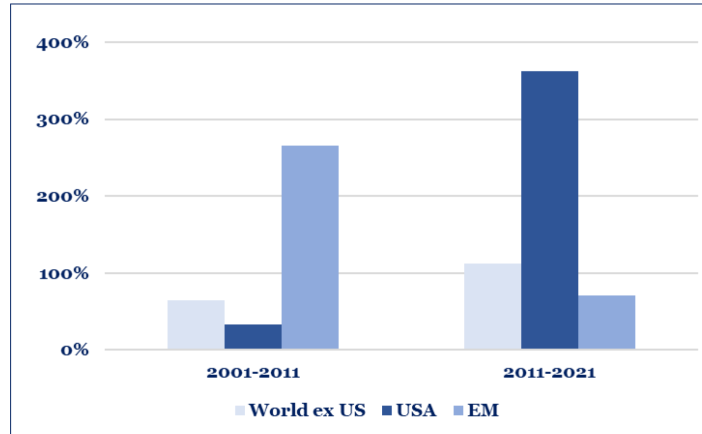
Can Emerging Markets Make a Comeback?

After a spectacular run in the 2000s, Emerging Markets were the worst performing equity asset class in the past decade, lagging both the United States and the international developed equity markets. During the 10-year period ending in Dec 2021, the US market was up 363% while MSCI EM and MSCI World ex US were up approximately 71% and 113%, respectively (Exhibit 1).

Exhibit 1. Equity Market Performance: Cumulative Return by Decades



Source: Bloomberg, MSCI, S&P

The prior decade ending in December 2011, however, was just the opposite when Emerging Markets rose 266%, significantly outperforming both the US and international developed markets. Consequently, the US and Emerging Markets have caught up in performance with almost identical returns over the last 20 years. A $100 investment made at the end of 2001 in the US and Emerging Markets would have returned close to $620 by December 2021. (Exhibit 2)

Exhibit 2: US versus EM Equity Market Performance of the Past 20 years

Source: Bloomberg, MSCI, S&P

As we look forward to the next decade, we ask the question: Will the US equity market continue to outperform? Or can Emerging Markets make a comeback and take leadership?

The easy answer is to assume the status quo. That is especially true as the Federal Reserve is in the early phases of monetary policy tightening and market participants are expecting as many as five rate hikes in 2022. After all, during the last taper tantrum in 2013, Emerging Markets declined -5% while the US equity market was up almost 30%. However, this time, we believe things could be different. In this report, we make a case for why we believe that the Emerging Markets could outperform in the coming years. Here are our key points:

- The US equity market entered the last decade with higher exposure to growth sectors, which turned out to be an advantage as growth outperformed value and caused a vicious cycle leading to the outperformance of US equities. By contrast, emerging equity markets were over-indexed in value sectors such as Energy, Materials and Financials, which created a headwind for performance.
- In a rising interest rate environment, we believe the growth-stock-heavy US is more likely to feel the negative impact of higher rates than will Emerging Markets which contain more value stocks.
- In addition, Emerging Markets are currently trading at historically attractive valuations. Even the largest EM country, China, which has more growth stocks has derated due to the Chinese government's crackdown on big technology companies and regulatory concerns while the smaller EM countries have higher exposure to cheaper value stocks. Thus, we believe that Emerging Markets are well-positioned to make a comeback even with higher interest rates.

Sector Composition

In Exhibit 3, we present the sector breakdown of the US versus Emerging Markets. As presented in this table, the US equity market is more heavily weighted in growth sectors such as Information Technology (I-T) and Health Care or more specifically Biotech companies. Meanwhile, Emerging Markets are generally lighter in healthcare companies. Amongst the growth sectors, the US is currently 16 percentage points overweight in I-T and healthcare although Emerging Markets are slightly overweight in Communications and Consumer Discretionary.

