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Investment Publications Highlights

CAMBRIDGE ASSOCIATES LLC

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"EM Equity in Two Decades—Refreshed"

Timothy Moe et al., Goldman Sachs,
March 15, 2013

Due to continued rates of high economic growth and deepening capital markets, emerging markets equity capitalization should substantially increase in both absolute and relative terms over the next two decades. Despite the expected increase in growth and capital markets maturity, investors should be careful to not overpay for the expected growth even as emerging markets equities currently offer investors attractive potential returns based on growth prospects.

Emerging markets equity capitalization should substantially increase in both absolute and relative terms over the next two decades. Driven by local GDP growth of around 5.1% per year, emerging markets companies should see earnings per share (EPS) grow at a compounded annual rate of around 4.7% over this period, not quite double the 2.7% expected for developed markets equivalents. Given less expensive valuations, emerging markets equities should also see multiple expansion of around 1.1% per year versus 0.8% for developed markets equivalents. The combination of faster EPS growth, multiple expansion, and equity market deepening will mean that emerging markets equity market capitalization increases from $17 trillion now to $72 trillion by 2030, or from 31% to 53% of the global total. The increase in the investable amount for foreign investors could be far less and depends on whether countries like China decide to expand access; our base case is that emerging markets increases from 13% to 31% of the MSCI ACWI.

These forecasts may come across as overly bullish on emerging markets equities. However, they are well within the historical distribution; for example, emerging markets equity market cap has actually grown at a compound annual rate of around 16% since 1990. Growth in equity market cap should also not be confused with performance; despite emerging markets equities trailing developed markets peers since 2009, they have retained the same share of overall market capitalization. Over the long term, equity returns are driven by EPS growth and dividends, as multiples are assumed to stabilize over time.

Growing emerging markets equity market cap will mean that developed markets institutional asset managers have to dramatically increase their holdings of emerging markets equities. These managers now hold just 6.3% of their overall equity allocation (36% of assets under management) in emerging markets equities—that percentage will likely rise significantly over the next ten to 20 years. For example, if emerging markets increases to 31% of the MSCI ACWI, developed markets investors may roughly triple their holdings of emerging markets equities to 18%. It also means that the institutionalization of emerging markets savings will continue to rise, driven by positive demographic trends, a large pool of household savings, and low current allocations to equities in general. Though total assets under management are well over 100% of GDP in many developed markets, the emerging markets figure is just a fraction of this, allowing significant room to catch up.

With the potential shifts taking place in the emerging markets landscape, investors should keep in mind a few important implications. Underlying profits of corporations tend to be highly correlated with economic growth and this bodes well for emerging markets equities. However, valuations also matter, and investors need to avoid overpaying for potential growth

that may or may not materialize. Still, current emerging markets valuations are moderate in absolute terms and relative to historical averages, and suggest attractive future returns.

There are a few caveats. One is that economic growth may not necessarily generate higher profitability due to political and regulatory interference. Another is that the distinction is blurring between where a company is located and where it sources the majority of its revenues and profits. Across both developed and emerging markets, companies are sourcing an increasing percentage of revenue outside their home country. For example, over 30% of S&P 500 companies' revenues are from outside the United States and close to 60% of Taiwanese companies' profits are sourced abroad. At an aggregate level, the demarcation will increasingly become blurred between emerging and developed markets equities, and adds uncertainty to any projections about the future. Still, more rapid emerging markets economic growth and the underlying profits generated by companies listed there should over time help increase emerging markets' percentage of the global market capitalization and increase their relative importance in the global investment landscape.

"Why Is EM Under Fire?"

Manoj Pradhan and Patryk Drozdzik, Morgan Stanley, April 24, 2013

Emerging markets equities and economic growth have faltered recently, as have commodity prices. The problems affecting emerging markets growth have largely been misdiagnosed as cyclical rather than structural. Even where structural reforms appear to be taking root, they have been somewhat mismanaged with the exceptions of India and Mexico. Until the underlying structural problems are fixed within emerging markets, do not expect economic growth to accelerate any time soon as the risk/reward trade-off of using cyclical policy tools has deteriorated.

