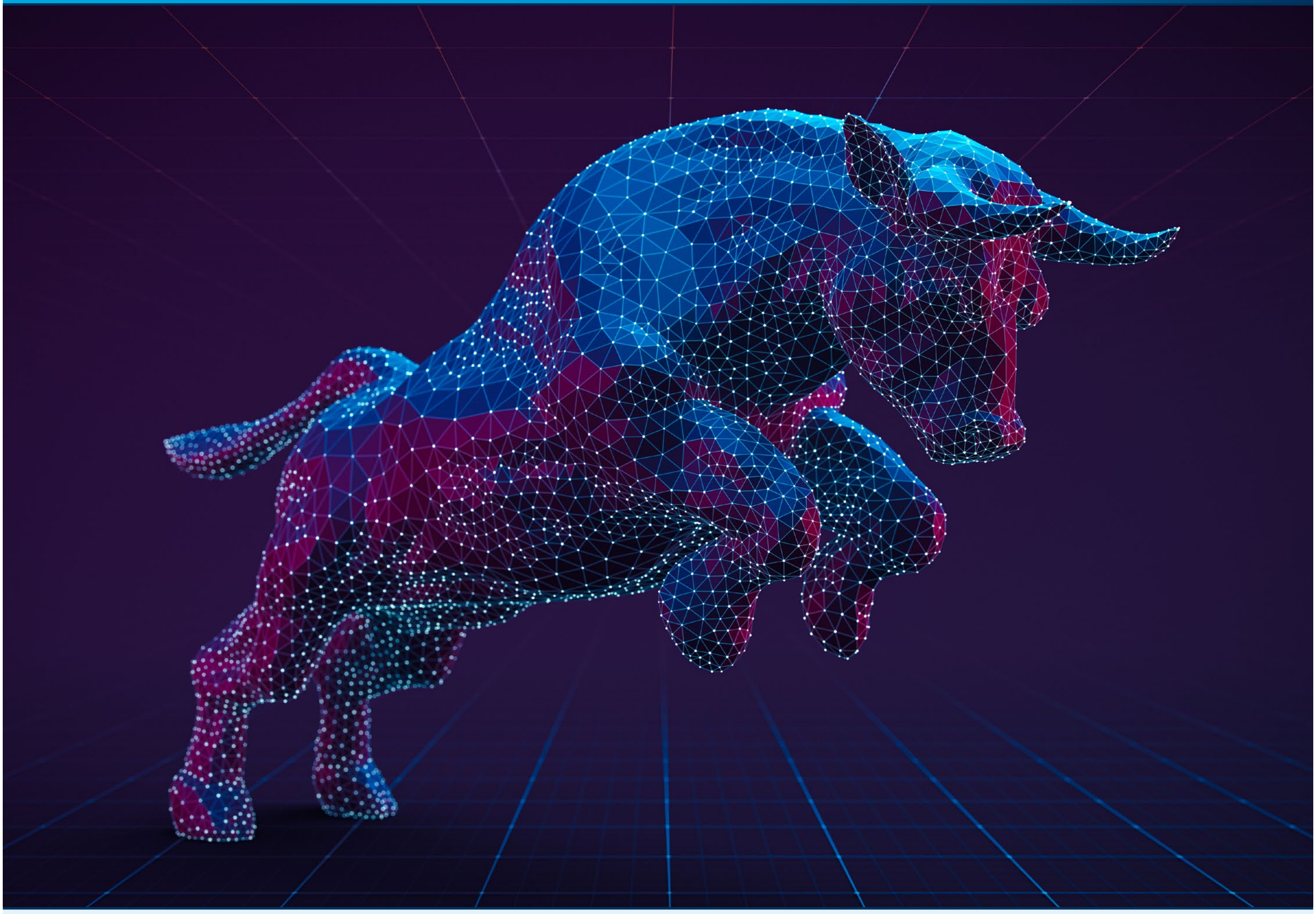
A new bull market cycle in Emerging Market equities

By Gustavo Medeiros and Ben Underhill



A decade of tech-driven US stock market outperformance has contrasted with tepid returns for Emerging Market (EM) stock indices. But past returns are not an indicator of future performance, and the drivers of markets over the next decade will be quite different from the ones over the last.

We see four pillars supporting the thesis for a new bull cycle in EM equities: improving macroeconomic fundamentals, an earnings cycle, a peak in the US dollar, and structural trends such as the energy transition and AI.

