The Evolution of Emerging Markets

November 2025

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Point of Discussion

Abstract

This white paper reviews the past two decades as two separate periods: the "Glory Days" of strong growth and confidence, followed by the "Dark Days" of slower performance and reduced investor interest. It also evaluates current global trends to determine whether a new cycle of opportunity may be developing in the Emerging Markets.

The Evolution of Emerging Markets

Emerging markets have experienced two distinct eras. For this paper we refer to the boom period as the "Glory Days" which occurred in the 2000's and were powered by China's WTO entry, booming commodities, and strong currencies that fueled global growth. During that time, investing in the asset class was largely a beta trade where broad exposure captured the cycle's upside. As growth matured and the dollar strengthened, those tailwinds reversed and the "Dark Days" began. Now it seems the tide may be turning again. Supply chain shifts, demographic trends, and advances in technology are reshaping the opportunity set and setting the stage for a more balanced and selective era in emerging markets.

The Glory Days in Emerging Markets: 2001-2012

In any given quarter from 2001 through 2012, performance reports showed the MSCI Emerging Markets Index leading the S&P 500 on a trailing three-year basis. Since 2012, there has not been a single quarter-end in which the EM index outperformed the S&P 500 on a trailing three-year basis. For this paper, we will refer to the 2001-2012 period as the "Glory Days".

The EM Glory Days were set up by China's economic opening under Deng Xiaoping, whose reforms shifted the country away from Mao Zedong's isolationism and laid the groundwork for WTO accession in 2001. China's entry into the global trading system triggered an export boom and a surge in demand for energy and industrial commodities. With cheap labor and a massive population, China became the "world's factory," fueling a new era of globalization.

Regional partners such as South Korea and Taiwan benefited as exports to China soared. Taiwan specialized in semiconductors and hardware, while Korea excelled in memory chips and industrial materials. Foreign direct investment across the region surged. Commodity-rich nations like Brazil and Russia also thrived as key suppliers of the resources that powered China's industrial ascent. Between 2001 and 2008, the Bloomberg Commodity Index generated returns greater than 19 percent annualized, underscoring the strength of the commodity super cycle that was underway.

The ongoing growth in Asia shaped the MSCI Emerging Markets index weights. As shown in Figure 1, China's structural changes starting in 2001 led to a steady rise in its weight in the MSCI EM index over the next decade. By 2009, China surpassed Korea as the largest country weight in the index. As China became a bigger player in global markets, the EM index grew more regionally concentrated. Figure 2 shows that in the early 2000s, Asian giants[1] overtook Latin American giants[2] and held a larger share of the index than Latin America ever did. The peak of EM performance came during this period of regional concentration, driven by rapid changes in Asia.

[1] China, Taiwan, South Korea

[2] Brazil, Mexico, Chile, Columbia, and Argentina

The EM Glory Days were also defined by strong currency tailwinds. As shown in Figure 3, the U.S. dollar weakened significantly from 2002 to 2008 against a basket of global currencies. Two major trends initiated this trend of Dollar weakness. The first was the bursting of the so called Dotcom Bubble, which pushed U.S. dollar net flows negative as investors sold dollar-denominated assets and redirected capital abroad. The second was interest rate differentials. The US Federal Reserve cut interest rates faster than other central banks in 2000 and 2001.This made U.S. fixed income securities less attractive compared to international alternatives. Taken together, these forces supported broad strengthening of emerging-market currencies, which in turn boosted returns for the asset class.

