Emerging Markets: The Bull Is Back

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Key Takeaways

- The last emerging markets boom was driven primarily by China's rapid industrialization phase. Today, a new boom is unfolding that extends far beyond China with far deeper participation among EM nations.
- Many investors expected EM economies to be especially vulnerable to rising rates, based on the view that rate increases caused serial crises in the 1980s and 1990s. But EM economies entered the pandemic with repaired banking systems and heightened financial discipline after a decade-plus of deleveraging.
- Select EM stock markets are now cheap, under-owned and have quietly entered an uptrend: a classic buy signal.

Ask Forstrong: Are emerging market equities entering a new bull market?

Asked to pinpoint the peak of the last emerging markets boom, an astute investor may suggest something like the second quarter of 2011. Globalization had been gathering pace since China's 2001 entry into the World Trade Organization — a single event that plugged a vast and previously isolated country into world supply chains, unleashing some 500 million new workers into the global economy. From there, trade among nations flourished, cross-border capital flows soared and, through it all, developed countries maintained accommodative monetary policies. The collective surge seemed unstoppable. Near the top, the BRICs, that handy acronym to describe the world's most dynamic economies, had fully worked their way into the public consciousness. And, they had impressive performance to back it all up: many EM stock markets had annualized returns which were double or more the US during the period. Everyone wanted a piece of the emerging markets.

Yet, as even the casual macro tourist now knows, that Eden has passed. It was an environment built on a well-oiled globalization: frictionless trade, a cooperative China and America, and, not to be missed, a naïve assumption that most EM nations would fall in line with free-market rules written by the West. That era is long over.

Since then, EMs have faced persistent headwinds. With their heavy reliance on exports and rising trade, sagging aggregate demand after the 2008 crisis hit EM nations disproportionately hard. Aggressive lockdowns in Asia and snarled supply chains during the pandemic further aggravated the trend. And, of course, hostile relations between China and America clogged the arteries of global trade. Meanwhile, the weaponization of the US dollar following the outbreak of war in Ukraine diverted trade patterns and created macro distortions as EM countries scrambled to re-position and hedge against America's financial might.

None of this has been easy for EM. And no one should be surprised that returns have languished over the last decade. But wait, what's this? Stock markets in India, Peru and Taiwan are all outperforming America in 2024. In fact, inclusive of frontier markets, 9 of the top 10 performing equity markets this year are outside developed markets.

Readers will rightly demand answers. Can all of this continue? Consider the setup. Most Western nations continue to struggle with a series of self-inflicted wounds: high sovereign debt levels, fragmentation into squabbling trade zones and, most notably, over-stimulating during the pandemic (and entirely missing the inflationary impulse afterward). In Canada, the combination of over-indebted households and an economy reliant on real estate has created a dangerous level of interest rate sensitivity. Even our own central bank has declared a "productivity emergency" for the nation (sigh … we could write volumes on this but it is the subject for another Ask Forstrong).

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By stark comparison, most emerging markets are leaning boldly into a new world order. In fact, deep cooperation is happening across many of these nations. Multi-lateral trade agreements are being swiftly signed. Settlement of bilateral trade in national currencies other than the US dollar is rapidly increasing. And, supply chain diversion is powering a manufacturing revival and investment boom outside of China.

What's more, EM capital is moving in a way it has never done before. War and sanctions have buoyed commodity prices and profits for EM commodity exporters. During previous booms, the proceeds were always recycled back into Western markets. Not this time. Money is now heading back into domestic markets, funding all stripes of entrepreneurial dynamism. Countries that formerly grumbled about America's privileged currency status (and did nothing) are finally pushing back.

EM Primed For Outperformance

Few saw this resilience coming. Most expected EM economies to be especially vulnerable to rising rates, based on the view that rate increases caused serial crises in the 1980s and 1990s. But this perspective extravagantly misses the big picture. EM economies entered the pandemic with repaired banking systems and heightened financial discipline after a decade-plus of deleveraging. During the pandemic, they borrowed less heavily for stimulus spending, and saw deficits rise on average by half as much as the US. In fact, excluding China, total EM government debt to GDP figures have fallen over the last year with improving fiscal deficits and higher nominal growth. External debt, often called the original sin in EM, has also declined dramatically. Only about 12% of EM government debt is now funded from foreign sources.

What happens next? Starting points matter in macroeconomics. Stronger sovereign, corporate and household balance sheets have lowered external vulnerabilities. But also, after a long period of foreign disinterest in EM, local currency valuations are trading near the crisis-lows of the early 2000s.