Ashmore

EM growth differential vs. DM increasing

Impressive EM growth has been coupled with better inflation and debt dynamics…

…leading to a string of credit rating upgrades

A better fit: *relative* GDP growth

Although it makes intuitive sense, it is misleading to assert that there is a direct relationship between a country's GDP growth and its equity market performance.[1] Since 1989, however, there has been a clear relationship between real GDP growth *differentials* and equity market *relative* performance. EM equities outperformed Developed Market (DM) (and US) markets between 1989 and 1994 and subsequently between 2001 and 2011. Both periods coincided with a significant increase in EM vs. DM economic performance (growth premium). Then, between 2012 to 2022, the EM growth premium declined, coinciding with the poor performance of EM equities vs. DM, despite some episodes of good EM absolute performance.

Since Covid, things have changed. According to the International Monetary Fund (IMF), 2020 DM GDP contracted 3.9%, while EM GDP declined by just 1.7%. EM then quickly bounced back to pre-Covid annual growth of around 4.0% as per Fig 1, while DM GDP growth remained tepid. The resilience EM GDP showed through the pandemic and over the last two years has reestablished a healthy growth differential, which the IMF expects will remain in place over the coming years.

Fig 1: **GDP Growth and Inflation:**[2] **selected EM and DM economies**

Region	Growth vs. Inflation							
	Real GDP				Average CPI			
	2022	2023	2024	2025E	2022	2023	2024	2025E
Latin America	3.6%	2.5%	2.1%	1.9%	8.9%	5.7%	4.4%	3.6%
Asia	4.0%	4.9%	4.8%	4.5%	2.2%	0.8%	1.7%	2.1%
Eastern Europe	4.6%	0.6%	2.4%	3.3%	19.0%	11.0%	3.7%	3.5%
ME/Africa	6.4%	-0.1%	2.2%	3.8%	7.3%	9.1%	9.7%	5.9%
EM	**4.1%**	**4.0%**	**4.1%**	**4.0%**	**4.8%**	**2.7%**	**2.6%**	**2.6%**
EM ex-China	5.2%	2.9%	3.5%	3.7%	7.5%	6.1%	4.6%	3.8%
DM	2.6%	1.5%	1.5%	1.5%	7.6%	4.6%	2.7%	2.2%
EM vs DM	**1.6%**	**2.4%**	**2.6%**	**2.5%**	**-2.8%**	**-1.9%**	**-0.1%**	**0.4%**

Source: Bloomberg, Ashmore. Data as at 30 August 2024.

Macro resilience

While growth is important, equity investors also care about downside risks. This renders GDP growth trivial without macro stability, and in the last five years, impressive EM GDP has been coupled with inflation falling more quickly than in DM. The IMF and the Bank of International Settlements (BIS) have put this macro stability down to sound fiscal and monetary policies, with a balanced fiscal expansion in the aftermath of the pandemic allowing for better debt dynamics in many EM countries.[3] We agree, and this is reflected in the recent trend of more EM sovereign debt upgrades than downgrades by rating agencies. Upgrades are particularly notable for some of the significant equity markets, such as Brazil and India, as well as smaller ones such as Türkiye and Kazakhstan.[4]

[1] See – https://www.msci.com/documents/10199/a134c5d5-dca0-420d-875d-06adb948f578
[2] Observed data for 2022/23 and expected for 2024/25. EM countries exclude Argentina, Russia, Ukraine and Türkiye.
[3] See – https://www.imf.org/en/Publications/GFSR
[4] See – *"The untold story of improving EM fundamentals"*, The Emerging View, 27 June 2024.

Ashmore

Earnings cycle

Solid macro lays a good foundation for equity performance. However, the most critical catalyst for a meaningful rebalancing of investor positioning towards EM equities will be a sustained increase in their earnings per share (EPS).

Over the last 25 years, the EPS of EM and DM rose by a similar pace: 6.5% for the former and 5.7% for the latter. The averages hide two distinct cycles. From 2000 to 2011, EM EPS rose by a whopping 17.2% per annum (p.a.). DM ex-US increased by 5.9% p.a, while US EPS growth was only 4.9% p.a. Then, over the last decade, this relative performance reversed, as EM EPS growth dropped to 2.3% p.a., DM ex-US was only 0.5% and US EPS increased by 6.4% p.a.

