Gresham

11.27.2023

Emerging Markets: Disappointment or Potential Being Realized?

Background

Over the last few decades, the potential of emerging markets ("EM") has enticed investment analysts. More recently, geopolitical tensions have generated clouds of doubt over this can't-miss investment opportunity. Now as investors flee these markets, they are asking what the future holds. We don't hold a crystal ball, but we can provide a look at where we are and what that might imply for the balance of risk and reward in these markets.

First, what are emerging markets? "Emerging markets" are those countries transitioning from low-income to middle-income status, typically with some measure of sustained market access, and where rapid industrialization and emerging middle-class consumption are leading to higher economic growth rates.

The investment allure of these outsized growth opportunities appears obvious. While economic growth does not directly translate to corporate revenue, earnings or earnings-per-share ("EPS") growth, it often creates uplift in company fundamentals and drives stock price appreciation, particularly when the size of these economies and populations is compellingly large, such as China and India and to a lesser degree Brazil and Russia. When the collective population of China and India, which today exceeds 2.5 billion people and constitutes more than one-third of the world's population, begins to experience rapid income and discretionary spending growth, the investment potential is understandably tantalizing.

To contextualize the magnitude of the potential impact of these changes, we offer the following:

- The 24 countries categorized as "emerging" account for 50% of global GDP and have accounted for 66% of global GDP growth in the past ten years.[1]

- By 2030, it's estimated there will be more than 8.5 billion people on Earth with more than 85% of them residing in EM countries, providing a substantial base for future

consumption-driven growth.[2]

- Goldman Sachs projects China will overtake the U.S. as the largest economy around 2035. By 2050, they project the five largest economies, in order, will be China, U.S., India, Indonesia and Germany.

- McKinsey and Co. expect EM economies will have represented 62% of global consumption growth between 2015 and 2023, the equivalent of $15.5 trillion. China's e-commerce sales already exceed 50% of total retail sales, are nearly triple those of the U.S. and are greater than the ten largest developed nations combined.[3]

- EM countries are not just "adopting" technology but innovating it. Over 40% of global fintech startups are based in EM regions.[4]

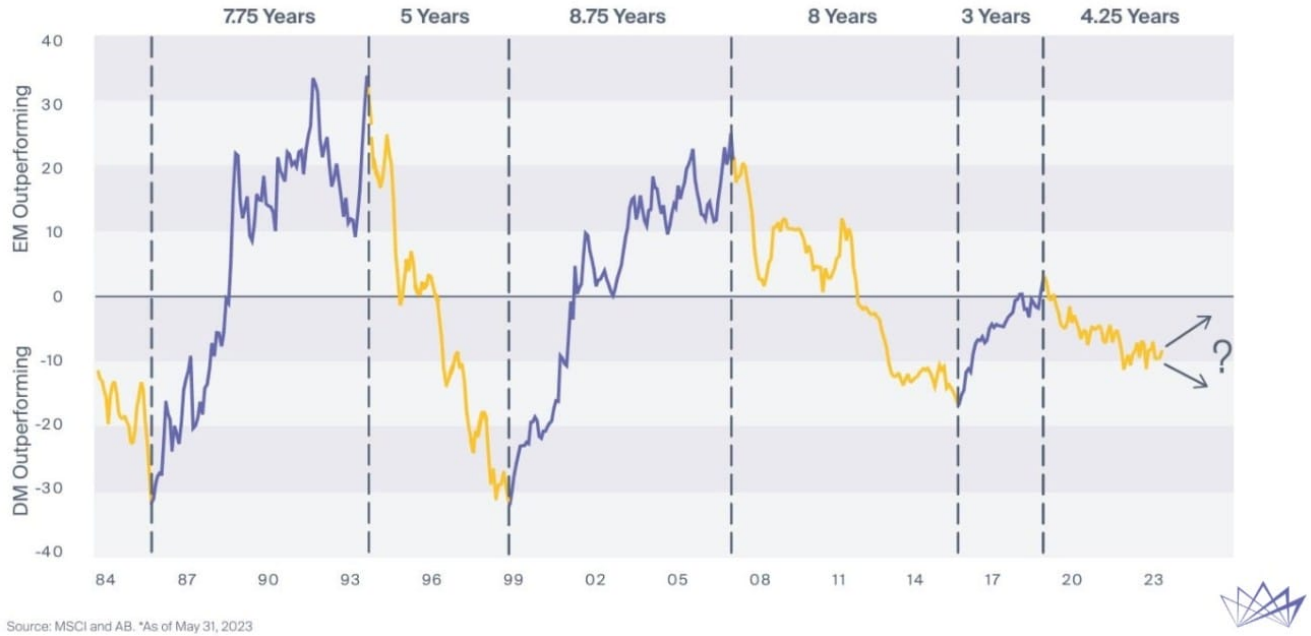
These are not simply hopeful narratives, but rather trends that are well underway and have been for decades.

