# Bullish on Emerging Markets Equities

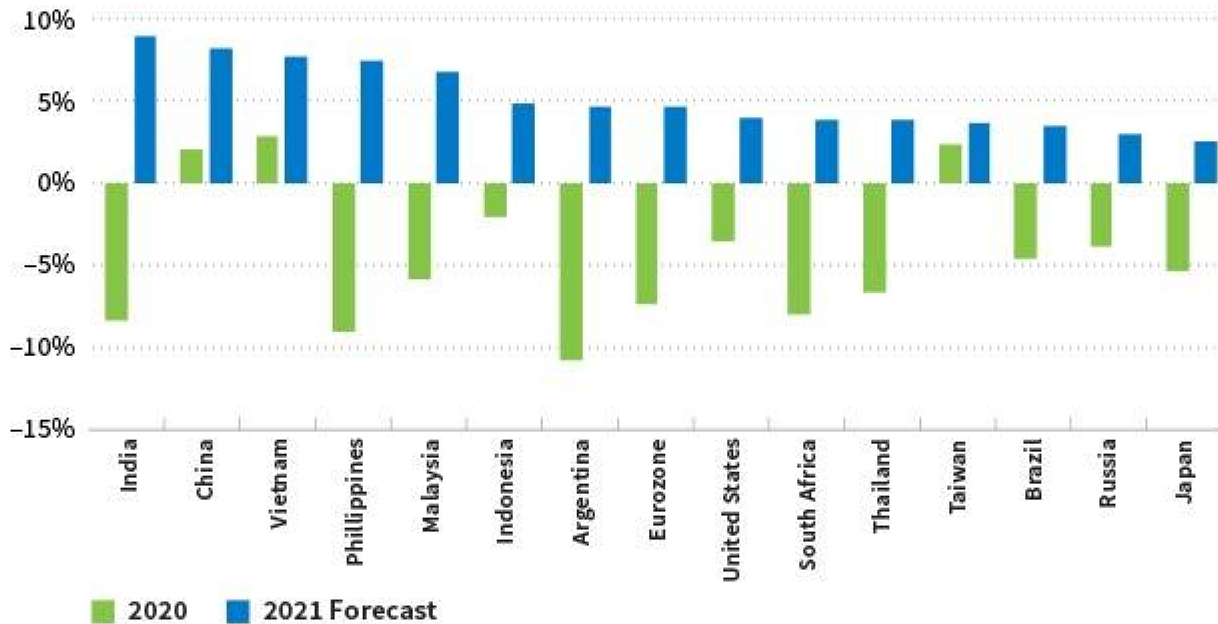
February 24, 2021

As we get further into 2021, we are more bullish on emerging markets (EM) equities than at any point in the past decade. After bouts of volatility in early 2020 caused by disruptions related to the COVID-19 pandemic—and a subsequent rapid recovery—we see room for strong growth in developing markets in 2021.

Several factors are driving our optimism for the asset class as whole, including a range of fundamental and geopolitical tailwinds.

**Growth Acceleration**

The gap in GDP growth between EMs and developed markets narrowed in recent years, but that gap seems poised to begin widening again. As shown in the chart below, the 2021 gross domestic product (GDP) growth forecasts for India, China, and several other prominent EMs are significantly higher than developed markets.



Source: Bloomberg, as of January 2021.

Historically, EM equities have significantly outperformed developed markets when the GDP growth gap has been widening. Moreover, economic growth is a significant driver of strong corporate performance; as a result, we expect earnings growth to accelerate in EMs.

**U.S. Dollar Weakening**

One tailwind for growth in EMs is ongoing weakness in the U.S. dollar, which appears to have entered a weakening cycle after an extended period of strength. A 1% decline in the U.S. dollar typically boosts global trade by 75 basis points (bps) and, according to J.P. Morgan, has added approximately 3.4% to EM equities performance, compared with just 2.1% for developed markets. J.P. Morgan has also observed that EM equities have outperformed developed markets in approximately 90% of the instances of U.S. dollar weakness.

Another important aspect of the weaker U.S. dollar is that many EMs have dollar-denominated debt, so a weaker U.S. dollar decreases their liabilities.

The weak U.S. dollar also allows more flexibility for central bankers in EMs to engage in looser monetary policies without worrying about harmful effects on their currencies. This ability to provide additional stimulus will likely be extremely valuable as countries continue to recover from the pandemic.

As central banks in developed markets continue to provide massive amounts of global liquidity, this should perpetuate conditions that are favorable for EM equities.