EM earnings growth to be fuelled by powerful structural drivers…

The first period of EM earnings divergence (2000-2011) was backed by a decade of important governance reforms across many sovereigns and corporations that started in the early 1990s. These reforms were a catalyst for deeper integration into global markets. Then, with China emerging as a major manufacturer for the rest of the world after the turn of the millennium, its huge demand for natural resources provided a tailwind for other EM countries. Unfortunately, the latter part of the EM bull market, from around 2009-12, became overexuberant. This led to macroeconomic imbalances via large external and fiscal deficits. The correction of this exuberance led to a sharp decline in earnings (2012-2016), which coincided with the first phase of US economic exceptionalism driven by low rates, the shale oil revolution and booming tech companies

What we are seeing today is very much the reverse. The US is now the centre of over-exuberance and macroeconomic imbalances – and probably due for a correction – while EM external and fiscal balances are largely healthy, setting a good foundation for earnings growth. After a two-year decline, 12-month EM EPS growth forecasts have been higher than the S&P 500 since October 2023 and have risen from 9% at the end of January to 25% at the end of August (vs. 10% for S&P 500).

Drivers to propel EPS

Coming from a low base, an EPS recovery in EM equities is already nascent, aided by a boom in manufacturing from South Korea and Taiwan. In our view, EM equities earnings growth will not only continue but will become self-sustaining, fuelled by powerful structural drivers, including AI and the energy transition, both of which will lean heavily on EM companies and attract inflows.

Beyond NVIDIA

…such as AI…

'In a gold rush, sell shovels.' In today's AI investment frenzy, owning NVIDIA is the most well-known way to play this mantra, sending valuations to very elevated levels. Naturally, investors are now looking for other compelling ways to buy into the AI story. EM countries are the engine room of the global AI revolution. Taiwan accounts for 90% of the leading-edge chip manufacturing in the world. Taiwan, South Korea and China together are responsible for 59% of the complete AI manufacturing supply chain.[5] This dominance will probably continue this year and beyond, presenting several phases of investment opportunities within EM. In our view, over the next year or two we will be moving into a 'democratisation' phase that will trigger a significant PC/smart phone replacement cycle. This cycle has historically happened every four or five years and was an important driver of earnings cycles in 2015/16 and 2020, when significant advances in tech hardware and the Covid-19 pandemic led to higher demand for the latest products. This should translate into strong growth for semi-conductor manufacturers and for the leaders in more niche hardware sub-segments across the value chain.[6]

[5] See – https://www.morganstanley.com/content/dam/msdotcom/what-we-do/wealth-management-images/uit/MSCo-Research-Report-Mapping-AIs-Diffusion.pdf
[6] See – https://citywire.com/za/news/you-need-to-use-a-different-lens-than-you-did-in-the-past/a2439501

Ashmore

Energy transition

...and the energy transition

EM countries hold the lion's share of the commodities needed to build energy infrastructure. For example, lithium-ion batteries are critical for electric vehicles (EVs) and energy storage systems. Chile, Argentina, Brazil and China dominate the world market for lithium deposits and can all boost production, while Indonesia is the largest nickel producer – another key metal for batteries.

Lower energy costs are boosting EM ex-China manufacturing competitiveness.

Another structural trend that will come with the energy transition is lower energy costs. Chinese solar panels are already the cheapest energy form available, and costs continue to fall rapidly. While this has led to an increase in protectionist measures in Europe and America, both of which are concerned about overreliance on China for energy products, more geopolitically agnostic EM countries across Latin America, Africa and the Middle East are taking full advantage. This is already having a material impact on their energy costs. A good supply of cheap, clean energy will help countries capitalise on 'nearshoring' and 'friendshoring' trends, as DM looks to redirect manufacturing investment away from China. We explored the *"EM ex-China manufacturing renaissance"* in a dedicated publication in February.[7]

The Fed easing cycle begins…

Valuations haven't yet followed earnings expectations in EM vs DM…

This divergence in earnings growth expectations between DM and EM is yet to be reflected in valuations. The Federal Reserve (Fed) cut interest rates earlier this month, and the MSCI EM index is hovering at 12x forward price/earnings (P/E), while the S&P 500 remains at 22x P/E. The last time there was a similar gap in valuations in the month of the first Fed cut (1998), the MSCI EM outperformed the S&P 500 by 20% over the next 12 months, returning 42% in absolute terms. Granted, this boom came from a low base, recovering after the Asian Financial Crisis of 1997. Nevertheless, with fundamentals steadily improving in many EM countries, it is notable that index valuations today are lower than they were then, even on an ex-China basis (14.5x P/E).