Disappointing or Continuing Opportunity?

With all these seismically positive trends, one might think EM equities have outpaced developed markets peers. However, headlines and recent performance statistics suggest that investors have been disappointed. So which is correct? Despite the negative rhetoric and recent underperformance, EM equities have outperformed U.S. and global developed markets indices since the inception of the MSCI Emerging Markets index in 1999, returning 7.3% annualized, compared to 7.2% for the U.S. and 5.6% for global developed markets through third quarter 2023. However, this has not occurred in a straight line with alternating multi-year periods of relative underperformance and outperformance as shown in the chart below.

Chart 1. Emerging-Market vs. Developed-Market Equities

Rolling Three-Year Relative Returns (Percent)



Source: MSCI and AB. *As of May 31, 2023

- 1988 – 1993: EM equities appreciated nearly 545% when the Brady Plan helped Latin American countries restructure their debts, restoring international investor confidence.

- 1994 – 1998: The Asian Crisis period challenged EM investors who experienced several unusual events, including the collapse of the Thai baht and Russia's debt default and devaluation of the ruble. Additionally, the U.S. dollar was particularly strong amid robust domestic economic growth during this period.

- 1999 – 2007: China's induction into the World Trade Organization and massive investment in commodities infrastructure to support global economic expansion benefitted many EM countries rich in natural resources. During this period, EM equities surged over 400% while the dot-com bubble burst in the U.S.

- 2008 – 2015: The U.S. and other developed market economies leveraged their robust fiscal and monetary capabilities to navigate the Global Financial Crisis. Concurrently, EM countries faced economic headwinds, marked by reduced trade, waning investment flows and falling commodity prices.

- 2016 – 2019: A weakening U.S. dollar, rebounding commodity prices and significant economic reforms in emerging markets, such as India's adoption of the Goods and Services Tax (GST), provided strong momentum for the performance of EM equities. More attractive valuations at the beginning of this period were also compelling for investors.

- 2020 – Present: A resurgent U.S. dollar curtailed revenue growth for EM companies with dollar earnings and created a headwind for performance. The Covid pandemic exacerbated conditions in non-U.S. markets as inadequate responses and resulting supply chain disruptions impeded economic growth in emerging markets.

