Key Questions

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Why Emerging Markets?

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There are still plenty of opportunities in emerging markets as investors contemplate a new model of investing.

The legacy of investing in the equities of developing countries has been the story of natural resources and inexpensive manufacturing capabilities. Extracted natural resources could be exported to the rest of the world for use in advanced machinery. And transferring the manufacturing of goods and (later) services to regions with underpaid labor checked a box of classical economic theory:

Producing goods and services more cheaply leads to greater profit potential when the finished goods are sold.

The globalization of supply chains expanded on the back of these regions to help fuel economic and production growth since the end of World War II.

Investing in emerging market equities today is a much different story, one that entails making a call on the purchasing power of the massive middle class that is coming into its own in Asian, South American, and Eastern European nations. Not only are these countries developing but the working-age population in them is also evolving into discerning consumers and savers: Consumption goals, insurance coverage, and savings accounts have overtaken the production and extraction capabilities.

There have been many stories in the news lately about China, the behemoth in emerging market investing. China represents more than 40% of emerging market indices and is the second-largest economy on the planet after the United States.

During the pandemic year of 2020, China was the only large country to grow its GDP, increasing 2.3%; it did not decline as did all developed nations. China has spent much of this year reining in overheated monopolistic tech companies, closing loopholes for firm equity listings overseas, and entrenching data security and social equality programs. All of these programs have been detrimental to China's equity market in the near term. Big technology companies in China have witnessed the erasure of nearly $1 trillion in market capitalization this year; private education and tutoring companies have been forced to adopt non-profit status, which destroys their traditional for-profit company prospects. In this, China is playing a long game: It cares more about the future than it does about the stock market in the present.

China's ultimate goal is to incubate its budding innovation industries in market sectors expected to dominate world culture over the following decades: healthcare, new technology, and brain science. Instead of using existing technology and intellectual property from the rest of the world, China's leaders want to achieve scale organically and become both the first mover and the dominant player in these industries. They are willing to sacrifice near-term volatility for greater long-term performance. Recent moves against monopolistic companies send a clear signal that those companies are not the leaders moving forward. While it is possible to find winners in China, they might not be the winners of the past.

Beyond China, the emerging markets story is still one with many economic drivers. Massive middle-class consumption expects to replace the production economics of a large workforce.

Instead of looking at individual persistent investment factors such as quality, valuation, and size, the new emerging market framework will focus on new and as yet undetermined factors related to transitional metrics in specific countries. Different governments will seek to promote different champion companies to the rest of the world. The divergence of the consumption economies from the resource-producing and manufacturing-reliant economies will provide a source of alpha for savvy active managers in the future. However, this shift will require time to take shape and solidify in the marketplace.

Traditionally, investment in emerging markets included broad-based country exposure since underlying constituents were inherently more volatile than their developed counterparts. Today, we may be on the cusp of a new model of investing in emerging markets. Such a shift may consist of disaggregating exposure into three pillars: standalone China exposure, resource exposure, and consumption activity, with the latter two spanning various countries in the developing world.

In the meantime, while we expect the market to remain choppy, there are still plenty of opportunities in emerging markets: China signaled its intentions to shelter and develop fledgling next-gen industries; Southeast Asia has a wonderful semiconductor chip network supply chain at a time when global chip manufacture is in a shortage; resource-producing nations are in the midst of a year in which commodity prices are rising; and a world revolving around digitization, connectivity, and consuming content has a home in the new emerging markets.

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