Maintaining perspective in emerging markets

The drivers of emerging market equities returns are undergoing a seismic shift. What is underlying this and how can investors position themselves to participate in potentially significant gains in productivity and earnings growth?

By *Daniel Graña*

Market volatility due to elevated inflation, subsequent monetary tightening, and rising geopolitical tensions has cast some investors' attention away from emerging markets (EM). The clouded macro environment is likely a reason why EM equities have lagged broader markets in 2023. These near-term developments have obscured the powerful trends that are reshaping the EM equities landscape.

Far more than the historical drivers of economic convergence and outsourcing, we believe future EM prosperity and earnings growth will be increasingly driven by the themes of innovation, deglobalization, and decarbonization.

While understanding the transformative potential of these secular themes is key when seeking to optimize one's EM exposure, so too is the manner in which one views these regions. We believe that an effective way to view the EM equities landscape is through the complementary lenses of country, company, and governance.

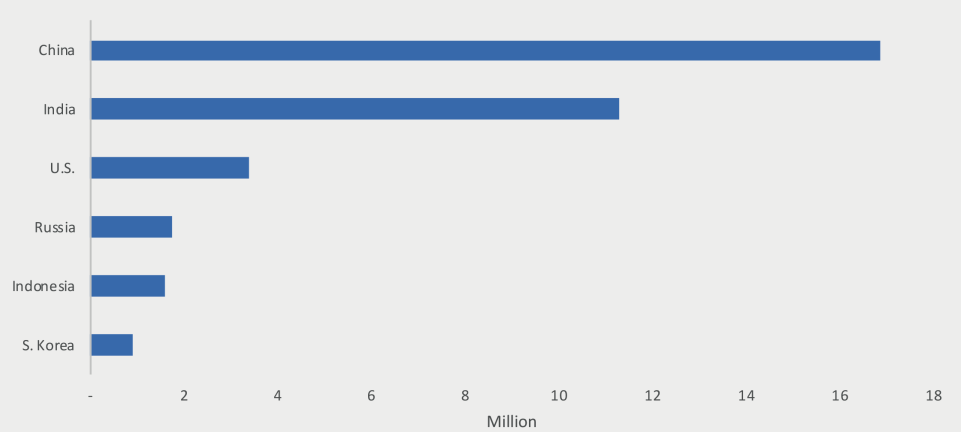
Country analysis matters when investing in emerging markets, because it is rare to find attractive investment opportunities in jurisdictions that are hostile to the private sector and that have unsound national finances and poor demographics. Instead, the potential for excess returns tends to be enhanced by the secular tailwinds associated with strong or improving macro fundamentals and political governance.

For investors with a longer-term view, we believe the current volatility provides an opportunity to better understand – and perhaps increase exposure to – these ascendent drivers of EM growth.

The rise of the EM innovators

Investors have long understood that EM countries yearn to move up the value chain to capture a greater share of profits for finished goods. What is perhaps new is the degree to which EM entrepreneurs are harnessing innovation to address EM-specific frictions that have long stifled social and economic progress. Chief among these is the share of populations that are under- or un-banked, as well as gaping holes in healthcare delivery systems. For example, across EMs, innovative companies are

FIGURE 1: NUMBER OF STUDENTS STUDYING SCIENCE, TECHNOLOGY, ENGINEERING AND MATH



Home-grown innovation is likely to be catalyzed by the number of students in digitally-forward EMs studying science, technology, engineering and math.

Source: Janus Henderson Investors

‘Reshoring of manufacturing capacity may spur stronger economic growth and investment potential in markets such as Vietnam and Mexico.’

marrying financial technology (fintech) and e-commerce to provide customers with greater access to both goods and methods to pay for them.

Another area where innovation has been prioritized is the push toward decarbonization, especially by China. The country is motivated not only by what it perceives as the strategic vulnerability of being dependent on hydrocarbon imports to fuel its industrial base, but also from a commercial perspective as it has positioned itself as a pivotal player in alternative technologies such as electric vehicles, solar, and batteries.

In a similar vein, Saudi Arabia has launched its ambitious Vision 2030 program with the complementary goals of decreasing its dependence on hydrocarbons and unlocking the country’s productive capabilities, including increasing women’s roles in the workforce. By reconfiguring the composition of the country’s economy – tilting it more toward value-added, innovative industries as well as consumption – Saudi leadership is attempting to diversify the levers of economic growth in a world less reliant on oil and gas.

As with nearly all innovation, these initiatives will require considerable investment. For EM countries without the benefit of tapping massive cash reserves, much of this funding will be raised from developed market investors. Yet, unlike during earlier waves of investment flows toward EMs, this iteration, in our view, is likely to see a greater portion of profits result from commercial activity within EMs, and by increasingly sophisticated regional companies.

Reversing course

Spurred by geopolitics and a desire for supply-chain security, the multi-decade trend of globalization is reversing. Rather than flowing to the cheapest source of labor, production will instead be increasingly defined by near-shoring and friend-shoring. We believe that the reshoring of manu-facturing capacity may spur stronger economic growth and investment potential in markets such as Vietnam and Mexico. We also see potential in the Middle East.