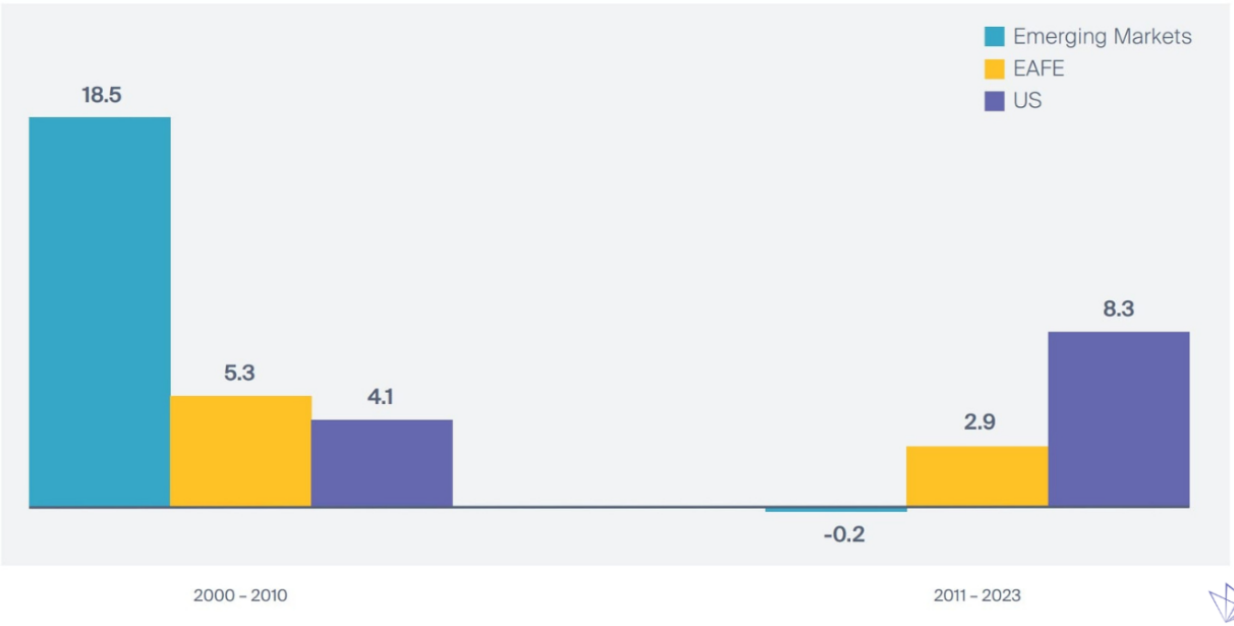
Market Performance Drivers

In analyzing both past performance and future potential of EM equities, it is important to differentiate between a country's economic growth and the growth of corporate revenues, earnings growth and earnings-per-share ("EPS"). Often, narratives around emerging economies center on rapid economic growth. Unfortunately, the translation of economic growth to EPS growth is often lost along the way. Surprisingly, history has shown that economic growth is often unrelated to stock market performance. In fact, most studies find that the correlation in any given year is near zero.

Further, even if economic growth does translate to EPS growth, U.S.-based investors are also subject to fluctuations in foreign currency exchange rates and changes in market multiples, such as price-to-earnings, that can alter – both positively and negatively – their investment returns.

Chart 2. Long-Term Earnings-per-Share Growth

Compound Annual Growth Rates, USD (Percent)