Emerging markets economies face a primarily structural headwind to growth: the misallocation of capital to a strategy whose time has passed. In 2009 and 2010, during the depths of the global financial crisis, economies such as Brazil, Russia, India, and China (the BRICs) deployed massive amounts of monetary and fiscal easing to protect growth. As seen in developed economies, these policies can support growth temporarily, but do not solve the underlying structural problems. In the developing world, as central banks and policymakers eased to support growth, they only reinforced the existing growth strategies of their respective countries, thereby creating a worse starting point for necessary rebalancing. Most commodity-producing economies, for example, committed too many resources to that sector, making a shift away from commodities and into manufacturing that much more difficult. In the BRICs currently, the lagging sector in each economy is the one that will be needed to drive growth in the future (i.e., consumption in China, manufacturing in Brazil and Russia, and investment in India).

For China to complete the transition from an investment-led economy to a consumption-based one, the government will have to liberalize the interest rate market. Chinese consumers save "too much"; liberalizing the capital markets can deliver better ways to protect and reward savings while reducing the incentive to over-save. However, rapid implementation of this approach could have negative, unintended consequences including the further misallocation of resources to areas like the non-productive housing sector. Also, if consumption

as a share of GDP rises too quickly, household savings will naturally fall. A too rapid fall in savings could weaken the implicit "subsidy" to banks, leading to an unintended sudden decline in investment and growth. China bulls argue that the process of urbanization has the potential to create synergies and demand for services, raising levels of productivity. This may well be happening, but growth is by no means guaranteed and urbanization could backfire if a lack of jobs means that migration reverses and wages rise. Still, there is cause to be optimistic that China will successfully undergo the transition to a consumer-based economy. The current pragmatic administration appears committed to implementing structural reforms, deregulating markets, and lowering corruption and wasteful public spending. Nonetheless, the economy will likely remain in transition for a considerable period.

The commodity price boom set off by China's investment-led growth also created a surge in commodity-oriented investment in other economies such as India and Russia, exposing them to the "Dutch disease," where an overemphasis on commodity-led growth bids up the price of capital and labor and crowds out other industries. As unemployment falls and wages rise, households spend more freely; service sectors grow, but so, too, does inflation. In the cases of Brazil and Russia, the manufacturing sectors could not compete against the forces of exchange rate appreciation and high wages, particularly because the price of manufacturing is set by global supply and demand. Each country also has its own respective structural problems. In Russia, the corporate sector is dominated by state-run companies, which do not enjoy the efficiency or flexibility of their private sector competitors overseas. In Brazil, state-subsidized lending for some sectors means the pool of resources for others is smaller, driving up real interest rates. The problem for both countries is that using a standard policy tool like rate cuts helps all sectors but does not correct imbalances. In Brazil, for example, 525 basis points of rate cuts meant consumer lending and inflation expectations soared—just what the economy did not need. Weak commodity prices in both countries will hurt growth on the cyclical horizon, but make policymakers far less complacent. However, until Brazil and Russia implement the necessary structural reforms, the downside risks to growth will persist.

India's structural issues (archaic labor laws and regulations, agricultural and energy subsidies, and a fragmented political system) are serious, but more in line with the country's low per capita GDP and moderated by exchange rates, interest rates, prices, and wages that are predominantly market determined. The biggest drag on growth in India is a deep cyclical downturn. Aggressive fiscal easing in 2009 and 2010 supported consumption and economic growth during the recession, but not productive activities. The result was a widening of the fiscal and current account deficits as well as an inflation problem that makes cyclical policy tools less effective. The long-term outlook for growth in India remains bright, but these factors will create a significant drag on the economy in the short term.

Emerging markets economies have largely addressed the problems affecting them with fiscal and monetary policy, rather than through structural reforms. Even where countries have correctly diagnosed their problems, policymakers have generally not delivered the "right" kind of reforms. As growth continues to slow, expect policymakers to pay more attention to structural reforms and to use industrial policy to direct resources to more productive sectors and activities. ■