Figure 1

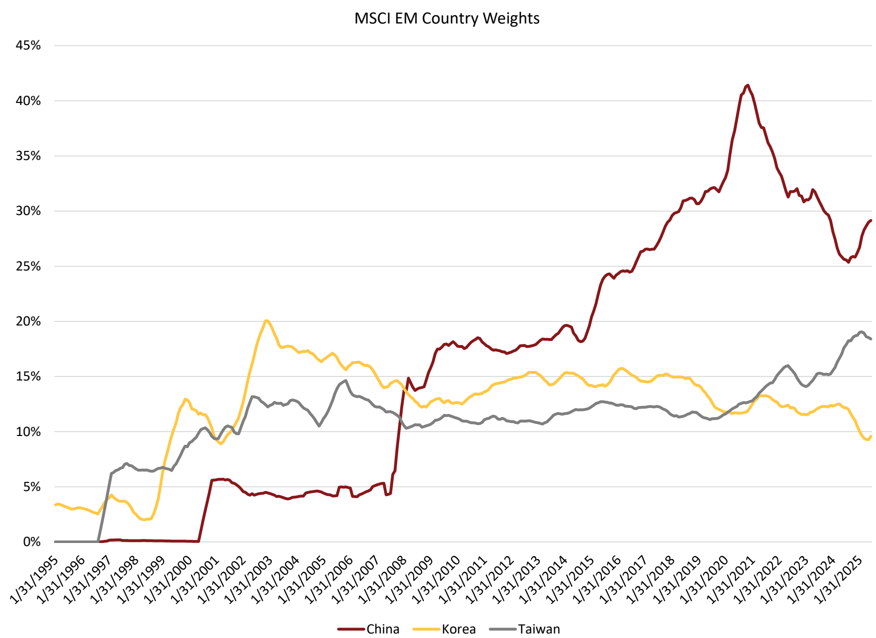
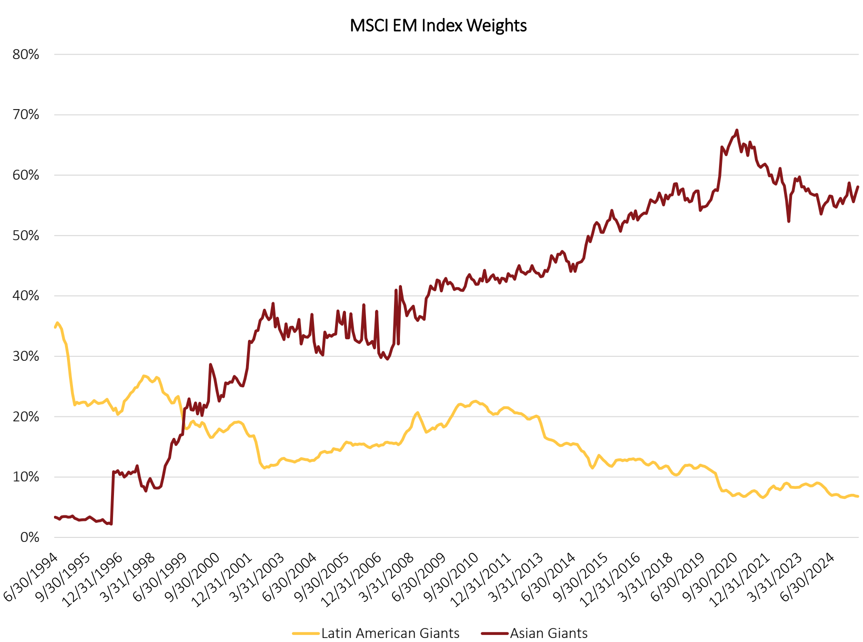
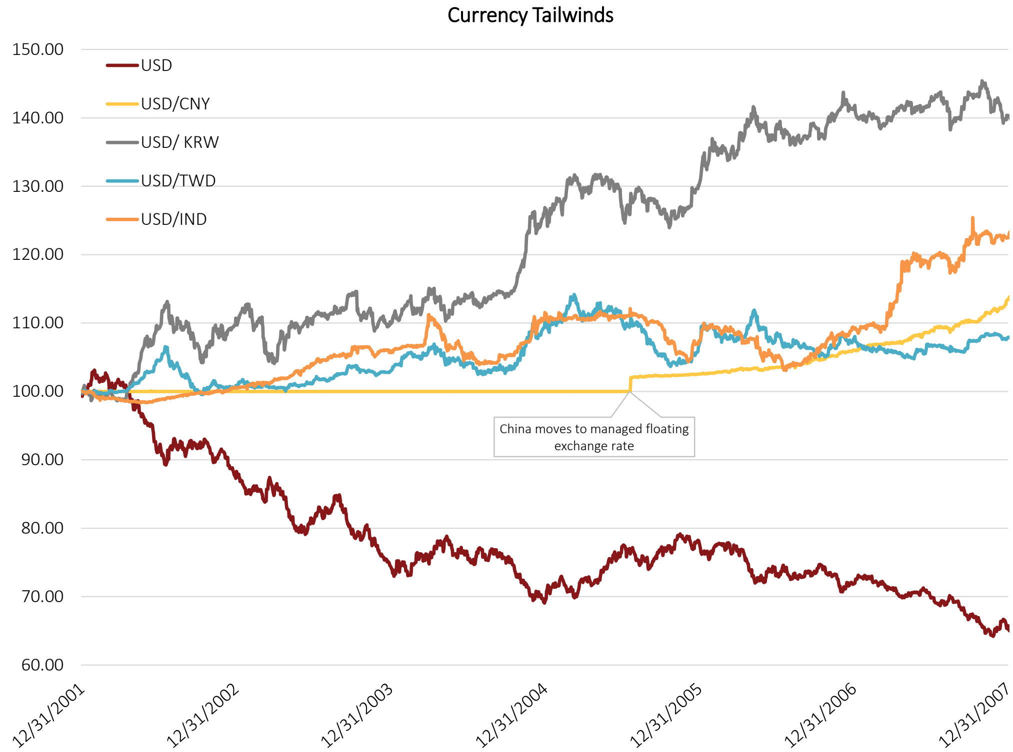


