

# The case for emerging markets

For professional /  
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clients and investors  
For marketing purposes

April 2024 | UBS Asset Management

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# 1

## Introduction

In 2013, when the Federal Reserve (Fed) announced the tapering of its quantitative easing and treasury yields surged, emerging market (EM) assets were heavily impacted as investors feared that the end of the unorthodox monetary policies would trigger a massive sell-off in global markets. In 2022, when advanced economies started raising interest rates to fight the surge in inflation, there was fear that emerging markets would face a similar fate with macroeconomic and financial instability.

These expectations proved wrong. While some EMs were heavily impacted, most navigated the interest rate hiking cycle better than expected. They started raising rates earlier than advanced economies to defend their currencies and fight inflation and did not let their domestic and foreign debt levels rise to unsustainable levels. This “preventive” macroeconomic management paid off and many EMs have already succeeded in bringing inflation under control. Some have already started loosening monetary policy and their currencies have gained against the USD and other advanced economies (e.g., Brazil).

The negative expectations about EMs’ ability to deal with higher interest rates were also fueled by China’s challenges. China’s lower-than-expected recovery following the lifting of Covid-related restrictions coupled with ongoing geopolitical tensions with the US further dampened the appetite of investors for EM assets.

We argue that investors should reconsider their allocation to emerging markets, considering these assets remain large underweight in global portfolios. The case for EMs rests on the positive growth differential with advanced economies – still intact despite the lower-than-expected growth in China – and long-term structural trends such as demographics, the rise of the middle class, and urbanization. The slowdown in globalization and international corporations’ diversification away from China have also opened up some new opportunities for other EMs, for instance Mexico and Vietnam.

In this paper we look at the “case for emerging markets”. First, we look at macroeconomics, which comprises solid macroeconomic fundamentals and better creditworthiness thanks to better macroeconomic management and low debt levels. Then we review the asset allocation case: a higher exposure to emerging markets’ assets, in line with their increased weight in the global economy, can improve the risk-adjusted returns of a global balanced portfolio. And finally, we elaborate on the market case: emerging markets’ valuations look attractive when compared to advanced economies and long-term investors should take advantage of these opportunities to increase their exposure to these economies which are and will likely remain the growth motor of the global economy.



# 2

## The macroeconomic case

### Solid fundamentals, better creditworthiness

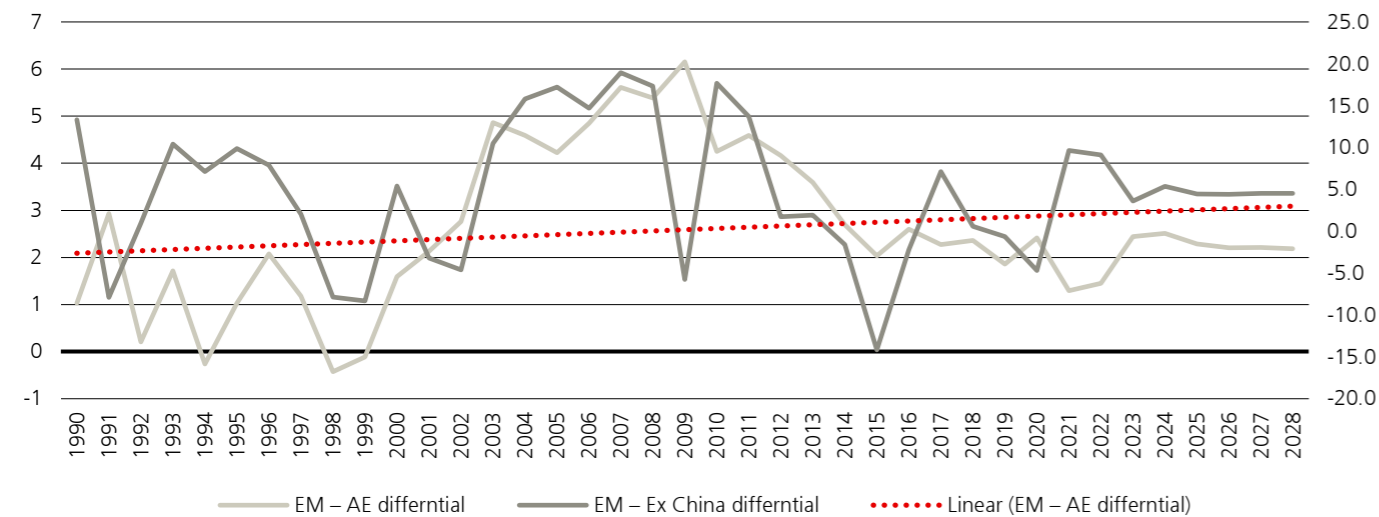
#### Solid fundamentals, better creditworthiness and a growth differential with advanced economies

The growth differential between EMs and advanced economies (AEs) has more than doubled over the last three decades: from an average of 1% in the 1990s to 2.7% in 2010-2023. According to the International Monetary Fund (IMF), this differential is expected to fall over 2024-2028 but should remain above 2%. This drop is largely explained by the drop in the growth differential between China and AEs.

The growth differential between China and AEs rose to a staggering 9% in 2000-2009 and fell to around 5% in 2010-2023; it is expected to fall to around 2% in 2024-2028. On the other hand, the growth differential between EMs ex-China and AEs is expected to increase from 3% in 2010-23 to 4.7% in 2024-2028 thanks to faster economic growth in Asian EMs ex-China, Middle East and Central Asia and Africa.

Exhibit 1: GDP differential EM-AE (LHS) vs EM ex China-AE (RHS)

GDP Differential EM - AE (lhs) vs EM ex China - AE (rhs)



Source: IMF World Economic Outlook as of March 2024, UBS.