…and EM has much more room to cut

...and lower interest rates can boost equity market performance in many EM countries

A significant US rate-cutting cycle has started. Markets are currently pricing 260 basis points (bps) of Fed cuts by the end of 2025, with a terminal rate of 2.7%. In the absence of a recession, this may be overblown. But the Fed should be able lower rates by a more reasonable 200bps and still have its policy rate significantly above inflation.

As the Fed cuts its policy rate, central banks across the world will have room to cut rates in tandem, lowering funding costs, boosting liquidity and supporting stock market performance. The table below shows the 20 countries with the highest ex-ante real interest rates for the next 12-months. In other words, these are the countries with the most room to cut. Unsurprisingly, 18 of them are in EM, including major economies with significant index weights, notably Mexico, Brazil,[8] Indonesia and India, as per Fig 2.

[1] See – *"An EM ex-China manufacturing renaissance"*, The Emerging View, 27 February 2024.
[2] Despite elevated real rates, the next move for Brazil's central bank will be a hike.
See – *"Brazil set to buck the trend and hike rates"*, Weekly Investor Research, 16 September 2024.

Ashmore

...and EM has much more room to cut

Fig 2: **The G-20 of real rates**

Group	Country	1yr Govt	2025 CPI E	1yr Real w/ 2025 Inflation
EM	Türkiye	50.8	29.4	21.4
EM	Kenya	16.8	5.6	11.3
EM	Egypt	27.9	17	10.9
EM	Zambia	19.0	10.1	8.9
EM	Brazil	11.2	3.6	7.6
EM	Mexico	10.6	3.9	6.7
EM	Kazakhstan	13.2	6.8	6.4
EM	Ivory Coast	7.2	2.1	5.1
EM	Dominican Republic	9.1	4.3	4.8
EM	Colombia	8.2	4.1	4.1
EM	Indonesia	6.6	2.8	3.8
EM	Uruguay	8.9	5.9	3.0
EM	Philippines	6.0	3.0	3.0
EM	South Africa	7.1	4.5	2.6
EM	Peru	4.9	2.4	2.5
EM	India	6.7	4.5	2.2
EM	Romania	6.0	4.0	2.0
DM	United Kingdom	4.3	2.3	2.0
EM	Hungary	5.5	3.6	1.9
DM	United States	4.0	2.3	1.7

Source: Bloomberg, Ashmore. Data as at 11 September 2024.

History shows that after the first rate cut in a cycle, the market consistently overestimates US EPS growth for the next year. Inflated valuations require ongoing earnings growth to avoid a sudden deflation, so US stocks are at risk of facing a big drop, having experienced a period of AI-driven exuberance which cannot continue forever. The technology's transformation is not a short-term story, and more and more investors now see the theme as 'overcooked' in markets, at least for now. On the other hand, lots of EM markets look underappreciated, with widening growth differentials and rate cuts ahead. In our view, the risk-reward in equities is strongly in EM's favour over the next year and beyond, with the asset class well-positioned for a significant rebound.

Bargain territory

Several EM countries in 'bargain territory'

