Are Emerging Markets Poised to Leapfrog?

September 2021

DeMarche

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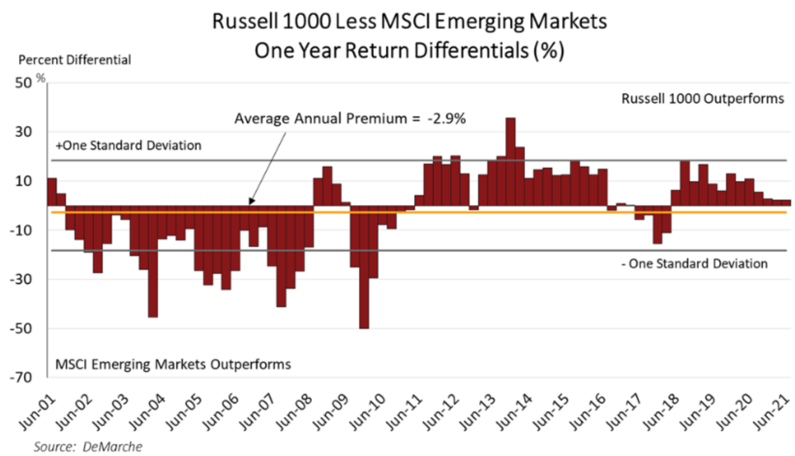
Point of Discussion

Abstract

Emerging markets have gone though many changes in the past few years and are poised to change more in the future. Developed markets appear somewhat expensive and look to face challenges in the wake of aging population demographics. Rapid technological change and consumer adoption paired with younger demographics paint a favorable backdrop for emerging markets investors. This paper will examine the diverging changes, challenges and opportunities that exist between the emerging and developed markets.

Since the Great Financial Crisis, monetary and fiscal policy have buoyed global markets, facilitating the longest bull run for equities in history. During this time frame, the United States has led the developed markets, with a 15.6% annualized return. In contrast, the MSCI EM index has returned an annualized 9.9%, slowed by headwinds including the persistent strength of the US dollar of the past decade. Despite the decade long outperformance of the US market, Emerging Market equities have, in the last 20 years, shown periods of lasting outperformance. This paper will look into some reasons that that outperformance may reassert itself.

