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BLOG POST

Emerging Market Equities

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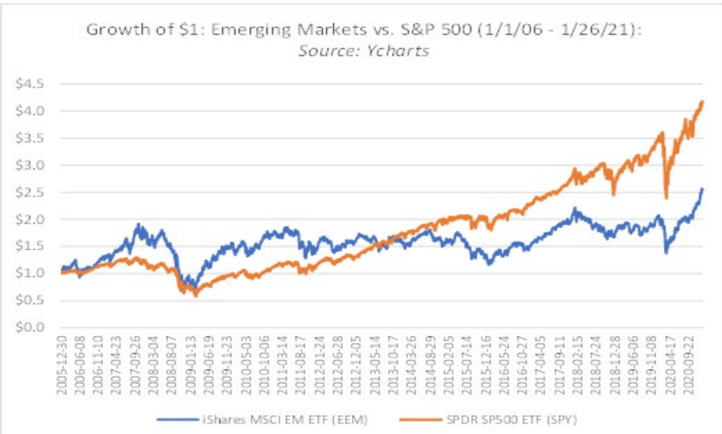
So far 2021 has been a good year for emerging market equities. Year-to-date the iShares MSCI Emerging Markets ETF is higher by roughly 8%, compared to a gain of approximately 3% for the SPDR S&P 500 ETF. As the chart below illustrates, ever since the financial crisis of 2008, emerging markets collectively have woefully lagged U.S. equities.

After moving more-or-less sideways for the better part of a decade, emerging markets have broken to the upside ever since the pandemic began in March 2020. Indeed, emerging markets have outpaced most developed market indexes.



To be sure, China drives much of the returns for the asset class, as it represents roughly 40% of the total market capitalization. The table below illustrates the top five emerging market economies, their percentage of the MSCI Emerging Market Index, and their respective performance for 2020:

Country	Weight	2020 Performance
China	40%	42%
South Korea	14%	39%
Taiwan	13%	32%
India	9%	15%
Brazil	4%	-20%

Source: MSCI, Ycharts

As the table above illustrates, returns for emerging markets were driven by strong performance, predominately from Asian economies. Latin American economies, such as Brazil, were harder hit by the coronavirus and materially underperformed the broader benchmark.

Given the recent run up in emerging markets, what could propel the asset class higher in 20201 and beyond? In the long-term, the likely catalyst is demographics. Developed markets such as the U.S. and Europe have aging populations, which could suggest lower productivity and GDP growth over the next decade compared to emerging market economies.

In their most recent capital markets report, JP Morgan projected GDP growth across emerging markets to be 3.9% in 2021, compared to 1.6% across developed markets (JP Morgan Long Term Capital Market Assumptions, 25th Edition). The report suggests both China and India will drive GDP growth, and that emerging markets productivity and human capital will gradually converge to developed market levels. This convergence is the narrative behind higher GDP growth.

In the shorter-term, currency valuations will have an impact on emerging market returns. The chart below illustrates the movements in the MSCI Emerging Markets Index against the USD Index:

Source: Lazard Outlook on Emerging Markets, 2021

Historically, there has been a strong negative correlation between movements in the USD and emerging market performance. As we have seen since the market lows in 2020, a weakening dollar has coincided with a rally in emerging market equities. With talks of further trillion-dollar COVID-19 relief, the USD could continue to weaken, which in turn could be a tailwind for emerging market equities.

Lastly, increased demand for commodities could help push emerging equities higher. According to Lazard Asset Management, a push for an infrastructure bill from the Biden administration should increase demand for materials and industrial products from emerging market countries (Lazard Outlook on Emerging Markets, 2021). Indeed, the S&P GSCI Commodity Index has moved higher by roughly 6% so far this year. However, investors should be reminded that promised infrastructure initiatives from four years ago never materialized.

Overall, there are some promising signs for emerging markets going forward. The long-term theme for investing in the asset class is driven by demographics – developed market populations are aging, while emerging markets, in terms of productivity and human capital – are catching up. This could lead to higher GDP growth for emerging economies over the next decade, but past that period, certain emerging markets may contend with their own demographic challenges. For example, China will need to grapple with the demographic consequences of its one-child policy.

In the short run, a weakening USD and increased demand for certain commodities from the U.S. could be a tailwind for emerging markets. Likewise, the continued distribution of the COVID-19 vaccine in countries outside of Asia should help lift the broader asset class.