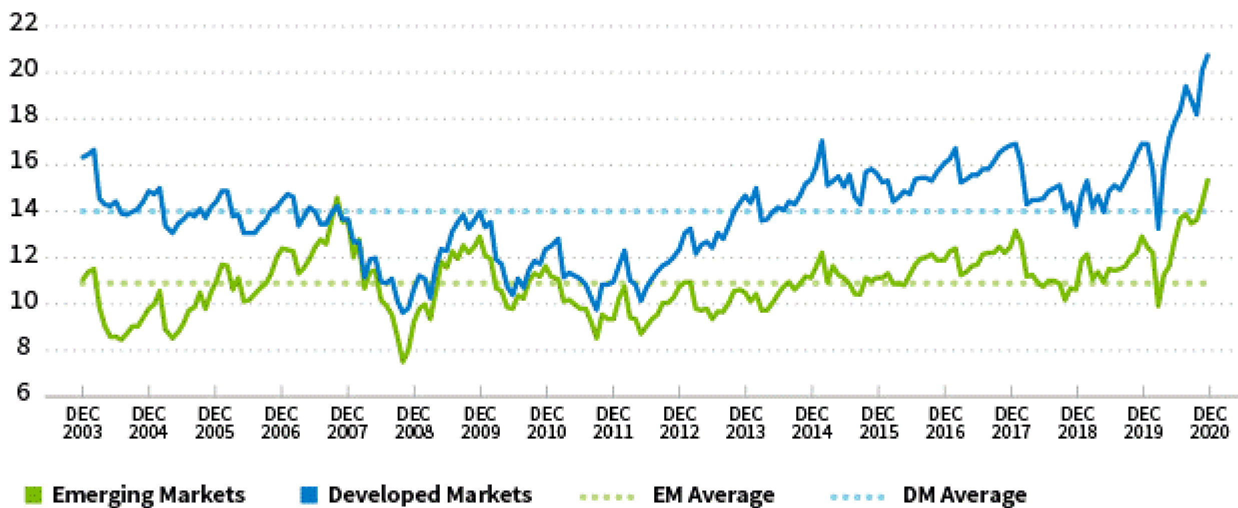
**Valuations That Do Not Reflect EMs' Growth Focus**

In terms of long-term price-to-earnings (P/E) levels, EM equities appear historically cheap versus developed markets, as shown in the chart below. We see EM equities as trading about 15% cheaper relative to their long-term

average discount compared to developed markets. While EM equities typically trade at a discount, this level offers significant upside for EMs from a valuation perspective, in our view.

EM valuations appear even more attractive when considering how the MSCI EM Index has evolved since the Global Financial Crisis (GFC). In 2008, low-valuation sectors (energy and materials) were about 40% of the index, and more growth-oriented, higher-valuation sectors (IT, consumer, retail, and media) were about 10% of the index. Now, those proportions are reversed, but today’s valuations do not appear to reflect this shift.

## Historical Valuation Differences Between Emerging and Developed Markets




Sources: MSCI, as of December 2020. Shows MSCI emerging versus developed market P/E ratio for FY2.

### Fund Inflows Driven By Rebalancing

Technical factors should support EM valuations in 2021. Among global equity portfolios, the current average weighting for EM exposure (7.3%) is currently well below the long-term average (9%) and even further below the neutral allocation (11.5%).

Moving from the current allocation to the long-term average would result in $350 billion of inflows into EM equities, and we believe that this movement has already begun.

Should the performance of EM equities continue to improve relative to developed markets, we believe that global funds will likely increase their allocations further, creating another positive catalyst for EMs.

### COVID-19 Vaccine

We believe that the AstraZeneca vaccine developed at Oxford University will be especially important to EMs. At $3 to $4 per dose, this vaccine is significantly cheaper than Pfizer’s/BioNTech’s ($20 per dose) and Moderna’s ($32 to $37 per dose) vaccines, and AstraZeneca’s vaccine should be easier to distribute without the need for extreme low-temperature refrigeration.

We acknowledge that the vaccine will take time for full distribution and economies around the world will not immediately return to a pre-COVID “normal.” Nonetheless, after extended global health and economic pain, the proverbial light at the end of the tunnel is visible, with pent-up demand likely to lead to a potent economic recovery.

### Changing Geopolitical Conditions

We believe that the U.S. political environment in 2021 will likely prove more supportive of EMs than in recent years.

We expect the administration of President Joe Biden to be more predictable than the Trump administration in trade policy and international relations; this should offer more stability for EMs and investors. At the same time, we believe that Biden will continue to be tough on China, although we expect that Biden's China policy will be more orthodox and based on traditional diplomacy compared with the Trump administration.

**ESG Reaching an Inflection Point in EMs**

EMs have historically been viewed as laggards in terms of ESG. Concerns about governance practices, as well as other issues including limited or inconsistent reporting of ESG data and policies, have caused ESG ratings providers to skew their ratings significantly more negative for EM companies than for developed market companies. These concerns have also tempered some investors' enthusiasm for EMs.

Efforts to close the ESG gap between emerging and developed markets, however, have been gaining momentum recently.

EM countries such as India, Malaysia, Mexico, South Africa, and Taiwan have some of the world's highest levels of sustainable reporting, according to a recent study by KPMG. Many other EMs have also made notable progress as a result of increased regulatory requirements—from both stock exchanges and governments—and higher ESG focus and scrutiny from local and international investors.

