Ashmore

A structural growth story: EM overtakes S&P 500 in Tech!

By Fernando Assad, Jan Dehn and Chris Mader

- More than 50% of the MSCI EM equity index (MSCI EM) now consists of structural growth companies, while the commodity share has fallen to just 14%.
- The tech share of MSCI EM is now higher than the tech share of the S&P 500.
- All other things being equal, the MSCI EM ought to trade at a premium to historical valuations and the gap with developed market equities ought to be closing.

Perceptions about Emerging Markets (EM) usually lag behind reality, sometimes by decades. Nowhere is this more evident than in the perception about EM equities, where the consensus opinion remains that EM equities – and the MSCI EM in particular – is primarily a commodities and cyclical play.

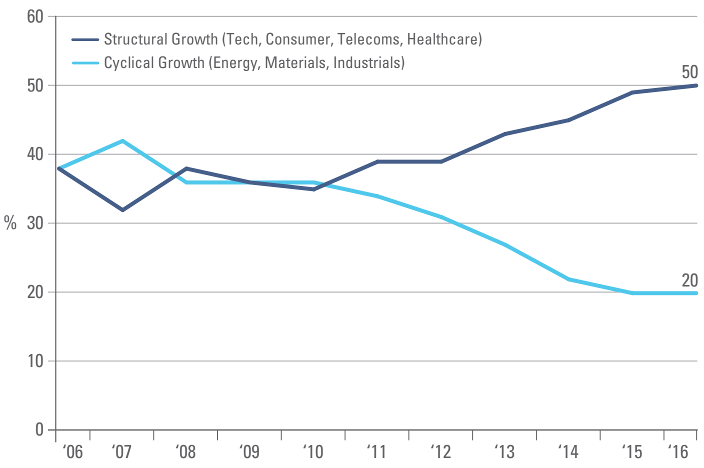
This view is outdated and wrong. Today, the structural growth drivers constitute more than 50% of the MSCI EM equity index, while the cyclical share is down to 20%. The commodity component has fallen to just 14%, which is less than half of its share a decade ago. Moreover, the tech share of the MSCI EM now constitutes 23%, which is greater than the tech share of the S&P 500.

The implication is clear: As a structural growth play, EM equities ought to trade higher than their historical valuation and should be closing the gap in valuations versus equities in developed economies. The fact that this has not yet happened suggests value in the asset class.

Cyclical to structural

As figure 1 below shows, structural growth drivers, including technology, consumer, telecoms and healthcare now make up more than 50% of the MSCI EM. By contrast, the share of cyclical drivers, which includes commodities, has fallen to just 20% of the index. This means that the MSCI EM is now mainly an index consisting of structural growth companies and sectors, a change that reflects a broader shift towards greater sophistication within EM economies.

Fig 1: **MSCI EM Index Composition (%): Now mainly a structural growth story**



Source: Source: MSCI, Bloomberg, Ashmore as at July 2016.

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Implications for valuations

The implication of this shift from cyclical to structural growth drivers is simple, yet startling. As a structural growth story EM equities ought to trade at a premium to their historical (cyclical) valuations, while the gap in valuations versus developed market equities ought to narrow or even invert.

A higher valuation due to the greater share of structural growth drivers is justified because price to earnings (P/E) ought to be a function of long-term growth. Structural growth companies have superior earnings visibility for multiple years compared to cyclical ones, so investors should be willing to pay a higher multiple.

Yet, as figure 2 shows, the MSCI EM P/E is still trading in-line with its historical average and far below the P/E of developed markets (MSCI World). This suggests that there is considerable value in EM equities going forward.

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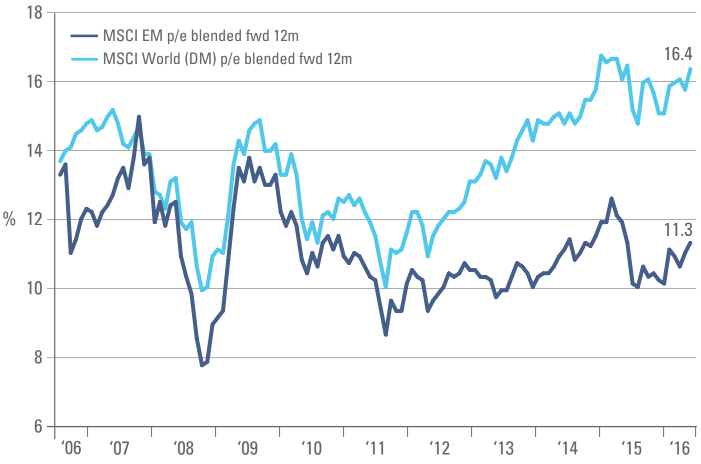
Fig 2: **Equity price to earnings**



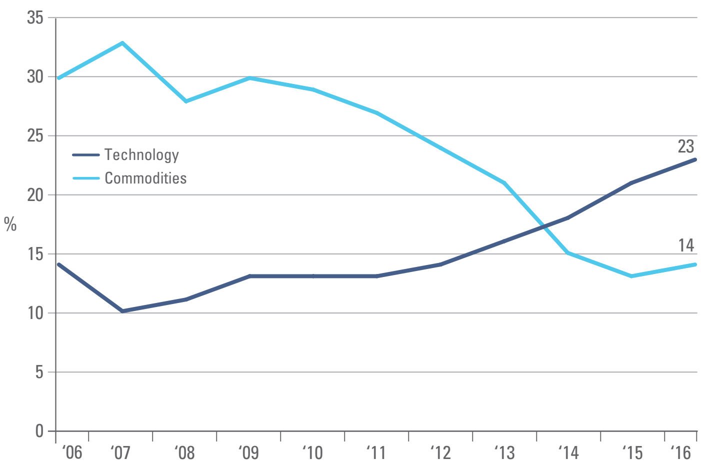
Source: MSCI, Bloomberg, Ashmore as at July 2016.