Exhibit 3. Sector Breakdown: December 31, 2021

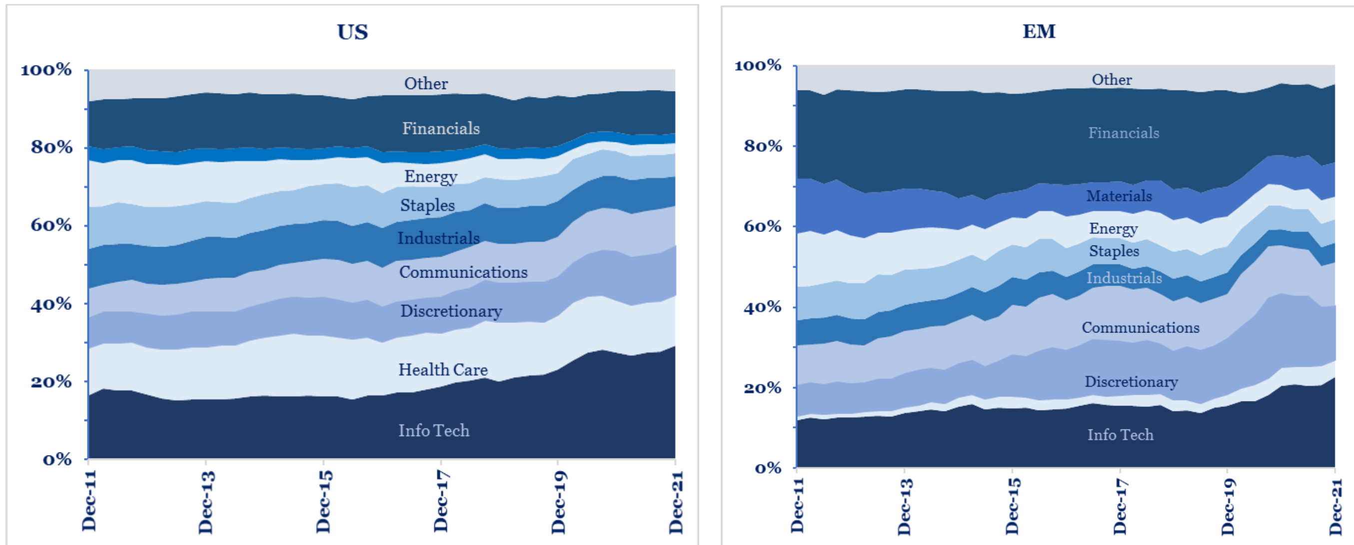
	MSCI USA	MSCI EM	Difference
Financials	10.5%	19.4%	8.9
Materials	2.5%	8.6%	6.1
Energy	2.5%	5.6%	3.0
Consumer Discretionary	12.6%	13.5%	1.0
Communications	10.1%	10.7%	0.6
Consumer Staples	5.7%	5.9%	0.2
Utilities	2.4%	2.4%	-0.1
Real Estate	2.9%	2.0%	-0.9
Industrials	7.8%	5.1%	-2.7
Information Tech	29.9%	22.7%	-7.2
Health Care	13.1%	4.2%	-8.9

Source: Bloomberg, MSCI

By contrast, Emerging Markets have a combined 18 percentage points more exposure to value sectors such as Financials, Materials and Energy. However, the higher value weight is not a new phenomenon. The historical sector charts in Exhibit 4 show that Emerging Markets have always had more value stocks. The US equity market entered the last decade with higher representation of growth sectors at 44% versus 30% in Emerging

Markets. As growth companies such as Netflix, Amazon, Meta Platforms (Facebook), Apple and Alphabet (Google) outperformed, their weights became larger causing the US to outperform further. Thus, growth outperformance created a vicious cycle leading to the US dominance.

Exhibit 4. Historical Sector Exposure: US vs. EM



Source: Bloomberg, MSCI

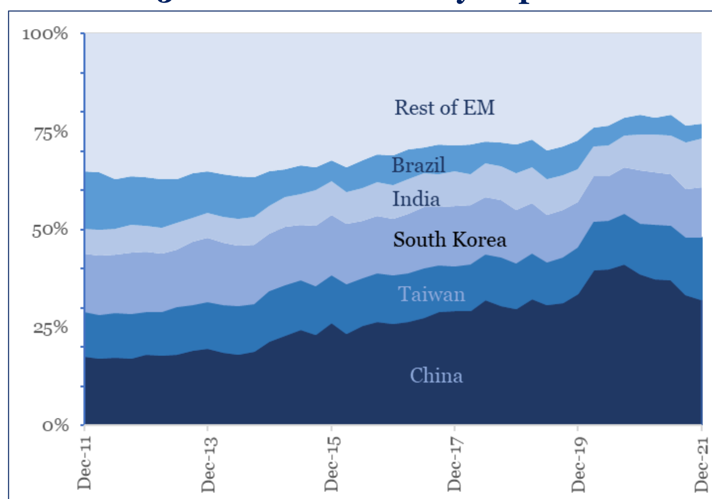
By contrast, Emerging Markets entered the last decade with almost double the value exposure relative to the US, at 49%. This created a scenario whereby as value stocks lagged, so did Emerging Markets. Even with growth companies such as Alibaba, Tencent and Taiwan Semiconductor, the emerging index never caught up with the US. By the end of 2021, value represented only 13.3% of the US driven by the decline in energy stocks from 12% to 2.7% while growth was 65%. In comparison, the Emerging Markets index was more balanced with 33.5% in value and 51% in growth. We believe that this sector mix could lead to a very different performance outcome of Emerging Markets this time. Although rising interest rates are bad for Emerging Markets, they are also negative for growth stocks, which are in abundance in the US.

Geographic Exposure

The divergence in value-growth performance over the last decade also impacted EM country weights (Exhibit 5). Brazil, Russia and South Africa, which are commodities-based economies declined from a combined weight of 28.7% to 10.4% driven by value underperformance. Meanwhile, China's dominance grew as large technology companies outperformed and in turn became even bigger. At the peak in October 2020, China was 42.7% of the EM index while the largest 5 countries were 80% of the benchmark.

