Will Emerging-Markets Equities Ever Reemerge?

Analysis of the Morningstar Emerging Markets Index reveals compelling valuations, potential catalysts, and some diversification benefits.

Morningstar Inc.
January 2024

Dan Lefkovitz
Strategist, Morningstar Indexes
dan.lefkovitz@morningstar.com

https://indexes.morningstar.com/

"Avoid emerging markets when everyone talks about them and invest twice as much as usual when nobody likes them" said Antoine van Agtmael, who coined the term "emerging markets" back in 1981.

U.S. equities have now dominated the investment landscape for over a decade. The combined market value of Apple, Microsoft, Amazon.com, Nvidia, and Alphabet exceeds that of the entire Morningstar Emerging Markets Index.[1] Frustrated fund investors have redeemed tens of billions from emerging-markets equities strategies in the past couple of years alone, according to Morningstar asset flows data.

Many of today's investors can't remember a time when emerging-markets equities were hot. Yet, in the early 2000s, China was booming; the European Union was expanding eastward, and the "rise of the rest" narrative was trending. BRICs funds proliferated, focused on the promising markets of Brazil, Russia, India, China (and sometimes South Africa). During a "Lost Decade" for U.S. equities from 2000 to 2010, emerging markets provided an oasis of strong returns.

In a sign of the times, Morningstar will soon retire its category for BRICs mutual funds.[2] China has been deemed "uninvestable" by some after the government kneecapped leading private companies in 2021. Russia's invasion of Ukraine the following year took it off the investment map. A commodities bust in the mid-2010s brought down Brazil, and while India has prospered, it has been overshadowed by the U.S. In the spirit of van Agtmael's contrarianism, it's worth examining the asset class.

Key Takeaways

- U.S. strength, China weakness, among other factors, explain emerging markets' underperformance. The link between the asset class and U.S. interest rates looks weaker than it once did.
- Valuations have supported emerging-markets equities for some time now; it's hard to believe the asset class traded at a premium to developed-markets equities in 2007 and 2010.
- Potential catalysts for emerging markets include India's growth, an oversold China, the energy transition, and the U.S. dollar weakening.
- Plenty of emerging-markets companies enjoy economic moats supporting sustained profitability.
- Emerging markets offer more diversification benefit relative to U.S. and European equities than developed markets offer each other.

1 For a full discussion of index methodology, see "Construction Rules for the Morningstar Global Markets Indexes." Morningstar.
2 See: Latest Updates: Morningstar Category Changes - Apr. 30, 2024.

Still 'Emerging' After All These Years

"Convergence"—the idea that developing economies will inevitably catch up—was once taken as a given. It happened for the "Asian Tigers" (high-growth economies of Hong Kong, Singapore, South Korea, and Taiwan) in the second half of the 20th century and across Europe's periphery as the EU expanded. Yet, the shine has come off emerging-markets investments in recent years. As displayed in Exhibit 1, the Morningstar Emerging Markets Index posted a cumulative return of just 46% for the decade ending in 2023, compared with a 135% increase for the Morningstar Developed Markets Index.

Exhibit 1 Emerging-Markets Equities Have Badly Lagged Developed Markets Over the Past Decade

Source: Morningstar Direct. Data as of Dec. 31, 2023. Gross return in U.S. dollars.

Why have emerging markets underperformed so dramatically? Part of the story is the strength of the United States, which now represents 68% of developed-market capitalization. A cohort of phenomenally profitable, fast-growing companies has dominated the investment landscape. Apple and Microsoft's share prices are both up by a factor of 10 since 2014. Amazon.com is up nearly 7 times, Meta more than 5, and Alphabet roughly four. The biggest contributor to Morningstar Emerging Markets Index returns for the past decade is Taiwan Semiconductor, which has benefited from many of the same forces as its global counterparts and is up more than 6 times since 2014—but it's something of an outlier.

The other side of the coin is emerging-markets weakness. The "Taper Tantrum" of 2013—when the Fed announced it would reduce monetary stimulus—dealt the asset class a massive blow. Commodity price collapses of 2014-16 hurt natural-resources-linked markets like Brazil, Russia, and South Africa. Russia's invasion of Ukraine and the ensuing sanctions regime took it off the map for most investors.

China is another key chapter in the story. In the years following the 2007-09 financial crisis, China became the largest emerging market. By the end of 2020, Chinese internet companies Alibaba and Tencent were among the 10 largest public companies globally, boosting emerging-markets' share of the

Morningstar Global Markets Index to 13.4%. Then came a government crackdown, which saw leading companies' market values slashed. At the macroeconomic level, China was widely anticipated to bounce back strongly in 2023 from "Zero Covid" lockdowns, but a property-market downturn and other woes undermined recovery. China's decline helps explain why emerging-markets' share of the Morningstar Global Markets Index fell to 11.75% by 2023's end.