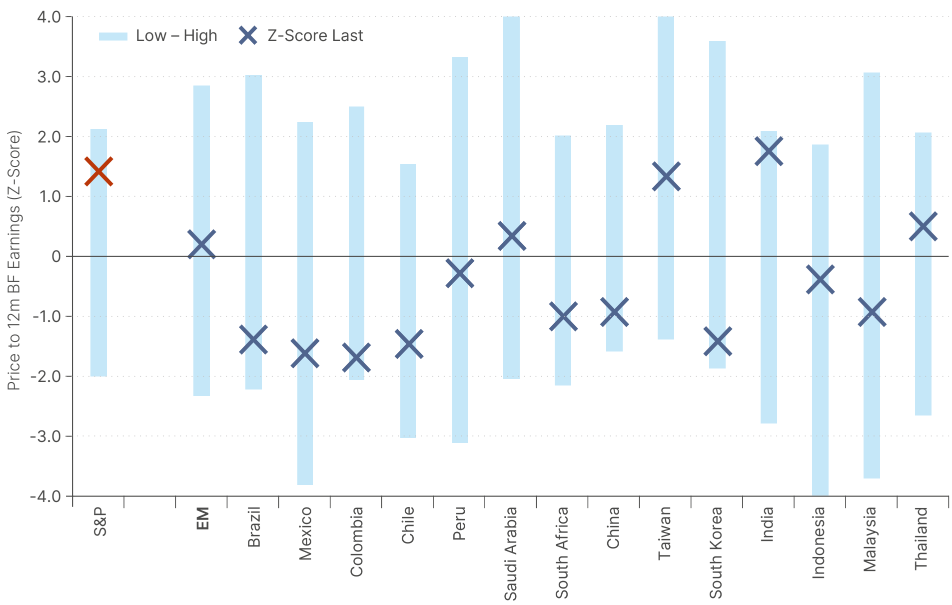
EM stocks look attractively valued on average, but finding value from a country perspective can be even more richly rewarded. Two success stories in recent years have been Taiwan and India. Taiwan is now the world's dominant semiconductor exporter and India is growing into its role as the new EM growth powerhouse, as economic reforms and infrastructure investment attracts more foreign capital. Investing in either of these countries at the end of 2019 would have led to a near doubling of your capital and would have beaten returns from the S&P 500 by a considerable margin.

Bargain territory

Such price action has seen valuations rise above historical averages in these two countries. In contrast, most other EM markets trade at discounts to their long-term averages, offering attractive entry levels. Brazil, Colombia, South Africa, China, and South Korea are at their lowest valuation levels since 2015, as per Fig 3. Low valuations are a good place to start as equity investors. For more extraordinary returns, investors should look beneath the high-level country valuations and understand the dynamics of the different countries.

Country selection is key in EM

Fig 3: **Price to 12m blended forward earnings: S&P vs. MSCI EM and largest EM countries**



Source: Bloomberg, Ashmore. Data as at September 2024.

Role of the dollar

The dramatic boom-bust dynamics in EM during 1970-1990 were caused by borrowings in foreign currency to finance both consumption and production. Today, EM countries borrow mostly in floating local currencies anchored by more prudent policy. Nevertheless, the links between the dollar system and global financial conditions remain powerful.[9] When the dollar strengthens, international banks lend less to the rest of the world, and asset allocators buy more US assets and fewer assets from elsewhere.

The dollar downturn since Q4 2022 is likely to accelerate...

However, the Dollar Index peaked in Q4 2022 at 114.8, and has failed to approach these levels since, despite the weakness of the yen and euro. In our view, the steady dollar decline seen since March this year is likely to accelerate as US economic activity weakens and the Fed cuts its policy rates. This may turn the past decade's negative feedback loop into a positive one for EM equities. Just as a stronger dollar attracts foreign capital to US assets, a weaker one drives capital to EM, boosting liquidity and asset prices.

[9] See – https://sites.bu.edu/perry/2016/06/28/bis-looks-through-the-financial-cycle/
https://www.imf.org/-/media/Files/Conferences/2022/10/3rd-workshop-international-capital-flows-financial-policies/7/original-sin-redux.ashx
https://www.bis.org/speeches/sp230324a.htm; https://www.bis.org/speeches/sp221102.pdf

…as investors are under-allocated to EM equities

Structural under-allocation to EM

It is hard to say what a 'neutral' balanced exposure to EM should be. But investors taking a passive stance are getting close to two-thirds of exposure to the US and less than a 10% allocation to EM equities. This is far too small from almost all perspectives. EM represents more than 50% of global GDP, and its participation is increasing. More than one-third of all revenues from MSCI ACWI companies comes from EM, with less than one-third coming from the US. Valuations drive the big discrepancy in market cap-weighted allocation to the US vs EM: overexuberant in the former and depressed in the latter. Higher demand for US assets also translated into a "dollar super-cycle" which will likely continue unwinding from its 2022 peak, regardless of the result of the November US election.[10]