Figure 2



In the Glory Days, the emerging markets rewarded simple exposure. Owning the index meant riding a wave of regional growth, strong currencies, and booming commodity prices. But every tide eventually turns. As those tailwinds reversed, the Dark Days began, and what was once a broad beta trade became a test of endurance and selectivity.

Figure 3



The Dark Days in Emerging Markets: *2013- Now*

From the end of 2012 through 2024, the MSCI Emerging Markets Index returned only 2.6% annualized, while the S&P 500 returned 14.6%. Hence the name "Dark Days". Diversified investors have been underwhelmed by the asset class for the past decade, especially when looking back at the returns from the Glory Days.

The key trend that led to the EM Dark Days was the maturation and slow down the Chinese economy. A couple trigger events led to the end of the multiyear, double digit GDP growth period for China.

The first was leadership transition from Hu Jintao to Xi Jinping in November of 2012. The new regime pivoted from a "growth at all costs" stance to a more conservative and sustainable growth stance. After massive stimulus following the Great Financial Crisis, the new regime wanted to bring China back to a more sustainable approach to fiscal policy. The Chinese government also began to restrict its financial sector. One example was in 2013 when the People's Bank of China engineered a liquidity squeeze known as the "Shibor Shock," allowing interbank rates to spike sharply as a warning against excessive leverage and speculative lending. By 2014, Chinese banks began tightening lending standards, which had a major impact on their capital markets.

The second was the slowdown in exports. As shown in Figure 4, export growth slowed significantly from 2012 onward. This trend largely was attributed to the Euro Area crisis that was ongoing. Europe, China's biggest export market, slipped into recession and demand collapsed. This had a major impact on China's exports.

Figure 4

As shown in Table 1, every key economic metric fell off over the subsequent 12 years. Notably, foreign investment collapsed. From 2013 to 2024, the MSCI China index returned 2.5% annualized. The combination of slowing economic growth and index concentration intensified the impact of the Chinese slowdown on the emerging markets as a whole.

Table 1

Stagnation in Chinese Growth Post 2012

	Glory Days[1]	Dark Days[2]
Real Gross Domestic Product Growth	11.4%	6.1%
Real GDP Per Capital Growth	11.1%	5.8%
Real Disposable Income Growth Per Capita	10.2%	6.1%
Growth in Foreign Direct Investment	10.1%	0.4%
Growth In Total Exports	17.6%	6.0%

Period Average Growth Rates; Not Adjusted for Currency Impact
[1] 2001 - 2012
[2] 2013 - 2024