Having traditionally been heavily skewed towards commodities… the MSCI EM equity index now looks very different

From commodities to technology

The rise of technology has been a particularly important part of EM's broader transition from a cyclical to a structural growth play. Having traditionally been heavily skewed towards commodities – until about ten years ago the commodity share of the MSCI EM was consistently above 30% – the MSCI EM equity index now looks very different indeed. As figure 3 below shows, the index ceased to be a cyclical commodity story some time ago as technology caught up with and now dominates commodities.

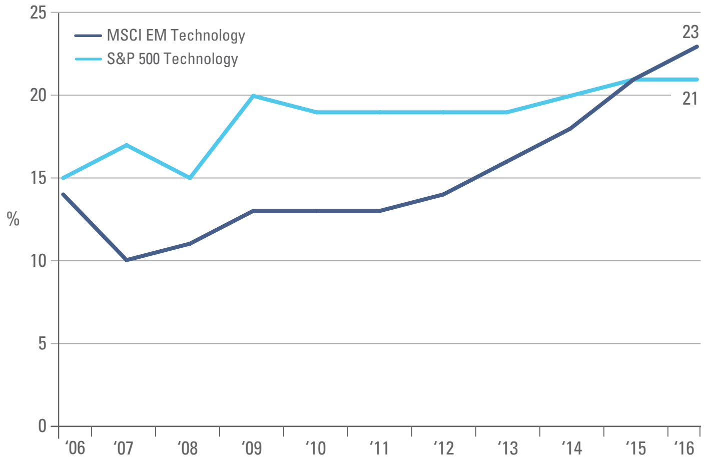
Fig 3: **MSCI EM Index Composition (%) – Technology versus commodities**



Source: MSCI, Bloomberg, Ashmore as at July 2016.

Moreover, at 23% the tech share of the MSCI EM is now greater than the 21% tech share of the S&P500 – see figure 4 below. Seven of the largest ten companies in MSCI EM equity index are tech companies, including Samsung, TSMC, Tencent, Alibaba, Naspers, Baidu and Hon Hai.

Fig 4: **Technology sector share (%)**



Source: MSCI, Bloomberg, Ashmore as at July 2016.

The ability to skip entire stages of development by adopting the most up-to-date technology allows EM countries to accelerate their convergence with wealthier countries

Tech as a structural driver in EM

It is appropriate to view technology as a structural growth driver in the EM context. The ability to skip entire stages of development by adopting the most up-to-date technology allows EM countries to accelerate their convergence with wealthier countries.

Also, software and internet services have outgrown EM growth for many years and these trends will likely persist. The transition of commerce from physical to electronic methods is advancing at a brisk pace as consumer preferences shift towards online shopping, driven by familiarity, convenience and falling transaction costs. And given lower starting points for tech penetration and per capita incomes in EM the potential for growth is that much higher and sustainable. While hardware development itself does not necessarily have its own 'hyper-growth' driver, it is the method of final delivery of electronic services, the shortening of replacement cycles and the greater predictability of service delivery that is structural in nature.

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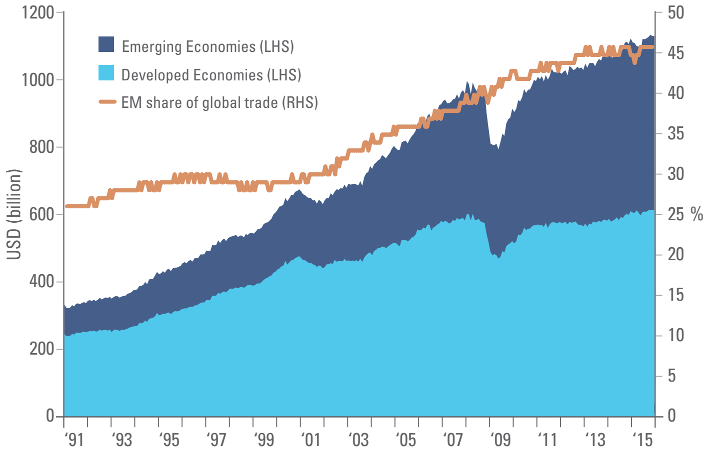
Structural change

EM's transformation from a cyclical to a structural growth play has deep roots that go all the way back to the end of the Cold War in the late 1980s, although the pace of change has been particularly rapid over the last decade. Aided by a rapidly rising share in global trade, despite lower commodity prices, many EM countries have been able to progress rapidly from erstwhile specialists in extraction-industries and other primary sectors to establishing themselves as prominent players in secondary industries such as processing and manufacturing. Now, many EM companies even compete successfully in tertiary industries such as services, technology and innovation. The EM equity universe has not only broadened and deepened, but the level of sophistication of EM companies within the MSCI EM has also increased sharply. These changes are all structural in nature.

Fig 5: **EM share of global trade – volumes in 2015 constant USD bn**



Source: CPB, Ashmore as at December 2015.

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