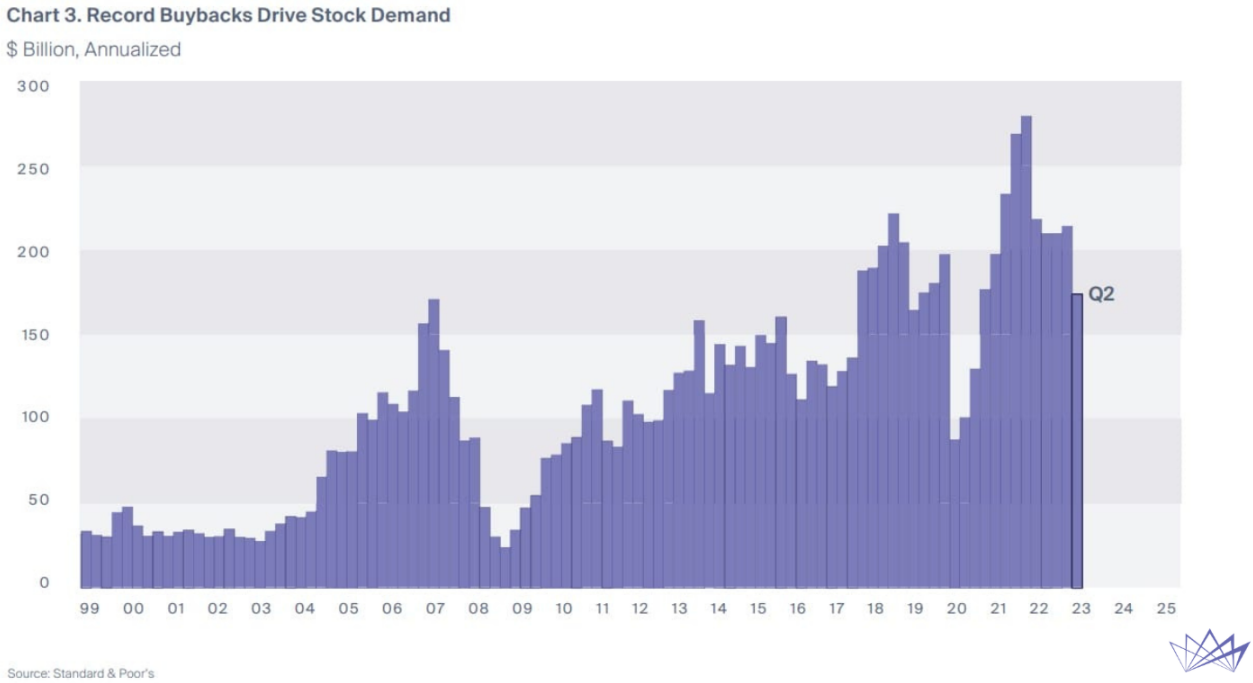


The importance of EPS growth can't be understated when discussing potential equity market performance. From 2000 to 2010, as seen in chart above, EPS growth in EM countries far outpaced developed markets counterparts. This largely corresponded to the strong EM equity outperformance from 1999 to 2007. Subsequently, EM EPS growth lagged developed markets peers from 2011 to 2023, which corresponded to the more recent period of underperformance that included a brief period of strong performance from 2015 to 2018.

Artificial EPS Growth Through Surging Buybacks

Share buybacks have become a strategic tool for corporations partially due to executive compensation being tied to per-share earnings growth. By reducing the number of outstanding shares, even static or slightly declining earnings can grow on a per-share basis. If the share buyback results in an elevation of the stock's market price, the value of executive stock option plans correspondingly increases, thereby enhancing the financial benefit to executives holding these options. Unlike counterparts in the U.S., EM companies did not benefit from an artificial boost to EPS growth resulting from a surge in share buybacks as shown in the chart below. Over the ten-year period beginning in 2010, S&P 500 companies bought back more than $5.3 trillion of stock, contributing one percentage point of their annual growth rate in earnings per share.[5] This tactic may be appropriate particularly when corporate equity is relatively cheap, but this has not been the case for the last few years as buybacks reached record levels. Corporate leaders are now using excess cash to improve these per-share metrics, sometimes at the cost of longer-term investments like research and development that may drive future revenue growth. This is not a limitless strategy and we have begun to see political pressure to limit these strategies that are viewed as

disproportionately benefiting the investor class.



Valuations

Post-2011, valuations of U.S. equities rose steadily, driven by the Federal Reserve's low-interest rate policy, corporate tax cuts and the growth and frenzied purchasing of a few technology stock darlings. Conversely, EM equity market multiples failed to expand during this period for several reasons.

- The perception of increasing risk due to growing geopolitical tensions between China, Russia and Western nations.

- Muted Covid stimulus programs when compared with the money cannons fired by the U.S. and other Western nations that are now resulting in increasing debt, debt service concerns and persistent inflation.

- EM central bank policies that didn't follow Western nations into full interest rate repression over the last decade for fear of kindling inflation. These low interest rates supported multiple expansion in developed markets.

The relative increase in price-to-earnings ratios accounted for a good portion of the

outperformance of U.S. and other developed markets equities relative to EM equities, and trade at a premium relative to EM equities today.



Where Are We Now?

What matters to investors is not economic growth, but rather 1) growth in corporate earnings per share, 2) expected future currency movements, and 3) the change in the price paid (valuation) for these earnings.

EPS Growth

After a long period of disappointing growth, analysts expect EM EPS growth to exceed the rate for U.S. and developed markets. Consensus estimates for EM earnings growth in 2024 are currently 19%, more than double the forecasted growth for the U.S. and other developed markets. Analysts' predictions are horribly unreliable, but can we have confidence, at least directionally, that these projections will be realized?

The removal of headwinds will be a supportive first step. Geopolitical tensions and concerns about supply chain integrity after Covid disruptions created a massive disentangling effort that was highly disruptive to EM economies. The effect of these changes will likely continue to diminish.