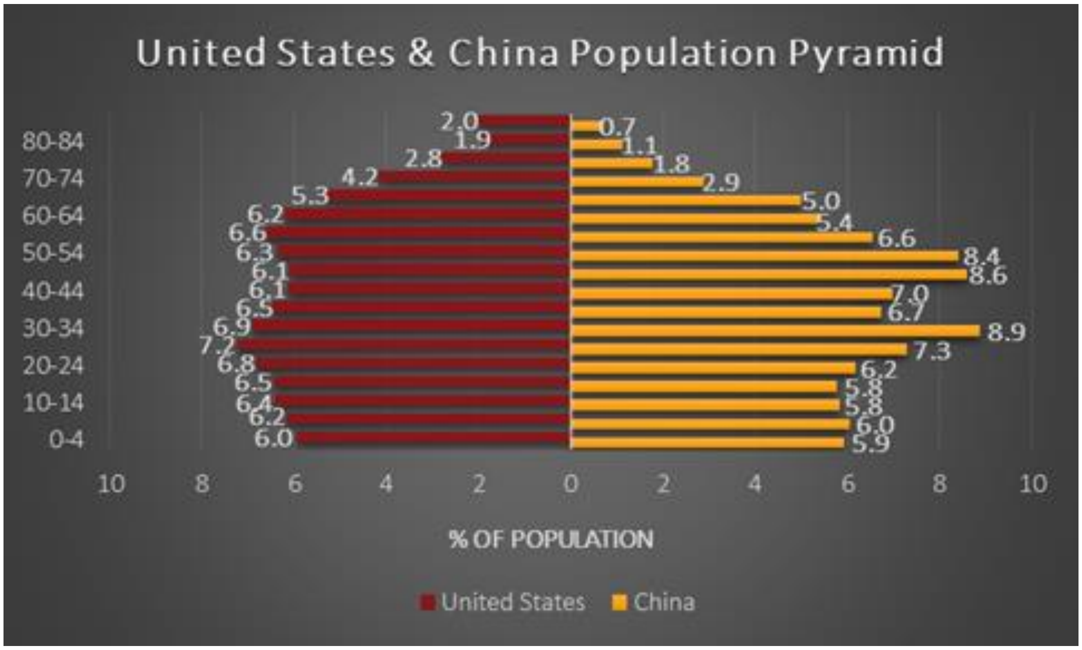


Although Emerging Markets equities have struggled to stand out relative to other regions in recent years, the case remains strong to not only maintain allocations, but to also consider increased exposure should risk tolerances allow. While easy fiscal and monetary policy have been the prevailing force in the market over the last decade, a rising tide of demographic and macroeconomic realities are poised to exert greater influence in the years ahead. Do these changes set the stage for the Emerging Markets to regain their dominance of the global equity market in the third decade of the 21st century?

Pyramid Inversion

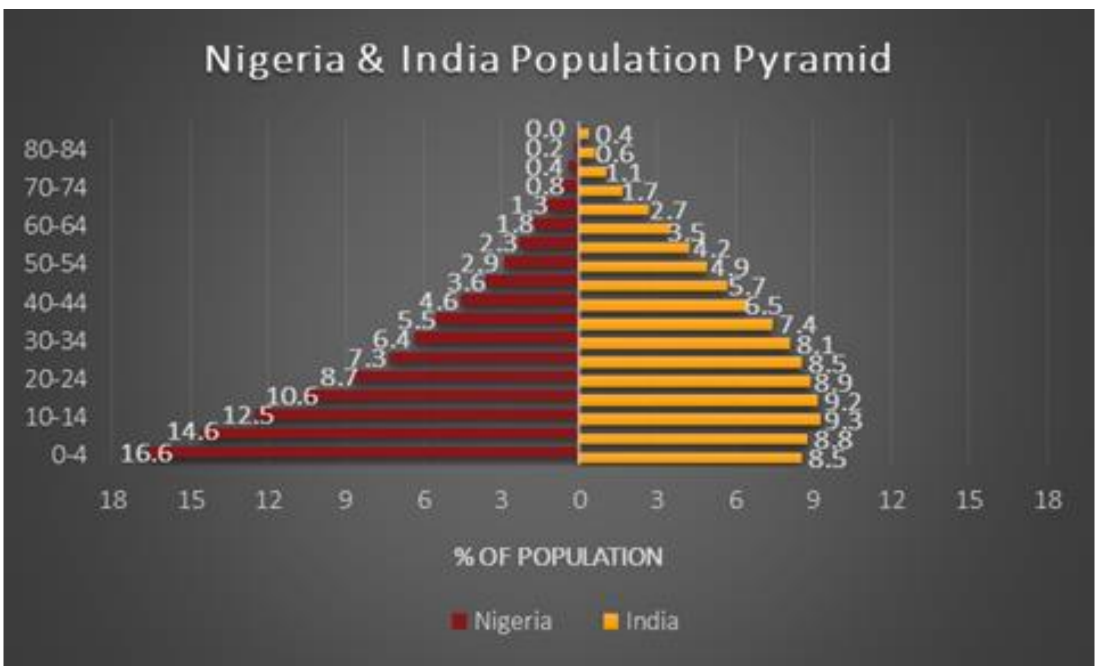
Let's for a moment consider what the demographics tell us. The developed world is getting older, quickly. By the UN's estimate, in 2050 individuals aged over-65 will represent 16% of the world's population, a three-fold increase from present values. The global population is aging. 50 years ago the median age was 22, now it is 31 and by 2050 it will be 36, according to United Nations projections[1].

[1] How Technology Creates Markets. (2018). *International Finance Corporation*. Retrieved September 1, 2021, from https://www.ifc.org/wps/wcm/connect/6616fd9f-854a-45bd-8588-6c3d57bec589/IFC-EMCompass-TechMarketsReport_FIN 2018-ForWeb.pdf?MOD=AJPERES&CVID=mdwBXRb.