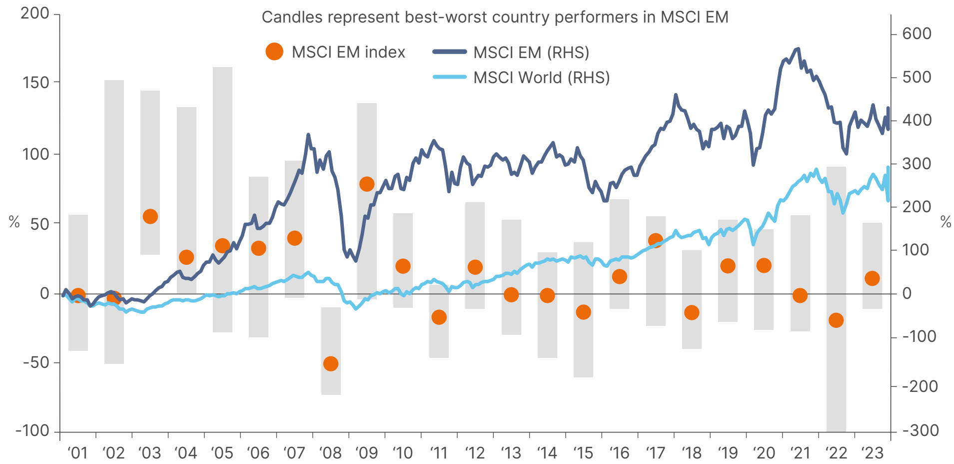
Active management has a disproportionate importance in EM

Go active or go home

Low-cost exchange-traded funds (ETFs) make economic sense for efficient markets with a survivorship bias, like the S&P 500. They make less sense for a benchmark composed of 24 countries with more than 1,300 constituent companies, with far lighter coverage from sell-side research. These characteristics mean active management has disproportionate importance in EM, whose companies lead the world in a wide range of industries yet sit in transformative economies with often immature institutions. The result is a high return opportunity for stock pickers alongside high market volatility, much of which can be attributed to top-down drivers.

The average yearly performance dispersion between the highest and lowest country in the MSCI EM since 1997 was 111%, with a 63% to 264% range, as per Fig 4. Political dynamics driving policy changes explains much of this dispersion. Countries suffering from top-down governance deterioration tend to underperform. By contrast, countries implementing reforms to improve macro stability and boost economic freedom to the private sector tend to do well.

Fig 4: **MSCI EM vs. MSCI DM performance (right) vs. annual MSCI EM returns and country performance dispersion (left)**



Source: Bloomberg, Ashmore. Data as at December 2023.

Several researchers have proven that most EM active strategies outperform

Active managers that understand these dynamics can increase exposure to nations on the rise, while limiting holdings in politically turbulent countries. Several researchers have statistically proven that most EM active strategies outperform, partially due to this large country dispersion. A recent paper by Wilmington Trust, using data from December 1999 to December 2023, shows that half the EM active managers beat their benchmark 75% of the time on a rolling 12-month basis, a much more frequent outperformance than for managers of US small cap and international developed (65%) and US large cap (38%).[11]

[10] See – *"The US Election's impact on Emerging Markets"*, The Emerging View, 31 July 2024.
[11] See – https://www.econ.berkeley.edu/sites/default/files/Kremnitzer.pdf
https://www.wilmingtontrust.com/content/dam/wtb-web/investment-management/active-passive/active-passive-final-paper.pdf
https://www.investmentmagazine.com.au/2023/09/active-management-shines-again-mercer/

Conclusion

The case for an outperformance of EM equities post beginning of US rate cuts is sound.

Macro fundamentals across EM are solid, and many companies are well positioned to benefit substantially from long term structural drivers such as AI and energy transition. As the Fed cuts policy rates, EM central banks will be in the position to ease more aggressively. Against that backdrop, with the dollar having peaked, and EM earnings expectations improving, the structural under-allocation to EM equities is likely to change.

The savvier investors will choose active strategies over passive or quasi-passive allocation, in an asset class where active management has a significant edge.

Head office

Ashmore Investment Management Limited, 61 Aldwych, London, WC2B 4AE T: +44 (0)20 3077 6000

Local offices

Bogota
T: +57 1 316 2070

Dubai
T: +971 440 195 86

Dublin
T: +353 1588 1300

Jakarta
T: +6221 2953 9000

Mumbai
T: +9122 6269 0000

New York
T: +1 212 661 0061

Riyadh
T: +966 11 483 9100

Singapore
T: +65 6580 8288

Tokyo
T: +81 03 6860 3777

Other locations
Lima

Fund prices
www.ashmoregroup.com
Bloomberg
FT.com
Reuters
S&P
Lipper

www.ashmoregroup.com @AshmoreEM