that dominate most indexes, and that there will be clear winners and losers. Although emerging markets appear to offer strong relative value as measured by the average price-to-earnings ratio for the asset class, the average masks pronounced differences between stocks at the high end and low end of valuation (see figure 5). The same type of divergences exist from a country perspective: Countries such as Turkey and Hungary are vulnerable to disruption in funding from foreign investors, but other countries have more stable internal sources of funding (see figure 6).

Consequently, we currently are favoring active investments in the emerging markets asset class. Some countries are in much better fundamental shape than others, again supporting a more selective approach. In recent times, we've observed currency pressures, deteriorating economic indicators, and political unrest among emerging-market countries. The developed world has largely been fixated by fears of deflations, and countries such as India and Brazil are struggling with inflationary pressures. We think that some countries are better positioned than others, and that some companies are poised to benefit from current trends while others are more vulnerable.

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