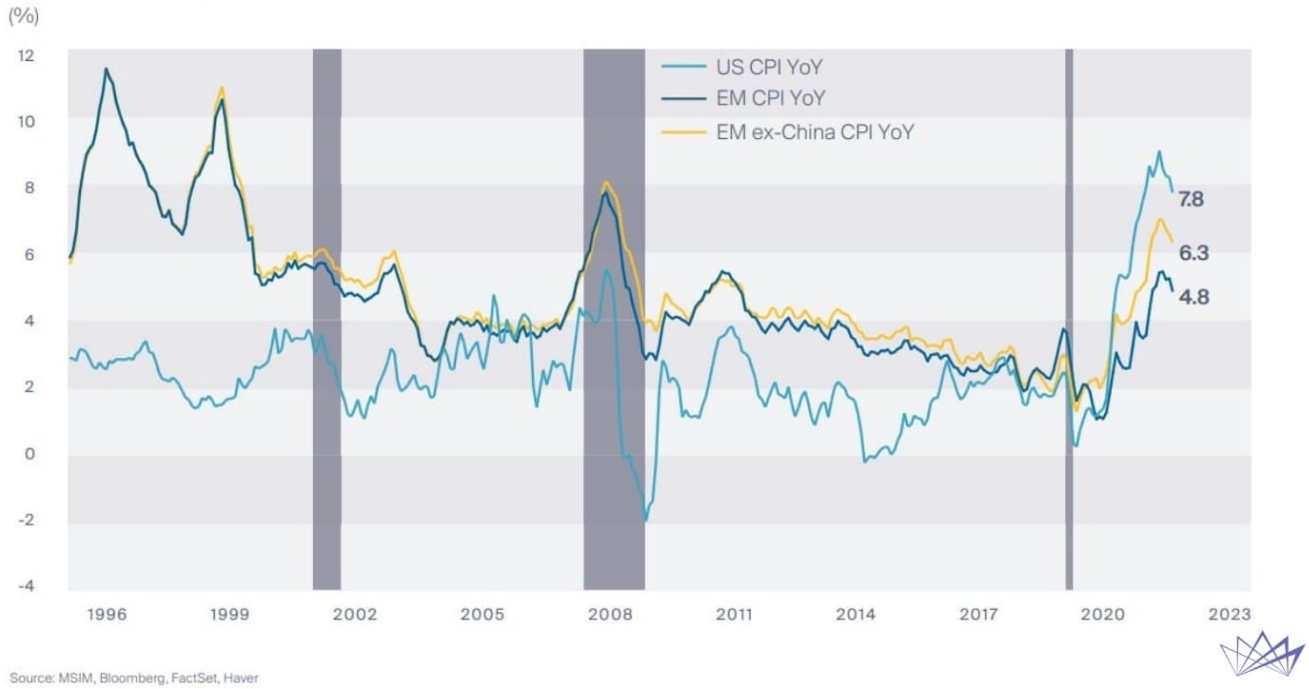
Prudent Fiscal and Monetary Policy

Although there isn't a direct correlation to EPS growth, EM economies are likely to experience several supportive economic tailwinds that should bolster corporate earnings.

- **GDP Growth:** The IMF forecasts 4% growth for EM economies in 2024 (adjusted for inflation), highlighted by growth estimates in China and India of 4.6% and 6.3%, respectively. Comparatively, the U.S. is expecting modest growth of just over 1% with the Eurozone expected to grow a similarly paltry amount. This is the widest expected economic growth differential in over a decade.

- **Central Bank Maturation and Lower Inflation:** EM central banks have matured significantly over the last few decades, creating the ability to influence local interest rates and combat inflation. Rampant inflation has been the weakness in many EM countries over the years, leading to rapid currency devaluations and recurring crises of U.S. dollar denominated debt defaults. As the chart below highlights, EM inflation rates are currently expected to be below those of the U.S. and the developed world for the first time in decades.

Chart 5. Inflation in EM Now Lower Than in the U.S.