However, since then, the Chinese government crackdown on big technology companies along with Xi Jinping's common prosperity agenda and tighter regulation on US-listed stocks have caused a drag. At the end of 2021, China was a third of Emerging Markets and the top 5 countries were 77% of the index while the remaining 20 countries made up only 23%.

Exhibit 5. Historical Country Exposure: EM



In Exhibit 6, we present country and sector matrix in EM with the largest sectors in each country marked in blue. Larger countries such as China and Taiwan also have more growth stocks. Meanwhile, those countries with higher exposure to value stocks were squeezed causing them to become smaller. Thus, almost half of the stocks in Financials, Materials and Energy are in Brazil and the smaller 20 countries while 80-100% of growth stocks are in the larger countries.

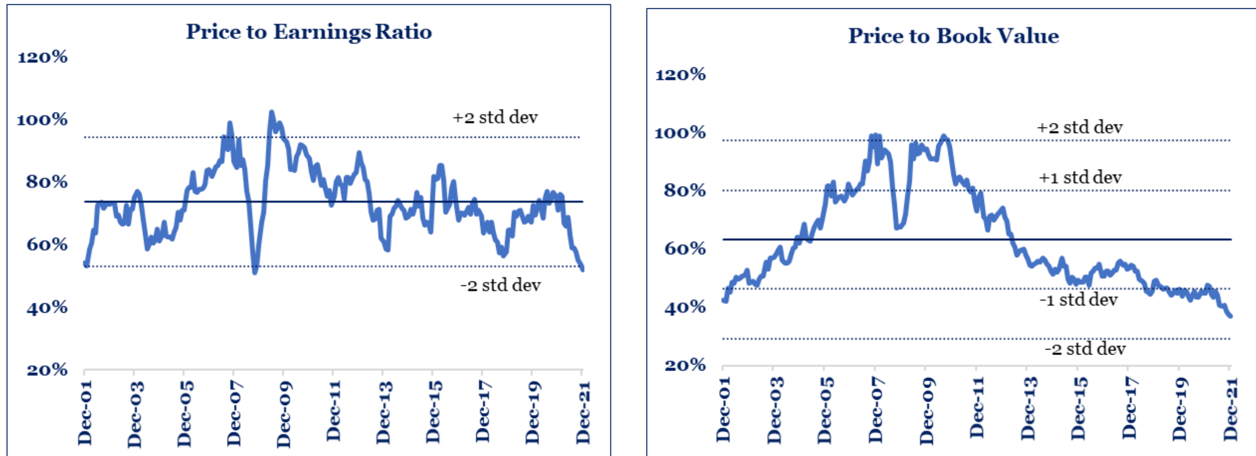
Exhibit 6: EM Sector Breakdown by Major Countries (December 2021)

		China	Taiwan	S. Korea	India	Brazil	Other	
Growth	Info-Tech	2.3%	11.6%	6.2%	2.5%	0.0%	0.1%	22.7%
↑	Communications	5.9%	0.3%	1.3%	0.4%	0.1%	2.7%	10.7%
	Discretionary	9.6%	0.4%	1.2%	1.0%	0.2%	1.2%	13.5%
	Health Care	2.3%	0.0%	0.7%	0.6%	0.2%	0.4%	4.2%
	Consumer Staples	1.9%	0.2%	0.4%	1.1%	0.4%	1.8%	5.9%
	Industrials	1.9%	0.5%	0.9%	0.6%	0.3%	0.9%	5.1%
	Real Estate	1.3%	0.0%	0.0%	0.1%	0.0%	0.5%	2.0%
	Utilities	0.9%	0.0%	0.1%	0.6%	0.2%	0.6%	2.4%
	Financials	4.7%	2.1%	1.0%	3.0%	0.9%	7.8%	19.4%
↓	Materials	1.1%	0.9%	0.9%	1.2%	1.0%	3.5%	8.6%
Value	Energy	0.5%	0.0%	0.2%	1.4%	0.6%	2.7%	5.6%
		32.4%	16.1%	12.8%	12.5%	4.0%	22.2%	100%

Valuation

Although Emerging Markets have been cheap for some time now, in Exhibit 7, we show that based on relative price to earnings and price to book value, Emerging Markets have not been this attractive in a very long time. Emerging Markets are currently trading two standard deviations below the mean on price to earnings relative to the US while on price to book, it is at the lowest point in the past 20 years. We believe the recent underperformance of China due to reasons mentioned earlier as well as the underperformance of value stocks in smaller EM countries have pushed Emerging Markets to an extremely attractive valuation.

Exhibit 7. Relative Valuation of Emerging Markets versus the US



Source: Bloomberg, MSCI

In comparison, during the taper tantrum in 2013, Emerging Markets were trading one standard deviation above the mean on a relative basis. Furthermore, the US and Emerging Markets were more balanced on their exposure to growth and value, in contrast to what it is today. At the end of 2012, US growth exposure was only around 45% versus 65% at present. As a result, we believe that the US is more likely to feel the pinch from the rising interest rates this time. By the same token, with higher exposure to value stocks that have valuation support, we believe the Emerging Markets are better positioned to weather the rising interest rate environment.