Emerging market equities: performance compared to developed markets

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Emerging market equities are widespread in the portfolios of institutional investors. Over 20 years, however, the MSCI Emerging Markets has underperformed the MSCI World. The following article aims to explain reasons for this underperformance. Our analysis shows that the strength of the dollar and the development of commodity prices have represented a significant headwind for the asset class, particularly in the last ten years.

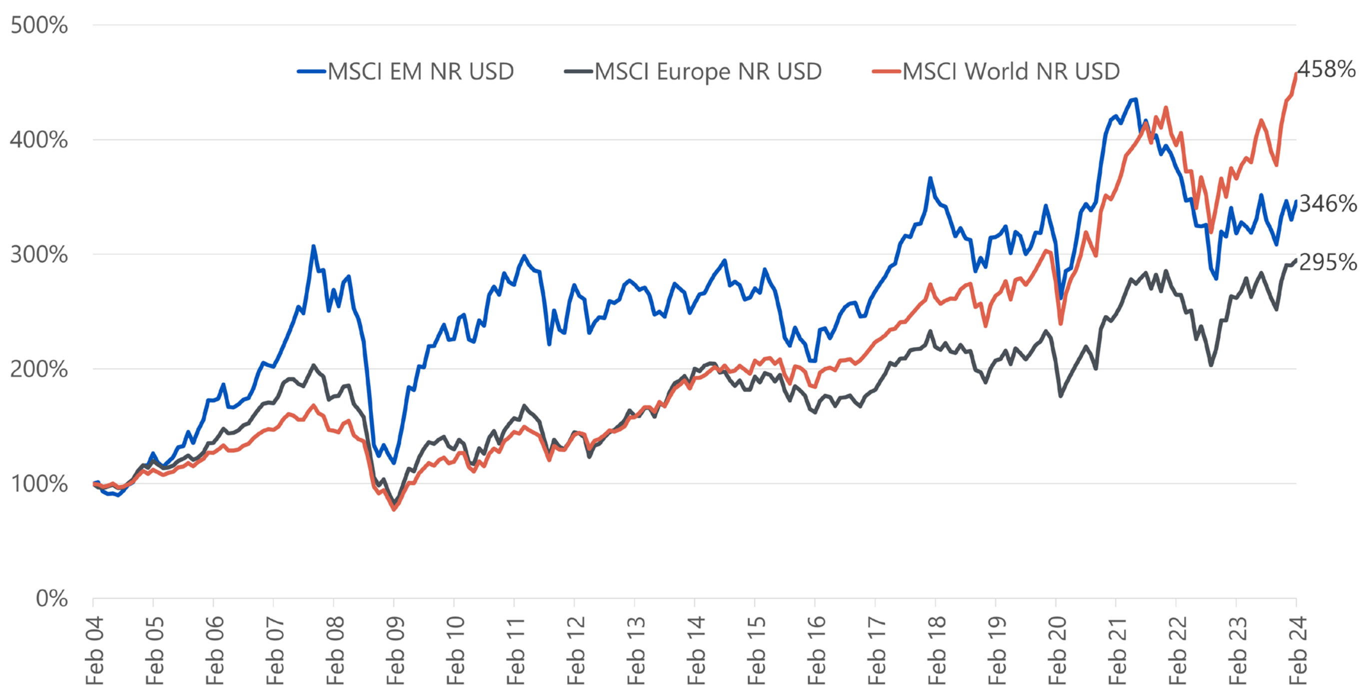


Chart: Performance over 20 Years (Morningstar)

Introduction

Emerging market equities are widespread in the portfolios of institutional investors. During the 2000s, they were regarded as the shining stars promising investors attractive returns. An important driver at the time was China›s opening to the world (accession to the WTO in 2001). Its growth potential attracted investors worldwide. In the 2010s, emerging market shares no longer delivered the expected excess returns over

developed market equities. When comparing the performance of the MSCI World with the performance of the MSCI Emerging Markets over a 20-year period, it becomes obvious that the excess return did not materialise. Over a period of 15 years, emerging market equities have also underperformed European equities. The underperformance is not just due to the disappointing performance of the last three years (e.g. China) or the strong performance of US technology stocks; there was also a phase from 2010 to 2016 when the MSCI Emerging Markets trended sideways overall. A volatility comparison shows that the volatility of the MSCI World was always lower than that of the MSCI Emerging Markets Index. In other words, investors achieved lower returns over several periods with higher volatility.