It was not so long ago that roles were reversed. From 2000 to 2010, U.S. equities experienced a "Lost Decade." The dot-com bubble burst in the first quarter of 2000; 9/11 happened; and then recession in 2022. The Morningstar Developed Markets Index managed just a 1.3% average annual return over 10 years.

Over the same span, emerging-markets equities produced a near-10% average annual gain. The asset class boomed, especially between 2003 and 2007. The U.S. Federal Reserve's move to slash interest rates in 2003 was undoubtedly part of the story, unleashing capital flows and a risk-on market mode. China's turbocharged economic growth fueled a "commodities supercycle," with demand for resources like iron ore, gold, and oil lifting many emerging markets. The European Union's eastward expansion helped the likes of Poland, Czech Republic, and Hungary. The global financial crisis that began in late 2007 hit emerging markets hard, but the asset price rebound of 2009-10, sparked by central banks' aggressive stimulus, put them back on top.

Exhibit 2 Emerging Markets Thrived from 2000-10, Dubbed "The Lost Decade" for U.S. Stocks

Source: Morningstar Direct. Data as of Dec. 29, 2023.

The link between emerging-markets' performance and interest rates in developed markets, especially in the U.S., looks to have weakened over the past decade. Years of zero interest-rate policy, or ZIRP, and negative rates in Europe and Japan failed to benefit the asset class. The Morningstar Emerging Markets Index outperformed only marginally in 2020, after global central banks responded to the pandemic with monetary stimulus. The low-rate environment of 2021 was a horrible year for the asset class, thanks mostly to China, while the Morningstar Developed Markets Index gained more than 20% that year. In the bear market of 2022, emerging-markets equities declined in line with their developed counterparts amid an aggressive central bank response to inflation.

Value Opportunity or Value Trap?

Emerging-markets equities have traded at a deep discount to their developed-markets counterparts for years now. As displayed in Exhibit 3, the trailing 12-month price/earnings ratio on the Morningstar Emerging Markets Index was just 13 as of the end of 2023, compared with 18.2 for developed-markets equities. The nearly 30% discount got as high as 41% at the end of 2021, but at times in 2007 and 2010, emerging-markets equities actually traded at a premium to their developed counterparts.

Exhibit 3 The Valuation Gap Between Emerging and Developed Equities Has Persisted for Years

Source: Morningstar's "2024 Market Outlook: What a 'Return to Normal' Means for Stocks." Data as of Dec. 21, 2023.

Higher risk, it could be argued, justifies emerging-markets' valuation discount. The Morningstar Emerging Markets Index has a higher standard deviation of returns (a measure of volatility) than its developed-markets counterpart for all trailing periods. The China and Russia case studies illustrate the political risk inherent to the asset class, as does the troubled location of the largest emerging-markets company: Taiwan Semiconductor.

Yet, the convergence view heard during the BRICs days is still relevant. Morningstar Investment Management's Philip Straehl articulates the long-term strategic case for emerging-markets:

> *"[T]he structural story around emerging markets remains intact. Emerging markets represent 80% of the world's population and nearly 70% of the world's GDP growth, but only 10% of the total global equity*

market cap. A burgeoning middle class continues to develop in emerging markets and should present interesting opportunities for investors, albeit with higher volatility." [3]

India now seems like the most compelling emerging market from the perspective of growth potential and demographics. Indian equities represented 20% of the Morningstar Emerging Markets Index at the end of 2023, up from 10% three years prior. Rupee weakness versus the dollar has diminished Indian equities' returns for unhedged U.S. investors, but an increasingly supportive policy environment, including infrastructure investment, is an undeniable growth driver. That said, valuations have risen too.

What about other potential catalysts for emerging markets? They include:

- U.S. dollar weakening after a long run of dominance, spurred by interest rates or other factors.
- Chinese valuation opportunities at the company level and/or the economy surprises on the upside.
- The clean energy transition, which is benefiting emerging-markets companies, from suppliers of basic materials (like copper) to businesses involved in electric vehicles, batteries, and so on.
- Supply chain changes ("Nearshoring," "Friendshoring," and so on).
- Indonesia, or other underappreciated emerging markets, rising in prominence.