China has made significant strides as well. Stock exchanges in Hong Kong and mainland China have been ramping up ESG disclosure requirements, and companies have been encouraged to communicate on their contribution to sustainable development goals (SDGs). Moreover, the September 2020 announcement by President Xi Jinping of China's commitment to achieving carbon neutrality by 2060 brought climate change and ESG to the forefront of the government's policies, and Chinese companies are aligning themselves with these priorities.

Increased ESG awareness is facilitating engagement with company management teams on these issues across EMs.

We have seen an increased number of companies proactively reaching out to investors to explain what they are doing or seeking advice on how to report in a way that is meaningful to investors. We believe that this is an encouraging development that should lead to positive value creation.

**Risks Facing EM Equities**

Despite the overall attractiveness of EM equities today, there are certainly risks that investors should consider.

Given that China is further along in its economic recovery from the pandemic than practically any other country, China could enter a monetary tightening phase defined by slowing credit growth sooner than expected, which could result in market volatility.

The speed at which COVID-19 vaccinations are rolled out in EMs poses another potential threat for investors. If the pace of vaccinations in EMs is significantly slower than the pace in developed markets, developed economies could rebound faster than EMs; this, in turn, could cause the post-COVID growth rebound in developed markets to outpace that of EMs, thereby attracting capital flows away from EMs and back to developed markets.

Finally, the continued weakening of the U.S. dollar, which historically has been a major tailwind for EM equities,

could be reversed if ongoing fiscal stimulus measures in the United States cause interest rates there to rise, which would increase the relative attractiveness of the U.S. dollar.

**Differentiated Performance Likely**

Despite our favorable view of EMs overall, the market is highly differentiated, and regions are recovering at disparate rates. As a result, we see a large but varied opportunity set full of high-quality growth companies that requires in-depth analysis to identify the most attractive opportunities. We will discuss these opportunities more in upcoming posts in this series.

*Todd McClone, CFA, partner, is a portfolio manager on William Blair's Global Equity team.*

**Emerging Markets Series**

Part 1: Emerging Markets Roar Into the 20s
Part 2: 2021: The Strongest Growth in a Generation?
Part 3: Bullish on Emerging Markets Equities
Part 4: Emerging Markets Debt Well Supported
Part 5: Emerging Markets: Localized Opportunities
Part 6: 6 Themes Driving Emerging Markets Debt
Part 7: China's Unwavering Growth Journey

**Disclosure:**

This content is for informational and educational purposes only and not intended as investment advice or a recommendation to buy or sell any security. Investment advice and recommendations can be provided only after careful consideration of an investor's objectives, guidelines, and restrictions.

Information and opinions expressed are those of the authors and may not reflect the opinions of other investment teams within William Blair Investment Management, LLC, or affiliates. Factual information has been taken from sources we believe to be reliable, but its accuracy, completeness or interpretation cannot be guaranteed. Information is current as of the date appearing in this material only and subject to change without notice. Statements concerning financial market trends are based on current market conditions, which will fluctuate. This material may include estimates, outlooks, projections, and other forward-looking statements. Due to a variety of factors, actual events may differ significantly from those presented.

Investing involves risks, including the possible loss of principal. Equity securities may decline in value due to both real and perceived general market, economic, and industry conditions. The securities of smaller companies may be more volatile and less liquid than securities of larger companies. Investing in foreign denominated and/or domiciled securities may involve heightened risk due to currency fluctuations, and economic and political risks. These risks may be enhanced in emerging markets. Different investment styles may shift in and out of favor depending on market conditions. Individual securities may not perform as expected or a strategy used by the Adviser may fail to produce its intended result.

Investing in the bond market is subject to certain risks including market, interest rate, issuer, credit, and inflation risk. Rising interest rates generally cause bond prices to fall. High-yield, lower-rated, securities involve greater risk than higher-rated securities. Sovereign debt securities are subject to the risk that an entity may delay or refuse to pay interest or principal on its sovereign debt because of cash flow problems, insufficient foreign reserves, or political or other considerations. Derivatives may involve certain risks such as counterparty, liquidity, interest rate, market, credit, management, and the risk that a position could not be closed when most advantageous. Currency transactions are affected by fluctuations in exchange rates; currency exchange rates may fluctuate significantly over short periods of time. Diversification does not ensure against loss.

There can be no assurance that investment objectives will be met. Any investment or strategy mentioned herein may not be appropriate for every investor. References to specific companies are for illustrative purposes only and should not be construed as investment advice or a recommendation to buy or sell any security. Past performance is not indicative of future returns.

Copyright © 2020 William Blair & Company, L.L.C. "William Blair" is a registered trademark of William Blair & Company, L.L.C. No part of this material may be reproduced in any form, or referred to in any other publication, without express written consent.