		MSCI World NR USD	MSCI EM NR USD	MSCI Europe NR USD
Return	1 year	25.0%	8.7%	12.6%
Volatility	1 yea	14.0%	16.3%	16.4%
Return	3 yeas p.a.	8.6%	-6.3%	6.0%
Volatility	3 years p.a.	17.0%	17.7%	18.2%
Return	5 years p.a.	11.7%	1.9%	7.3%
Volatility	5 years p.a.	18.0%	19.0%	19.4%
Return	10 years p.a.	9.1%	3.0%	4.0%
Volatility	10 years p.a.	14.9%	17.2%	16.3%
Return	20 years p.a.	7.9%	6.4%	5.6%
Volatility	20 years p.a.	15.5%	20.8%	18.2%

Table: Comparison of Risk and Return metrics over time and selected regions

The following research aims to identify the main drivers of this underperformance.

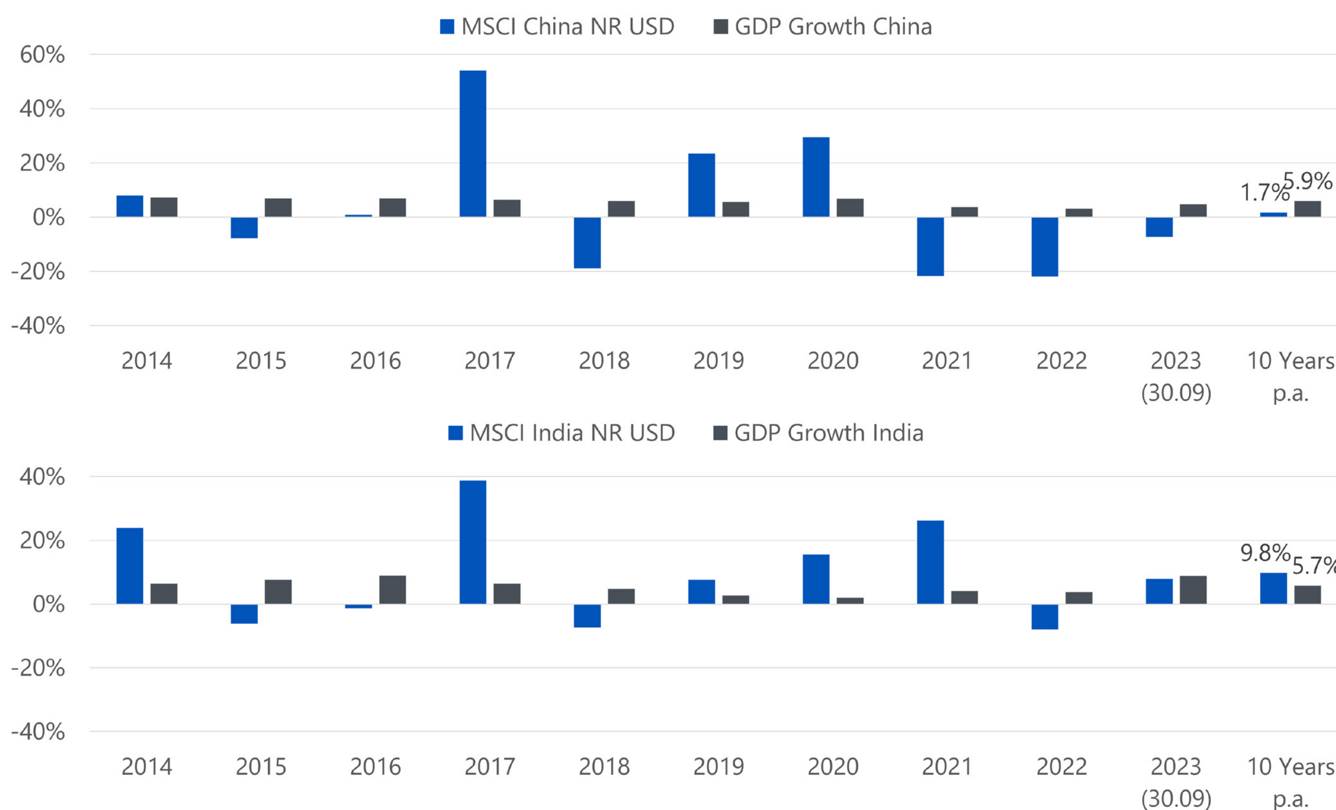
Approach

In order to examine which drivers have a significant influence on the performance difference between developed and emerging market equities, a quantitative analysis was carried out. The analysis focussed on three factors. These factors include commodity prices, the strength of the dollar and the growth differential between emerging and developed countries. The analysis covers a period of 20 years (4th quarter 2003 to 3rd quarter 2023).