Source: MSIM, Bloomberg, FactSet, Haver

- **Fiscal Health:** Debt levels in EM governments have gone up, but if you exclude China government debt, there's been a small decrease to 54% of GDP thanks to better budget management and stronger economic growth. Importantly, most of this debt (85%) is domestically funded, which insulates these countries from international financial stress and currency fluctuations, which has led to several

prior EM crises.[6]

- **Corporate Balance Sheets:** EM companies are generally in better financial shape than those in developed countries, mainly because they've been careful to reduce debt. Apart from China, EM companies have lowered their debt, contributing to a 5% decline in private sector debt, now at 86% of GDP, due to tighter control over corporate and consumer borrowing.

Given these positive indicators and the fact that valuations in EM countries remain almost half the level of U.S. counterparts (~13x vs ~20x), the investment case for EM is increasingly compelling for those seeking growth potential at a very reasonable price. Forecasts and crystal balls are worthless, but the risk reward of EM equities based solely on where we are today has become more compelling.

Gresham's Implementation in Emerging Markets

Investors have many choices for capturing opportunities in emerging markets, including both active and passive strategies in public markets, and various private strategies in venture capital, traditional buyouts and real assets. One important recognition for investors is that while emerging economies and their capital markets tend to be grouped together, these are 24 distinct countries each with different economic cycles, performance drivers and vastly different opportunities.

In public markets, significant market inefficiency leads us to a preference for active management given the higher probability of managers' creating above benchmark returns. We have a strong inclination to "local" managers who cultivate deep networks that offer access to on-the-ground intelligence and where only local professionals possess a nuanced understanding of regional trends. Such expertise is especially crucial in markets like China and India, where the blend of cultural, political, and economic intricacies demands a hands-on approach to investment. However, we also recognize that a few select managers can rotate capital across regions and countries to capture alternating economic cycles and specific country effects. This is a very different skill and investment process that is quite difficult to execute consistently.

For public markets investors, the volume and opportunity are quite limited beyond the relatively developed markets of China and India. While many country-specific markets have a few large investable companies, most local managers must constrain their asset bases to effectively invest with any depth in these markets. The typical large, branded managers that are available to investors in mutual funds and through bank and broker dealer platforms are

limited to investing in only the largest of companies in these markets and must rely on geographic and sector rotation as a primary source of value-add. With heightened geopolitical concerns, Covid-lockdown and vaccine missteps, and ham-handed regulatory intervention, China's public markets have experienced significant outflows driving valuations to multi-years lows, possibly deservedly so. However, value investors are beginning to find interesting opportunities as the current risk-reward balance has become quite favorably skewed.

In private markets, much of the EM private investment ecosystem remains underdeveloped. China is furthest along, and their venture capital market has experienced a robust period of growth but is now facing its first true "winter" as many western investors are concerned about geopolitical risks tied to the current government. India's private investment ecosystem is far less developed, partially because of the relatively slower consumer and GDP-per-capita growth when compared to China's transformation over the last few decades. However, India may become a beneficiary of capital outflows from China as investors seek other places to invest. This remains to be seen and we remain cautious in our approach here.

Conclusion

Since the inception with the MSCI Emerging Markets Index 25 years ago, EM equities have offered investors a mix of promising gains, unfulfilled opportunities and high volatility. While these markets have at times outperformed developed markets, they've also been characterized by fluctuating periods of superior and inferior performance. Moreover, EM countries aren't uniform; they vary in market structures, economic drivers and development stages. Although many EM countries present appealing valuations and significant EPS growth potential compared to developed markets, investors should brace for continued volatility and occasional underperformance to reap the potential long-term benefits of investing in these markets.

Footnotes

[1] www.worldeconomics.com

[2] United Nations

[3] International Trade Association, Shopify

[4] Findexable Global Fintech Index

[5] S&P Down Jones Indices

[6] Morgan Stanley Investment Management, J.P. Morgan, IMF

The statements made in this article are the opinion of Gresham Partners and were developed from market research and data. Nothing in this article is intended to nor should be implied to be intended as any offer or solicitation for the purchase of securities or investments. No representation or warranty expressed or implied is made as to the accuracy or completeness of the information contained herein. Nothing contained herein should be relied upon as a promise or representation of future performance or as being intended to be investment advice.



Gresham Partners LLC
November 27, 2023

Copyright © 2026 Gresham Partners LLC. All rights reserved.
May not be reproduced or distributed without permission.