From a bottom-up perspective, it's worth noting that emerging markets are home to some high-quality businesses. Many benefit from economic moats, or durable competitive advantages, in the eyes of Morningstar's Equity Research team. Exhibit 4 displays a select group of emerging-markets constituents of the Morningstar Global ex-US Moat Focus Index, which includes competitively advantaged companies whose shares trade at compelling valuations. The companies span country and sector.

Exhibit 4 The Valuation Gap Between Emerging and Developed Equities Has Persisted for Years

Company	Country	Sector
MediaTek	Taiwan	Technology
NetEase	China	Communication Services
Ambev	Brazil	Consumer Defensive
Shanghai Pharmaceuticals	China	Healthcare
Samsung Electro-Mechanics	Korea	Communication Services

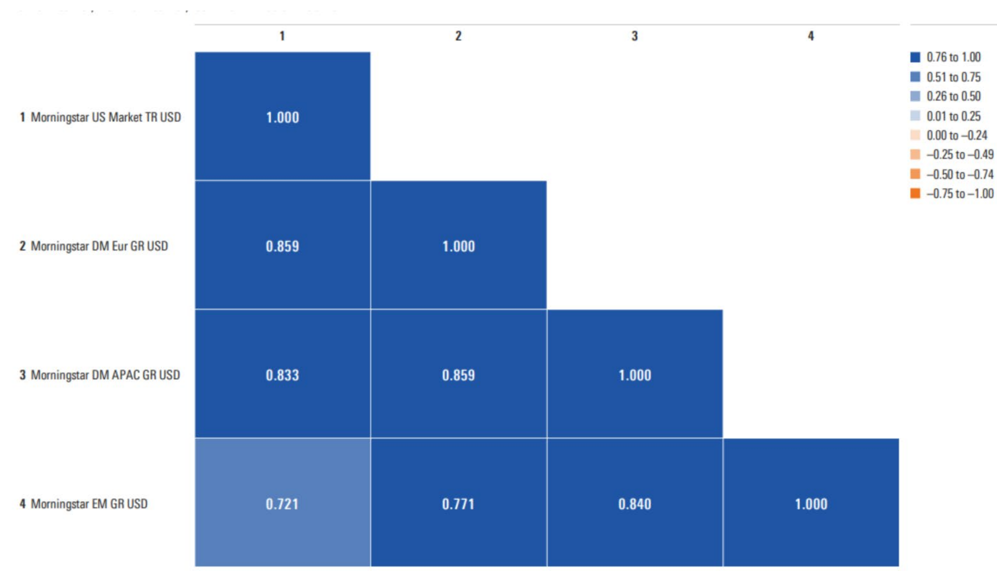
Source: Morningstar Indexes. Data as of Dec. 31, 2023.

3 Straehl, Philip. "Global Convictions: April 2023 Asset Class Research." Morningstar Investment Management. April 27, 2023. https://mp.morningstar.com/en-us/articles/bltfde9e78437d85ee5/global-convictions-april-2023-asset-class-research

The Diversification Benefits of Emerging Markets

Exhibit 5 shows that emerging markets have been less correlated with developed-markets equities than the U.S. and Europe have been with each other. The Morningstar Emerging Markets Index's 10-year correlation with U.S. equities is 0.72, and with developed European equities it's 0.77. Emerging equities are more correlated with developed markets in the Asia-Pacific region like Japan, Hong Kong, Singapore, and Australia, which may have to do with economic links between China and those markets.

Exhibit 5 Emerging Markets Are Less Correlated Than Developed Markets



Source: Morningstar Direct. Ten-Year Correlations as of Dec. 31, 2023.

Combining asset classes with correlations below 1.0 reduces a portfolio's overall risk profile and can contribute to superior risk-adjusted returns. That's cold comfort for long-term holders of emerging-markets equities for whom they've been a persistent drag on portfolio returns. Yet, the prospect that the cycle will turn again, and emerging markets will reascend makes them worthy of investor consideration. Perhaps we will look back at this as the moment to have heeded Antoine van Agtmael's exhortation to "…invest twice as much as usual [in emerging markets] when nobody likes them."

About Morningstar Indexes

Morningstar Indexes was built to keep up with the evolving needs of investors—and to be a leading-edge advocate for them. Our rich heritage as a transparent, investor-focused leader in data and research uniquely equips us to support individuals, institutions, wealth managers and advisors in navigating investment opportunities across major asset classes, styles and strategies. From traditional benchmarks and unique IP-driven indexes, to index design, calculation and distribution services, our solutions span an investment landscape as diverse as investors themselves.

Please visit indexes.morningstar.com for more information.

Contact:
indexes@morningstar.com

22 West Washington Street
Chicago, IL 60602 USA