The regression analysis shows a positive and significant correlation between the development of commodity prices and the price differential between emerging market equities and developed market equities (MSCI Emerging Markets minus MSCI World). Rising commodity prices would therefore indicate an outperformance of the MSCI Emerging Markets compared to the MSCI World, while a negative development would indicate an underperformance. The development of commodity prices (measured by the Bloomberg Commodity Index) over 20 years tended to be flat while it was negative over 10 years. Thus, this factor may have acted as a headwind to the emerging market equity return differential (especially over the last 10 years).

The factor dollar strength has a negative coefficient, which is statistically significant. A stronger dollar represents a headwind for emerging markets, while a weakening of the dollar favours a development in the opposite direction. A stronger dollar increases the financing costs and external debt levels of emerging market countries, which in turn can negatively impact growth momentum. From the perspective of dollar investors, stronger dollar also means currency losses on their emerging market equity holdings. Over the past ten years in particular, a long phase of dollar strength has been recorded, which represents a significant headwind for emerging market returns.

The growth differential between the emerging markets and industrialised countries is not statistically significant in our study. Hence, the coefficient (GDP difference) does not provide explanatory power regarding the relative returns. If the absolute growth of emerging markets is regressed against the absolute index return of emerging markets, a positive correlation can be observed, which is statistically significant. However, observations from individual countries show that the correlation can vary greatly from one country to another. Among other things, this is also related to the significance of its export sector. Another important factor is the investable universe within a country. If this investment universe does not correspond to the composition of an economy, significant divergences between GDP growth and stock market performance can arise.



Tables: Comparison of stock market performance and GDP growth for China and India

A comparison of China›s GDP growth with the MSCI China NR USD over ten years reveals that the return on the equity index lagged significantly behind growth. Over ten years, annualised GDP growth was 5.9%, while the index return was 1.7% (the yuan depreciated by -1.7% p.a. against the dollar). While GDP grew at an annualised rate of 5.7% p.a., the stock market generated a return of 9.8% p.a. there. The local currency (rupee) depreciated by -2.8% p.a. against the dollar over the same period. In the Indian market, the country index realised a higher increase in value than the annual growth of the national economy. The two examples show that the realised return on a country›s financial markets can deviate significantly from realised GDP growth and that this can remain the case over a multi-year period. When comparing the time series, it is also noticeable that there were more frequent and more significant drawdowns in China over these ten years than was the case for the Indian market.

40 YEARS 1984 2024

Key findings

In our multifactor regression, the variables dollar strength and commodity prices are significant (at a significance level of 1% and 5% respectively). The GDP growth differential was not significant in our regression analysis. The coefficient of dollar strength is negative, while the coefficient of commodity prices is positive. Over the last ten years, the strength of the dollar has been very pronounced, while commodity prices have tended to decline. Both factors have therefore proved to be headwinds for emerging markets equities.

It can also be observed that equity market performance can sometimes deviate significantly from a country›s GDP growth, even when analysed over several years. In addition to the investable universe the export orientation of an economy and thus also global economic growth are key considerations here. The tensions between the USA and China in the form of various trade conflicts and trade barriers as well as geopolitical tensions (including Ukraine) proved to be negative factors here.

Implications for institutional investors

Institutional investors should discuss whether and how emerging market equities fit into their strategic asset allocation. From a risk/return perspective, an inclusion of this asset class does not necessarily make sense, especially if an investor assumes that the dollar will remain strong and geopolitical tensions will not subside. Moreover, historically, when the MSCI World suffered setbacks, the emerging markets were often affected as well, meaning that diversification (by including this asset class) did not work when it was needed the most.

When considering the portfolio, it is also important to discuss position sizing and the type of implementation. Are equities the right instrument or can an emerging market exposure also be achieved using bonds[1]?