The Chinese slowdown had second and third order effects on Emerging Markets over the next decade. A third order effect of the Chinese slowdown was weakness of EM currencies. As China's growth decelerated, demand for industrial commodities weakened, bringing an end to the commodity super cycle that had once fueled the Glory Days for resource-rich nations. The decline in demand weighed heavily on commodity-linked emerging market currencies, which weakened against the U.S. dollar. During the same period, the United States underwent a transformation from a net energy importer to one of the world's largest exporters during the shale revolution. The surge in domestic oil production not only reshaped global energy flows but also reinforced dollar strength as a greater share of global oil trade was done in dollars. The combination of falling commodity prices and a rising dollar compounded the pressure on emerging market returns throughout the Dark Days of EM investing.

Flows into the US after the Great Financial Crisis also played into EM weakness. In the US, massive stimulus and near-zero interest rates fueled equity inflows, a rapid post-2008 recovery, and record corporate borrowing at low cost. U.S. firms used cheap debt to expand, repurchase shares, and optimize balance sheets, setting the stage for a period of capital inflows and economic growth.

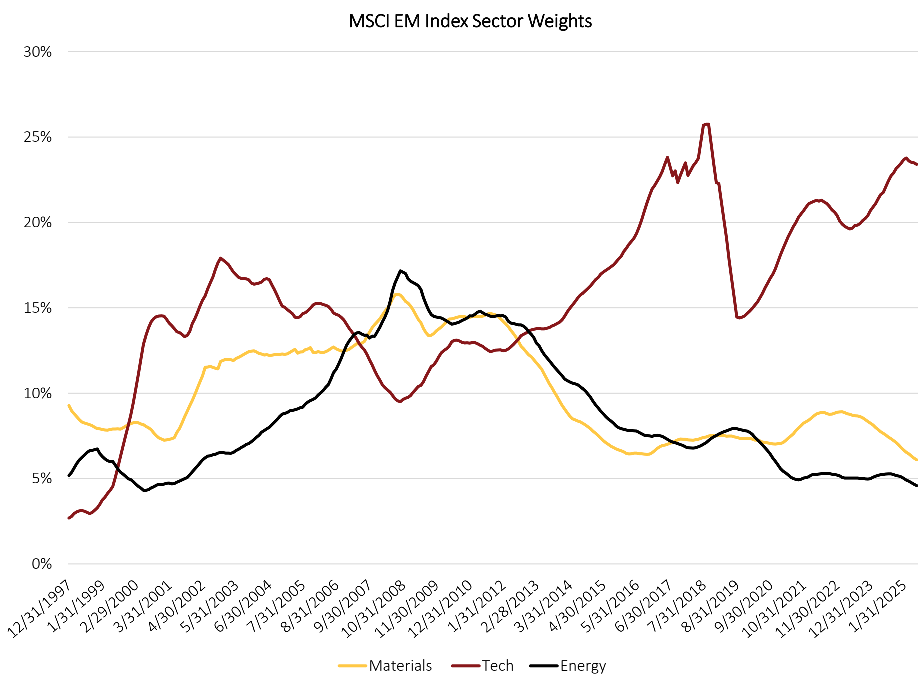
Over the next decade, U.S. corporations shifted from tangible assets like factories and equipment to intangible assets such as software, data, and intellectual property. Innovation in asset light technology applications enabled scalable, high-margin business models that strengthened U.S. dominance through the 2010's and 2020's.

While U.S. companies expanded margins and valuations through innovation and recurring revenues, emerging markets remained anchored to capital- and labor-intensive industries. Although EM indices now carry higher technology weights, many of these firms are capital-intensive and far less profitable than their U.S. counterparts. As a result, most value creation and profit retention during the Dark Days have stayed within the United States.

Higher revenue growth, wider margins, and asset-light models also drove valuations of U.S. equities. The S&P 500's forward P/E expanded from roughly 10x in 2008 to above 21x today, while the MSCI EM Index has rarely exceeded 14x. This valuation gap reflects global conviction in U.S. innovation leadership and has continued to draw capital away from emerging markets since the end of the Glory Days.