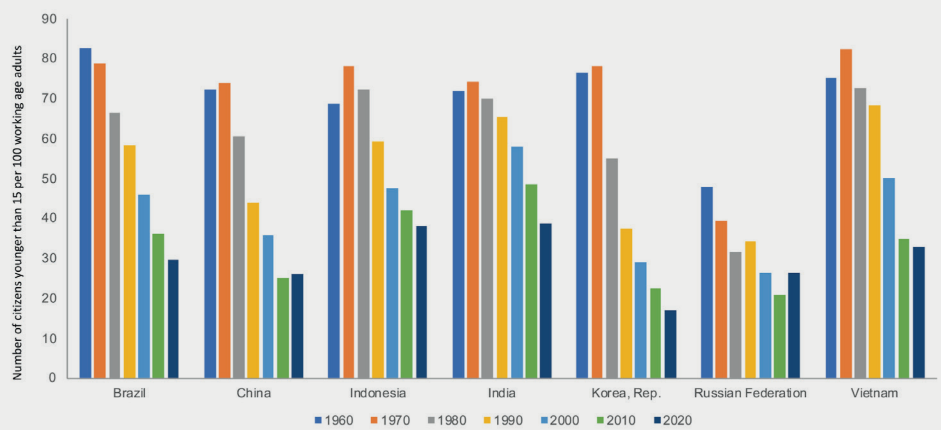
China’s economic decoupling

China will remain an important component of the EM equities universe. Many of its industries are likely to benefit from economic decoupling as they seek to lower >

Daniel Graña

Head of the Emerging Markets Equities Team, Janus Henderson Investors

FIGURE 2: FAVORABLE DEMOGRAPHICS IN INDIA



In contrast to some other countries, India maintains a higher ratio of citizens younger than 15 relative to the broader population.

Source: Janus Henderson Investors

PHOTO: ARCHIVE JANUS HENDERSON INVESTORS their exposure to external forces. This rationale is behind the country's dual circulation model, which entails generating more growth from domestic sources while also continuing to supply the rest of the world with manufactured goods.

Furthermore, when considering China exposure, investors must understand how the government's attitude toward – and objectives for – the private sector have evolved. Increasingly, the central government expects commercial activity to be aligned with the party's goals of common prosperity, innovation, and decarbonization. As such, we believe investors should incorporate a governance lens to determine whether commercial initiatives in China align with those of the central government.

India's time?

One potential destination that is rightfully garnering investors' attention is Asia's other giant: India. The subcontinent's dominant economy meets many of the criteria that we consider conducive for generating excess returns over a multi-year horizon. India has favorable demographics, with the benefits inherent in a young workforce magnified by the trend toward urbanization.

The country is rapidly improving its historically subpar infrastructure with the aim of unlocking productivity. Furthermore, the government is championing a reform agenda that seeks to increase the private sector's role in propelling economic growth.

While on the surface, India and China have similar dependency ratios[1], their composition reveals diverging demographic paths. In 2020, India counted roughly 10 citizens older than 65 for every 100 working-age adults. For China, the ratio was a far grayer 18. Perhaps more importantly, the ratio of youths in China per 100 working-age adults slid from 61 in 1980 to 26 by 2020. For 2020, India's youth dependency ratio stood at a much healthier 39.

It should also be noted that India is a democracy. And while the negotiations and compromises inherent in parliamentary chambers can be messy, they tend to provide a level of transparency and accountability that reassures investors. Good governance is not only requisite on the sovereign level, but also in corporate boardrooms. India possesses a strong equity culture where the interests, roles, and rights of minority shareholders are recognized.

'India has favorable demographics, with the benefits inherent in a young workforce magnified by the trend toward urbanization.'

Monitoring Brazil

Investors may want to approach Brazil with more circumspection. With its large population and abundance of natural resources, Brazil rightly commands a place in EM equity allocations. But the country has a complicated history of fiscal management, which has resulted in numerous crises.

Most recently, Brazil's fiscal largesse in the wake of the COVID-19 pandemic was among the most generous in the developing world, with much of it geared toward stimulating consumption. The country is now dealing with the aftereffects of its credit excesses, including the air pocket that inevitably forms when consumption is pulled forward to such a degree.

Ahead of the policy game

A dose of perspective may also help investors become more comfortable with EMs in the current environment. EM central banks were far ahead of the US and Europe in confronting inflation. A long history of inflationary shocks has taught them that they did not have the luxury of waiting to see if rising prices were transitory. Consequently, should the global economy continue to slow, EMs may be better positioned to ease still-restrictive policy.

Inevitably, EM growth will continue to be influenced by the global economic cycle. But over the mid-term, we expect the degree to which macro factors impact EM economic and earnings growth will decrease. As this evolution unfolds, we believer other, more durable forces such as innovation, near-shoring, and consumption will take the lead in propelling EM corporate earnings growth. ■

1 A country's age dependency ratio is the number of citizens younger than 15 and older than 65 per 100 working-age citizens.

SUMMARY

Far more than the historical drivers of economic convergence and outsourcing, we believe future EM prosperity and earnings growth will be increasingly driven by innovation, deglobalization, and decarbonization.

For investors with a longer-term view, we believe the current volatility provides an opportunity to better understand – and perhaps increase exposure to – these ascendent drivers of EM earnings growth.

As the macro's impact on EMs subsides over the mid-term, we believe other, more durable forces such as innovation, near-shoring, and consumption will take the lead in propelling these regions' growth.