Whether the last ten years can be considered representative for the coming years depends, among other things, on the development of the dollar and commodity prices. The end of the dollar›s strength has often been predicted without it ever materialising. However, there are various valid arguments - in addition to the foreign trade deficit, the debt situation is also likely to prove a burden for the dollar. Thus, there is a chance that the headwind of the dollar›s strength will ease somewhat. With regard to commodities, a volatile or cyclical development is more likely. An alternative scenario could materialise if the transformation to a greener economy were to result in a new commodity supercycle. This could then favour commodity exporters within the emerging markets in particular.

Negative factors

The future direction of globalisation and geopolitical tensions have the potential to create significant disruptions in financial markets (emerging markets in particular). Issues such as nearshoring/friendshoring could lead to a change in global supply chains, which can be detrimental to various economies (including China). At the same time, friendshoring offers new opportunities for other countries (e.g. Mexico in recent years).

With regard to China, various negative factors must be taken into account. In addition to the unfavourable demographic structure, the deleveraging of the real estate sector and local governments as well as the shift in sectors composition will have a negative impact on growth over a multi-year period.

Governance problems and regulatory issues may also prove to be further stress factors for the financial markets. The year 2021 clearly illustrates the disruptive potential of strong regulatory action. At that time, the Chinese government unexpectedly regulated various sectors (e.g. technology), which led to significant price losses for Chinese equities and, due to their index weightings, also at MSCI Emerging Markets level.

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1 It must be pointed out that the country composition of the JPM EM bond indices (EMBI, CEMBI and GBI) differs significantly from that of the MSCI Emerging Market Index.

Markets and Indices change over time

It should also be noted at this point that financial markets and the composition of benchmark indices can change significantly over time. For example, the importance of the commodities (materials) and energy sectors and their share of the MSCI Emerging Market Index used to be significantly higher, whereas today the financial and technology sectors have higher weightings. There have also been significant changes in the country weightings over time. For example, the share of Russia and South Africa used to be significantly higher, whereas today the Asian region has an even greater weighting. The index weightings also change within the regions, with China›s weighting ranging from 30% to 33% for a long time. At the end of February 2024, this country weighting was around a quarter.

Investors are therefore well advised to regularly monitor the index composition and determine whether an inclusion of this asset class is still advisable or whether an allocation should be reconsidered.

Valuations are lower

In connection with emerging market equities, the argument is often made that valuations are low. At the end of February, the MSCI Emerging Markets had a price/earnings ratio of 15.2, while the MSCI World had a price/earnings ratio of 21.7 (MSCI North America at 25.4, MSCI Japan at 16.4)[2]. It should be noted that valuations can also be an expression of different risk premiums and different sector compositions and can therefore differ over the long term. In addition, the MSCI Europe has a price/earnings ratio of 14.8. The valuation there would therefore be even lower. In general, the current valuation level is more of a factor or argument for tactical positioning (short-term overweighting and underweighting) and less for strategic (long-term asset class weightings) asset allocation.

Heterogeneity of emerging markets and their development

Our analyses also show that emerging markets are a very heterogeneous group of countries that can display very different dynamics. A comparison of the four index heavyweights China, India, Brazil and Taiwan alone clearly shows that their performance can vary significantly even over five years. Taiwan, for example, has recorded a cumulative return of 117% since February 2019, while China has posted a negative return of around -27% over the same period.