The Dark Days exposed the limits of what had been a beta trade during the Glory Days. As China matured and growth slowed, the exposure that once powered returns became a source of concentration risk. The asset class grew increasingly tied to one economy and one cycle. Dollar strength, weaker commodities, and flows into the United States exposed these risks over the past decade. Now, it seems the tide may be turning again. As supply chains shift, demographics evolve, and technology transforms production, new inefficiencies are emerging. The next phase of emerging markets may not be defined by one dominant country but by a more balanced set of opportunities. In this type of environment, investment manager skill should drive returns.

Figure 5



The Future of Emerging Markets

Technological and Structural Realignment

The immediate impacts of the COVID-19 pandemic were clear, but its longer-term effects have emerged gradually. As lockdowns disrupted supply chains, companies began diversifying production to reduce dependence on any single country.

China, which became the world's factory after joining the WTO, saw its manufacturing output rise from about $625 billion in 2004 to a peak of $4.9 trillion in 2021. Since then, manufacturing output has decreased by roughly 6 percent. This slowdown reflects both supply chain diversification and competition from countries with favorable demographics. China's population is aging rapidly and the birth rate is well below replacement. Many economists believe this trend will erode China's production cost advantage over time.

As China's cost advantage begins to erode and geopolitical tensions have increased, multinational firms have begun pursuing "China + 1" strategies, expanding production into Southeast Asia, India, and Latin America. India, Vietnam, Indonesia, and Mexico have emerged as key beneficiaries, attracting foreign direct investment (FDI) and expanding manufacturing capacity. According to the United Nations, Vietnam's inward FDI has risen more than 70 percent over the past decade, and Mexico's manufacturing exports to the United States reached record highs in 2024. This reallocation of capital is reshaping global trade patterns and may fuel a new phase of investment-led growth across emerging markets outside of China.

The global competition is also shifting from a race for low-cost labor to a race for technology-driven production. Nations now compete to build data centers, robotics hubs, and AI capabilities instead of labor-intensive production processes. AI and automation increase demand for data, computing power, energy, skilled talent, and intellectual property. Energy and computing power are currently the most supply constrained. For this reason, many countries, both developed and emerging, are investing in advanced semiconductor production and energy capacity

For emerging markets, this transition brings both risk and opportunity. Economies reliant on low-cost manufacturing face eroding advantages as AI and robotics expands, while those rich in educated human capital and digital infrastructure stand to benefit. India exemplifies the latter. Its long-standing investment in STEM education, anchored by the Indian Institutes of Technology and Information Technology, has created one of the largest engineering talent pools in the world. Labor costs remain competitive, though infrastructure, particularly power capacity, lags behind. Continued foreign investment could help bridge that gap and enable India to become a data center hub in Asia, benefitting from AI and robotics driven growth.

Looking ahead, the emerging markets landscape is likely to become more geographically balanced, shaped by regional trends in technology, manufacturing, and demographics. For long-term investors, this diversification broadens opportunity but also calls for more selective, active allocation rather than index-based exposure.

A Case for Active Management in Emerging Markets

The story of emerging markets has always been one of transformation. The Glory Days rewarded broad exposure as a rising Asian tide lifted the entire EM asset class. Over time, that same exposure became a liability as the asset class grew concentrated in a handful of countries. Today, China, Taiwan and South Korea account for more than half of the MSCI Emerging Markets Index, leaving investors heavily dependent on a narrow set of political, regulatory, and economic outcomes.

The index is still concentrated and sensitive to areas of heightened geopolitical risk, giving investors good reason to be cautious about broad emerging markets exposure. At the same time, data availability, transparency, and regulation across the asset class have improved dramatically, while sell-side analyst coverage has not kept pace. The result is an increasingly inefficient market where information is abundant but underutilized. Additionally, falling transaction costs and advances in quantitative research have also created a tailwind for active managers.

In this environment, success is likely to hinge less on passive exposure and more on the ability to identify skilled managers who can exploit emerging inefficiencies. Those who can recognize structural shifts early and leverage improvements in data availability, transparency, and regulation will be best positioned to capture alpha and avoid risks that are index inherent.

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Sources Utilized:

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