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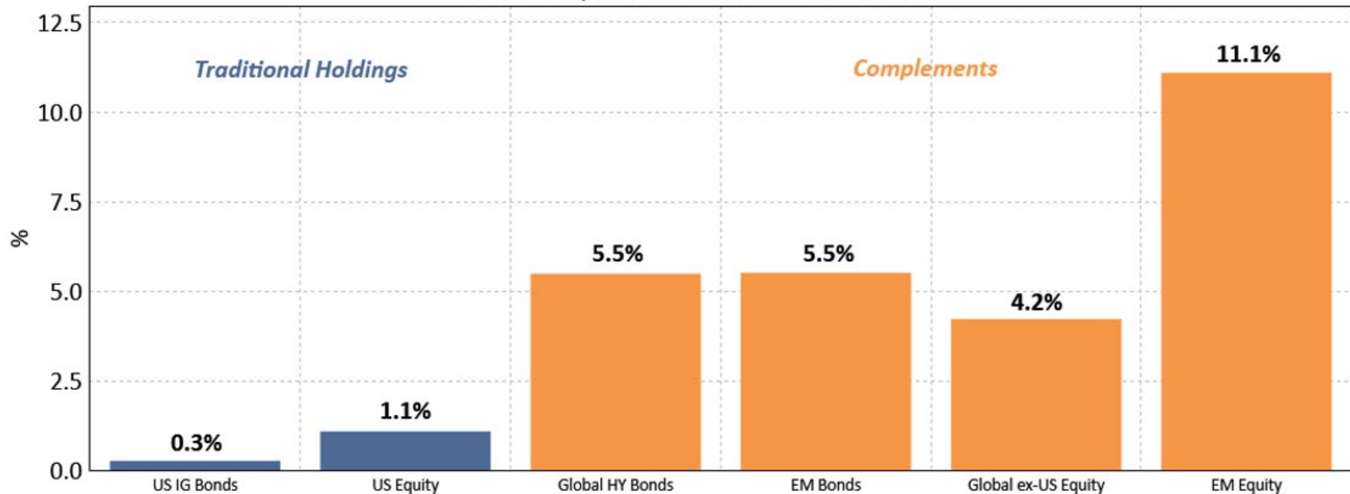
Cheap currencies are the cheat code for national economies. In fact, low currency valuations have always been wonderful starting points for EM outperformance in the past. Heightened competitiveness boosts exports. Capital then follows higher growth. And so, a virtuous cycle begins.

Layered on top of all this, is an unfolding policy easing cycle. The absence of fiscal excesses and more proactivity toward combating inflation has kept prices more contained in EM compared to the developed world. In fact, for the first time ever, average inflation levels in major EM economies are lower than major developed economies. Now, having lots of levers to pull —in the form of lower interest rates or higher fiscal spending — provides a huge comparative advantage.

Of course, trends in EM have never fit neatly into one storyline. The last EM boom in the 2000s was driven by China's rapid industrialization phase. This new phase extends far beyond China with far deeper participation. Importantly, India, long deficient in critical infrastructure, is now deep



into a major capex boom, as evidenced by a steep rise in gross capital formation and surging private sector new project announcements. The global push to build a greener economy is increasing demand for raw materials, benefitting commodity-exporting countries like Brazil, Chile and South Africa. Countries where wages are low, populations are young and relatively skilled — such as Vietnam, Indonesia, and Mexico — are benefitting enormously from supply chain diversification. Even the Gulf states, lured by Asia and eager to diversify their economies away from fossil fuels and restore national images are witnessing a boom in cross-border trade and current account surpluses.

It should not be difficult to see what is happening here. Increased infrastructure investment and trade is integrating more of the world's developing economies into the global economy at an accelerated pace. So much for deglobalization. Excluding China, these countries comprise more than 3 billion people, where demographics are favourable, incomes are growing, and constructive dialogues are leading to a surge in cross-border commerce and economic partnership. To ignore this new reality is now an exceptionally risky position for long-term investors.

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Investment Implications

Despite better growth, lower debt and lower inflation, many EM stock markets are still trading at crisis-level valuations. That leaves plenty of room for re-rating. But an index-based approach to EM is unlikely to be the right strategy. Passive investing in broad-based indices often means buying yesteryear's winners. Today, EM stock markets allocate far too much capital to digital economy heavyweights like Chinese internet stocks and not nearly enough to real economy sectors like manufacturing, industrials and natural resources. The top four nations — China, Taiwan, India and South Korea — currently comprise nearly 75% of the MSCI EM Index.

This makes passive investing in EM a concentrated call on a small number of Asian economies, who (apart from India) have economic growth trajectories that are now in a more mature phase relative to the high growth experienced in recent decades. ***Active management will be crucial to capture the pockets of opportunities within countries, sectors and themes.***

Our investment team has such strong conviction in this thesis that Forstrong launched our own actively-managed EM-focused equity ETF (TSX: FEME) based on the view that this region of the world will dramatically outperform in the period ahead. The last decade's carnage in EM offers an excellent entry point at a time when momentum has begun to take hold. Given the potential returns, investors need to have a strategic allocation to this part of the world brimming with opportunity.

Tyler Mordy, May 2024

Delve further into EM with our *'A Global Macro ETF Approach To Emerging Market Investing'* whitepaper.

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