2 Data according to MSCI Index Factsheet as of 29 February 2024

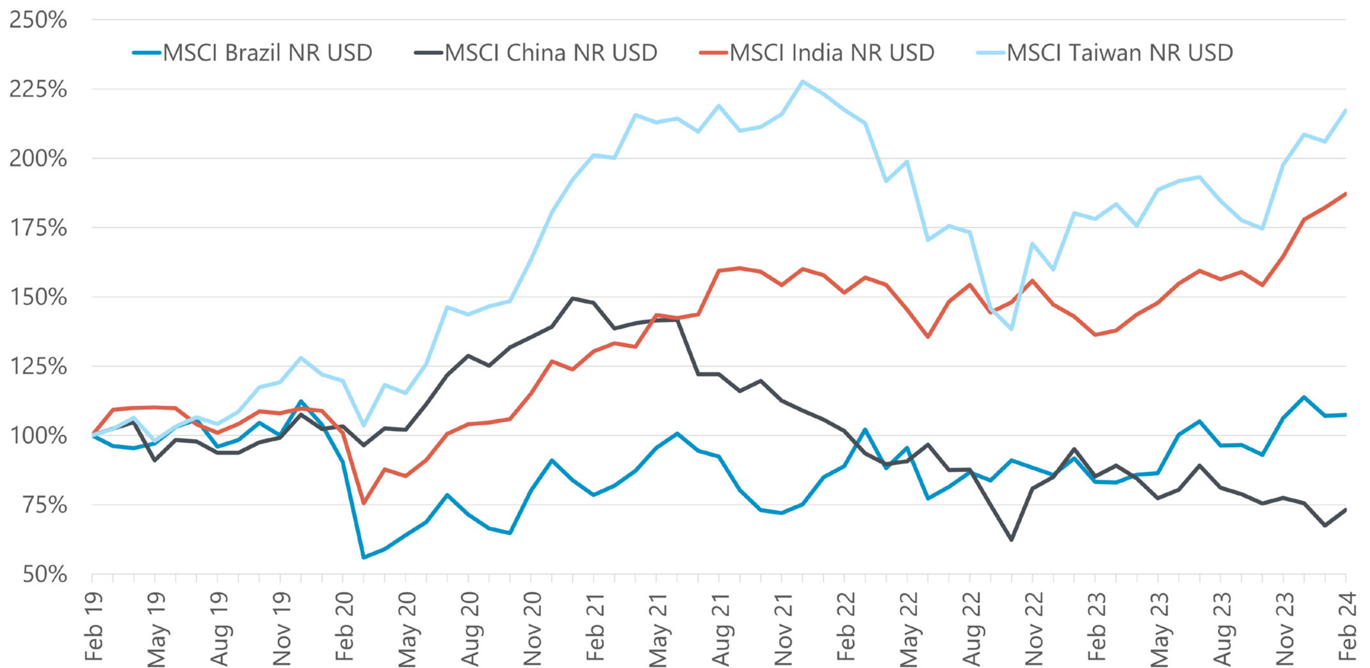

Chart: Stock market performance of selected countries over a period of 5 years

Conclusion

Investors must decide to what extent an inclusion of emerging markets is advisable and how this exposure can best be achieved. Over the last ten years, the MSCI Emerging Markets has shown a significantly lower return than the MSCI World, with higher volatility. In addition to the last three years, the period from 2011 to 2016 also proved to be challenging with respect to the achieved performance. Over the last decade, the strength of the US dollar and the development of commodity prices proved to be a clear headwind for the asset class. Prospectively, the headwind from the strength of the dollar could weaken.

In the context of strategic asset allocation, it is necessary to consider risk/return considerations, the heterogeneous growth dynamics of the various emerging market regions, any governance risks and also geopolitical considerations. Investors should also be aware that the implementation costs (including custody and administration costs) for emerging market equities tend to be higher than for developed market equities.

Appendix – analysis methodology and factors

The results of the analysis described above are based on a multi-factor regression using three factors. The factors included are the development of commodity prices, the strength of the dollar and the growth differential between emerging and developed countries. The analysis covers a period of 20 years (4th quarter 2003 to 3rd quarter 2023). The Bloomberg Commodity Index was used as a proxy for commodity prices. The U.S. Dollar Index (DXY), which measures the relative development of the dollar to a basket of other major currencies, was used for the dollar strength. The difference in GDP growth between developed and emerging countries was used for the growth differential. As an approximation for these GDP growth rates, the weighted average of the GDP growth rates of the eight largest countries (index weights) of the respective MSCI indices is used. The weighting is based on the market capitalisation of the countries in the respective indices. As GDP growth data is only available on a quarterly basis, data sets such as returns were also used for our multi-factor regression on a quarterly basis.

The multifactor regression shows that two of the three variables have significant estimators at a significance level of 5%. Commodity prices and the strength of the dollar are significant, while the GDP growth differential factor is estimated to be insignificant. The multi-factor regression was tested for robustness using a series of statistical tests. As not all variables are normally distributed and this can lead to distortions in the regression, a bootstrapping procedure was used to generate a normal distribution by means of simulation. As time series often exhibit autocorrelation, which was also the case with this model, an alternative procedure (Cochrane-Orcutt estimation) was used to address the autocorrelation. According to these two methods, the same two variables turned out to be statistically significant.

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