BLOG POST
Don't Give Up on Emerging Markets
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To say that emerging market equities have underperformed U.S. equities since the Great Recession of 2008-2009 is to state the obvious. Perhaps no other segment of the global equity universe has come under more pressure over the past ten years than those of developing countries. The underperformance has been substantial. But it's important to take a longer-term view and consider where emerging markets could go over the next ten years.

Prior to the Great Recession, emerging market equities provided attractive returns versus U.S. equities. On a cumulative basis from 2004 through 2007, emerging markets gained roughly 180% (as measured by the iShares MSCI Emerging Markets ETF) versus a corresponding gain of roughly 40% for large-cap U.S. equities (as measured by the SPDR S&P 500 ETF).

As pointed out by the IMF paper The Impact of the Great Recession on Emerging Markets (Llaudes, Salman and Chivakul 2010), the years prior to the Great Recession were marked by robust global trade and rising financial interconnectedness. Indeed, emerging markets reaped the benefits of a global economic expansion.

But as the authors point out, over the pre-crisis expansion, many emerging market countries developed external vulnerabilities, such as high current account deficits. Domestic demand was fueled by capital inflows. But when the music stopped, that is, when money center banks in developed countries imploded in 2008, financial interconnectedness was broken and capital inflows simply stopped. As shown in Chart 1 below, emerging markets as an asset class has been essentially "stuck" ever since. While the reasons for emerging market equity woes over the past ten years are myriad, the lesson seems to be that recessions after a financial crisis can be unusually long.

So, what does the future hold for emerging markets? To be sure, the equity markets in developing countries have always been volatile. The geopolitical and currency risk adds to the uncertainty of future returns. In addition, thematic reasons for investing in the asset class itself seem to be changing. As pointed out in the Financial Times (Does Investing in Emerging Markets Still Make Sense? Jonathan Wheatley, 2019), the "hyperglobalization" that began in the 1990s, in the form of a commodity supercycle and cross-boarder trade, drove emerging markets on a path of convergence with the developed world. But the landscape is different now. Commodity prices, in general, are lower today than where they were a decade ago, as measured by the GSCI Commodity Index. Today, we face trade wars in the form of tariffs, which is a far cry from the trade climate twenty years ago. In addition, direct foreign investment into emerging markets in aggregate is at its lowest level since the 1990s.

Despite the challenges, there are reasons, in our view, to hold an allocation to emerging economies if you have a long-term time horizon. Based on projections from the IMF, real GDP growth for developing economies in 2023 will be 4.8%. More specifically, India and Indonesia's real GDP growth are expected to be 7.4% and 5.3%, respectively. In contrast, projected real GDP growth for the U.S. by 2023 is expected to be 1.6%. For advanced economies in aggregate, projected real GDP growth is a mere 1.5%. Moreover, emerging markets have higher population and per-capita GDP growth rates. According to PwC Global, the size of the E7 economies (China, India, Indonesia, Brazil, Russia, Mexico and Turkey) could be double the size of the G7 economies by 2040.

One of the risks of investing in emerging markets is capital flows from wealthier, developed countries. In other words, local investors typically hold a smaller portion of the country's market capitalization, compared to foreign investors. But if demographics continue to shift, the impact of foreign capital flows on emerging market equity returns could diminish.

Despite current headwinds – tariffs, strong dollar, slower GDP growth from China – there is a rationale for holding a dedicated allocation to emerging markets within a global equity portfolio. The effects of the Great Recession hit emerging markets especially hard, and there are unique risks to consider. But the bottom line is that emerging markets will likely exceed developed markets in terms of population and GDP growth in the decades to come. As a consequence, they will likely represent a growing share of the world's market capitalization.