Emerging Markets – monthly insights

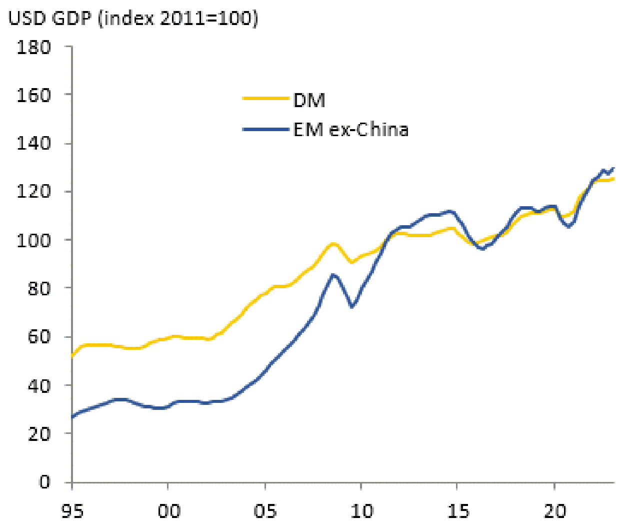
August 2023

We had an interesting question from a long-standing client recently asking why, when emerging markets' gross domestic product (EM GDP) growth has been stronger than developed markets' (DM) growth, the EM asset class performed so poorly over the last decade or so. Below is a brief outline of our views on this.

There has been quite a lot written historically on whether there is a correlation between GDP growth and stock market returns. Jeremy Siegel's, *Stocks for the Long Run* is probably the most well-known study on this topic. His book showed that there tended not to be a correlation, and he explains why this was likely the case, with the strongest being that future economic returns were discounted by markets. In the case where that growth is more volatile (ie EM), this could perhaps explain why, following a strong bull market in 2003-2010, the following decade was poor, as markets had extrapolated a rate of growth that didn't subsequently occur.

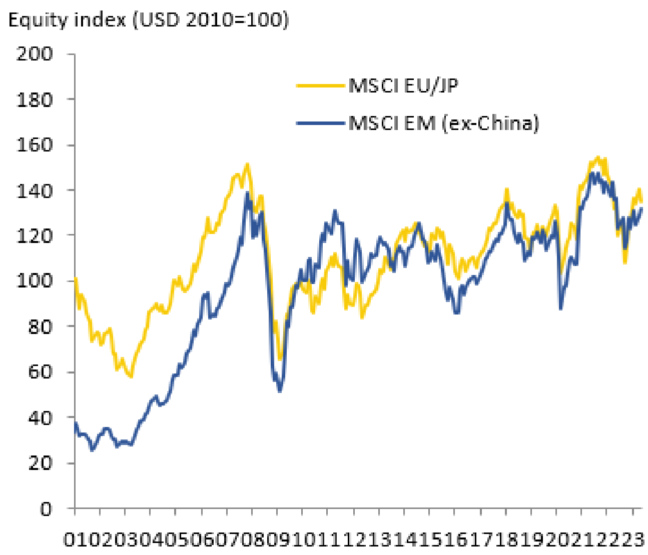
However, more detailed work on this, specifically as it relates to EM, has been done by Jon Anderson at Emerging Advisors. There are two important additional points he makes with which we would agree.

Firstly, he argues that the underlying assumption that EM GDP growth should lead to stock market returns is just wrong. EM has outperformed DM in GDP growth. But what really matters is not local real GDP growth, but rather nominal US dollar GDP growth, and here, ex China (which we will come on to in a moment), EM has not outperformed for over a decade now. If you look at the following chart, it plots EM ex-China GDP in US nominal dollars against DM ex US GDP (which we will also come on to) in US nominal dollars.



Source: EM Advisors Group

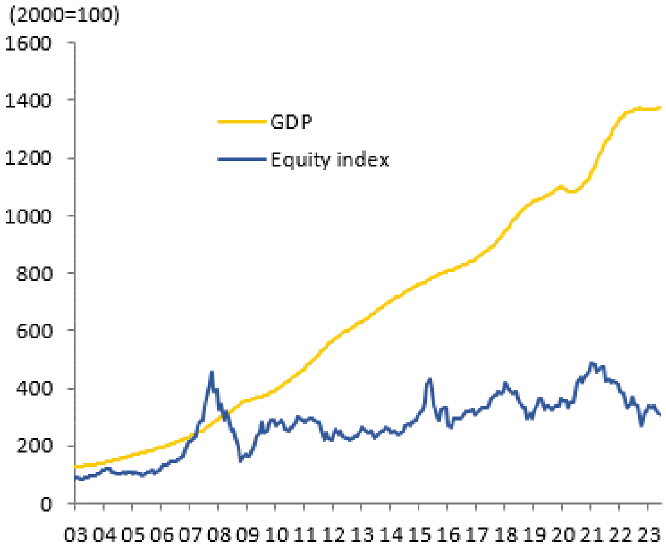
You can see that there were huge gains in US dollar nominal GDP in the early 2000's when you had the commodity boom, fuelled by the rapid industrialisation of China that pulled all EM economies along in its wake. But as that boom ended and the trade cycle rolled over in 2011/12, you've had minimal dollar GDP growth to speak of and, as mentioned, lacklustre equity returns. And that's your story, weak nominal dollar GDP growth and weak returns.