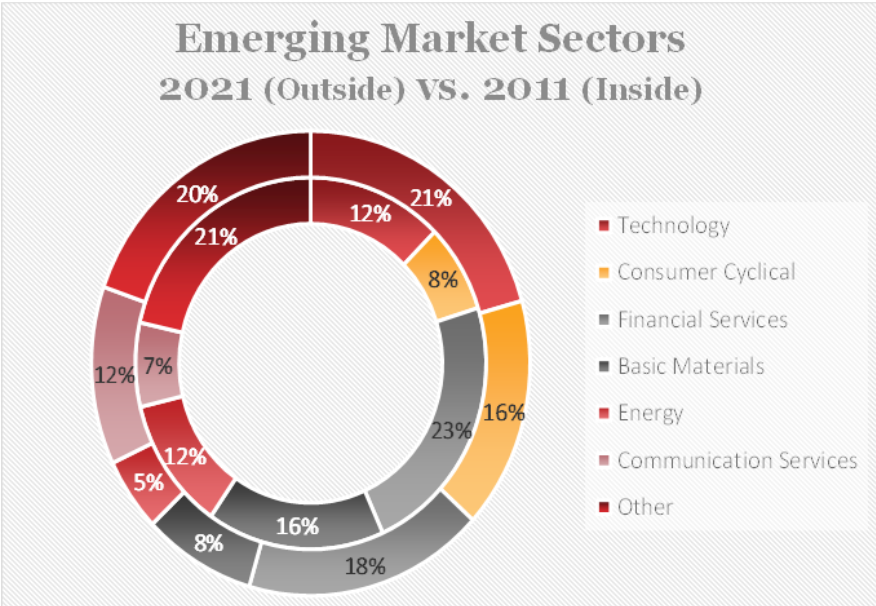
The chart to the left shows that not only is the United States aging, so is China[2]. While China's weight in the index has grown dramatically, this shift in demographics suggests that other younger countries have the potential to move the index forward. This signals that for the first time in human history, the population aged 30 years and older will outnumber the population under 30[3]. Birth rates from the 1970's to present day have declined from a global average of 4.9 children per woman of childbearing age down to 2.5[4]. An increased focus on elderly care in tandem with a proportionally smaller eligible workforce will only serve to slow future growth prospects. Concurrently, it is expected that by 2050 Gen Z babies born between 1997 and 2014 will generate an estimate $70 Trillion worth of income annually[5].

Unsurprisingly, 9 out of 10 of those babies will be born in emerging markets countries, giving investors a clear sign of where their focus should be. The faster growing and younger populations of India and of even Sub-Saharan Africa provide the groundwork for far-sighted investors to prepare for the long-term. The diverging demographic phenomena will lead to different economic and spending trends, with developed markets focusing on health care, and emerging markets more heavily investing in technology and infrastructure.



[2] Population Pyramid data sourced from https://databank.worldbank.org/source/population-estimates-and-projections
[3] How Technology Creates Markets. (2018). International Finance Corporation. Retrieved September 1, 2021, from https://www.ifc.org/wps/wcm/connect/6616fd9f-854a-45bd-8588-6c3d57bec589/IFC-EMCompass-TechMarketsReport_FIN 2018-ForWeb.pdf?MOD=AJPERES&CVID=mdwBXRb.
[4] Ibid.
[5] Ibid.

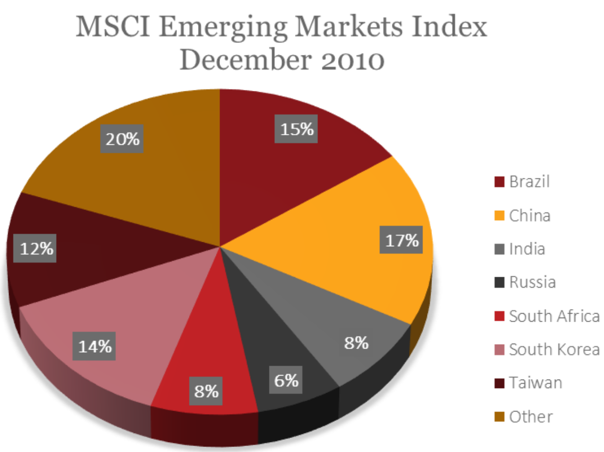
A 21st Century Index

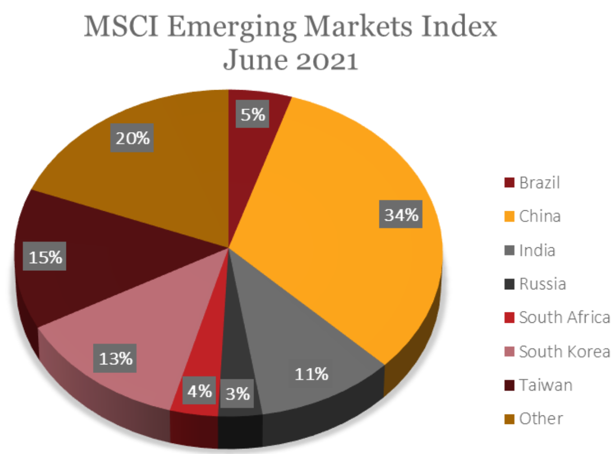


In the last 10 years, the MSCI EM Index has shifted from being largely driven by commodities and financials, to being dominated by the technology and consumer cyclical sectors[6].