Source: EM Advisors Group

It is worth emphasising here that there is a clear correlation with US nominal dollar GDP growth for the two broad universes above. The stock market performance does largely mirror the experience of US dollar nominal GDP growth. But the real issue comes when you add in the two outliers… and it also happens that these two outliers are the largest stock markets on the planet.

The first is China. This third chart shows US dollar nominal GDP for China in yellow and the MSCI China index in blue:



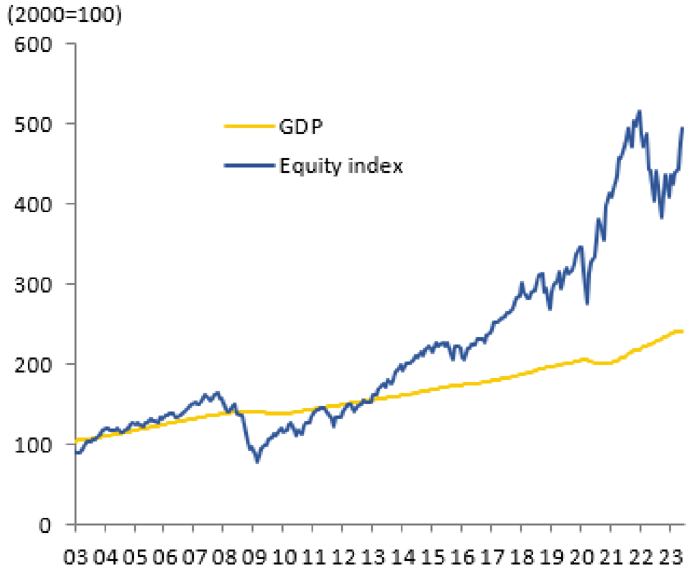
Source: EM Advisors Group

And this is pretty striking! You can see a 10-fold increase in US dollar GDP, but over the last 15 years, absolutely nothing from a stock market point of view. You've actually lost money! How on earth is this possible, you might ask. I don't think there is one answer here.

Certainly, you could point to a gap between GDP and earnings, mainly in the overseas listed tech companies, where you have had a good number of tech companies that haven't made money and are yet to turn profitable. But we think two bigger factors are likely, firstly, an even bigger de-linkage in the domestic stock market due to valuations where you started at 55x earnings a few years ago, and now you're trading at 12x earnings. And secondly, there is the impact of the huge amount of issuance in the Chinese market over the last 10 years. To put this in context, over the last 10 years, the number of companies listed on China's domestic stock exchanges has doubled to over 5,000, bringing the total universe of Chinese listed companies to over 6,700. So, in China, quite clearly, over the last 20 years or so, there has persistently been no relationship between equity performance and the macro. Investors should have made lots of money, and instead they've made nothing. Given the extent to which China dominates the EM universe, this has significantly impacted the returns to EM investors.

Lastly, although it is straying off topic slightly, I think it is worthwhile just bringing in a fourth chart, as it is relevant to asset allocators when trying to think about what to do next.

This chart tackles the other outlier, the US market, over the same time period:



Source: EM Advisors Group

And what you see here is almost the exact opposite of what we observed with China. US GDP has been similar to the rest of DM, gradually rising but nothing very special. But investors in the S&P have made multiples of their money by investing there. This is also very striking! This is partially down to earnings, which have done ferociously well, outperforming GDP growth, but also, as you may be aware, there has been a massive valuation increase, mainly in the tech sector. In addition, one can also observe that since 2007, US firms have retired about US$84bn a quarter from US equity markets. In contrast, Chinese firms have issued some US$87bn a quarter in the same period. So almost exactly the reverse of what you've experienced in EM.

So, where does this leave us? Firstly, if we look at the EM universe ex-China, as mentioned in several of our commentaries over the last few months, there are marked reasons for optimism regarding US dollar nominal GDP growth from here. Whether you're looking at current account deficits, terms of trade, low inflation, fiscal balances or strengthening domestic markets, we expect the EM ex-China universe to deliver much stronger US dollar nominal GDP growth over the coming years.

When we turn to China, many more factors are at play, be it geopolitics, regulation, sanctions, etc. This largely explains our underweight position, which has persisted for some time. The team will continue to set the bar high for Chinese companies to make it into the portfolio.

That being said, the starting point for investing in China now does appeal to a contrarian nature. It is universally loathed, valuations are at historic lows, and the market is perennially worried about economic growth, debt burdens and politics. And yet, there are still companies with increasingly entrenched competitive moats that are coming to dominate key niches in the supply chains for several important industries (electric vehicles, batteries, solar, semiconductor design, 5G etc.) Over the last decade, despite all the regulatory and geo-political headwinds, finding companies that can capitalise on these trends can be phenomenally profitable (e.g. Tencent's share price is up over 300-fold since listing, and CATL is up c.20x since listing in 2018).

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