With China's share of the index growing from roughly 17% in 2011 to around 35% in 2021[7], the index has grown increasingly concentrated. While this illustrates how in recent years investors have looked to China for much of their Emerging Markets exposure, a contrarian viewpoint would urge us to consider other parts of the emerging markets in the years ahead.

Increased regulatory scrutiny of big technology in China, coupled with an artificially skewed population pyramid due to the lingering effects of the one child policy will only serve to hamper future growth prospects.





While China dominates the Emerging Market index, there are opportunities in other countries to earn alpha including Korea, Taiwan, and India, and for more risk-tolerant investors, even strategic allocations to rapidly growing frontier markets such as Vietnam and Sub-Saharan Africa. In fact, in the past year dated 6/30/2021, the frontier markets index has outperformed the emerging markets index by about 1.5 percentage points[8].

[6,7,8] Data originated from Morningstar

The Leaping Frog

The comparatively muted returns of the last decade in the emerging markets have overshadowed the massive leaps and bounds in technology and infrastructure that many developing nations have undertaken. Penetration rates for technologies such as broadband and mobile phones have continued to accelerate, creating the potential for some of these countries to leapfrog more mature markets in their development. In fact, an increase of 1.8% in mobile broadband penetration can lead to GDP growth of 0.7%[9]. Instead of continuously updating older infrastructure, entirely new systems can be put in place ("the leaping frog"), facilitating the adoption of new technology such as mobile payments at rates well above their developed counterparts.

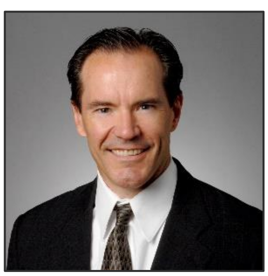
Take China for example, whose leapfrog generation exemplifies an ideal blueprint for rapid adoption of new technologies. Without legacy payment systems such as Visa and MasterCard to hinder progress, China had a rapid uptake in mobile phone adoption that also coincided with mobile payment adoption. From 2013 to 2019, the digital wallet businesses grew at an annualized rate of 140%, culminating in 700 million unique users[10]. With a muted US equity return environment in the coming decade likely, a principled and targeted approach to the rapidly evolving emerging markets may create a strong source of alpha in an overextended equity market.

Setting a Proactive Course

Emerging Markets are poised to provide investors with access to markets that are likely to demonstrate greater growth in the decades ahead. Following a decade of equity leadership by U.S. large cap stocks, the U.S. market looks expensive in relation to Emerging Markets stocks that trade at much lower price/earnings multiples. A well rounded investment portfolio includes exposure to different investment factors, demographics and geographies. Research on demographics also shows that some of the fastest growing parts of the globe are in so called "frontier" markets. As these economies grow and mature, investment opportunities are expected to present themselves. We have seen it already in the adoption and proliferation of financial technology (global payments) and communications. Institutional investors should proactively consider making allocations to emerging market managers that take a broad view when evaluating their opportunity set, seeking to capitalize on investments that will benefit from these growing demographic and macroeconomic tailwinds.

Put Research To Work

with the DeMarche Team



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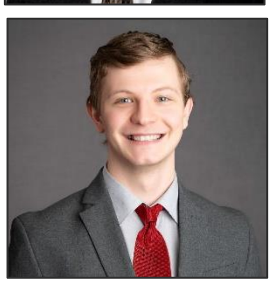
Sources Utilized:

- *DeMarche*
- *IFC*
- *Morningstar*
- *The World Bank*



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[9] How Technology Creates Markets. (2018). International Finance Corporation. Retrieved September 1, 2021, from https://www.ifc.org/wps/wcm/connect/6616fd9f-854a-45bd-8588-6c3d57bec589/IFC-EMCompass-TechMarketsReport_FIN 2018-ForWeb.pdf?MOD=AJPERES&CVID=mdwBXRb.

[10] Ibid.