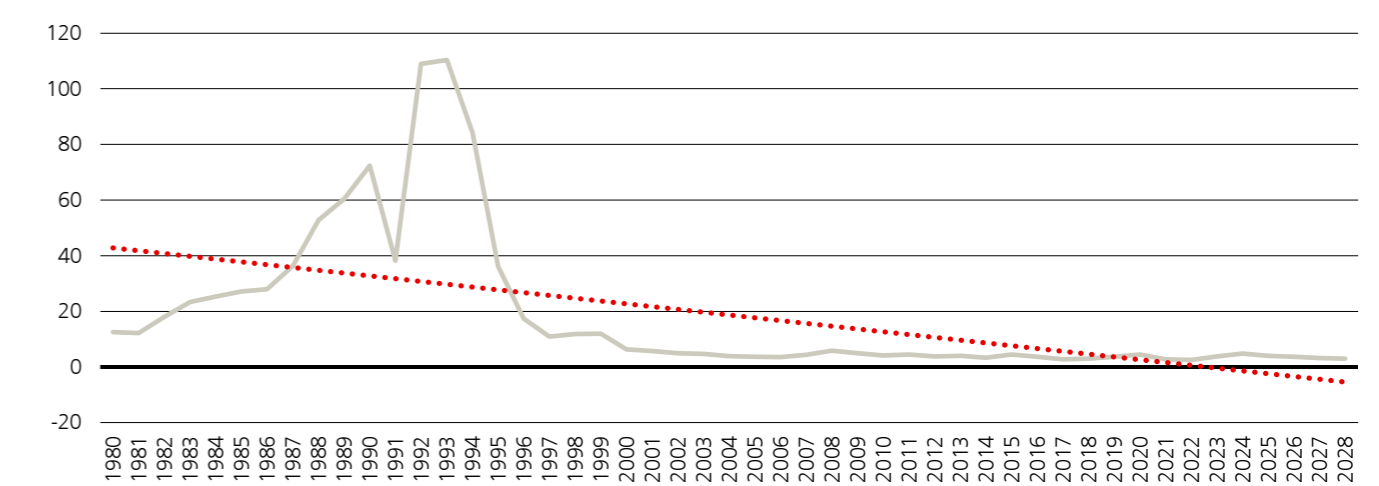
#### Improved macroeconomic stability

EMs economic growth outperformance over AEs is not only due to a catching-up effect (i.e., the increase in income levels). It is also the result of improved macroeconomic stability and better macroeconomic management. With some notable exceptions, most EMs have succeeded in

moving away from the 1980s and 1990s era of double-digit inflation rates. The EM-AE inflation differential has been steadily falling over the last few decades and averaged 3.6% between 2010-2023, in line with higher nominal growth in EMs. The IMF expects inflation in EMs to remain stable over 2024-2028.

Exhibit 2: The EM-AE inflation differential

Inflation differential EM vs AE



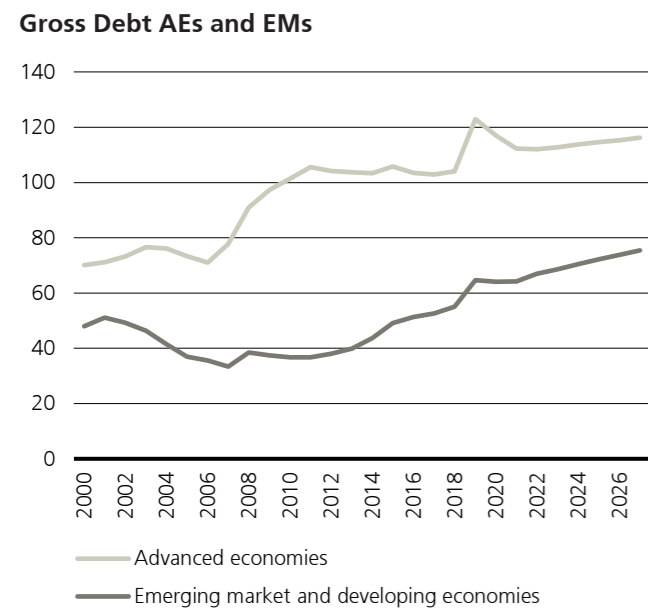
Source: UBS



EM inflation has been brought under control thanks to sound monetary and fiscal policies. Most EMs have switched to inflation targeting and central bank independence in the last few decades, in line with advanced economy best practice. On the exchange rate front, many EMs moved away from unsustainable fixed exchange rates. This helped to reduce external debt levels that have fallen – as a percentage of GDP – by around 10% from the 1990s to 2010s.

On the fiscal front, EMs have adopted a more conservative stance than AEs. Over 2000-2023, public debt in AEs has increased by more than 40% of GDP, while it has increased by less than 20% in EMs. On average, in 2023, AEs had a public debt-to-GDP ratio of more than 110%. EM ratios stand below 70%, and many would easily pass the European Maastricht criteria for debt sustainability.

Exhibit 3: General government gross debt, EM vs AE



Source: IMF World Economic Outlook as of March 2024.

**Better macroeconomic management**

More sound monetary, fiscal and exchange rate regimes provided a fertile ground for long-term macroeconomic stability, supporting a healthy growth environment. EMs have also shown an increased ability to respond to external shocks as demonstrated during the post-Covid surge in global inflation. Drawing lessons from past inflation episodes, they started raising rates much earlier than advanced economies and thus avoided falling behind the curve.

The best example is Brazil: the central bank started raising interest rates in April 2021, one year before the Fed started its hiking cycle. The country acted aggressively without being slowed down by debates over the “transitory” nature of the inflation shock prevailing across the US and Europe. By the summer of 2023, inflation was within target and the central bank was able to start decreasing rates again; since then, it lowered policy rates by 2.5%.

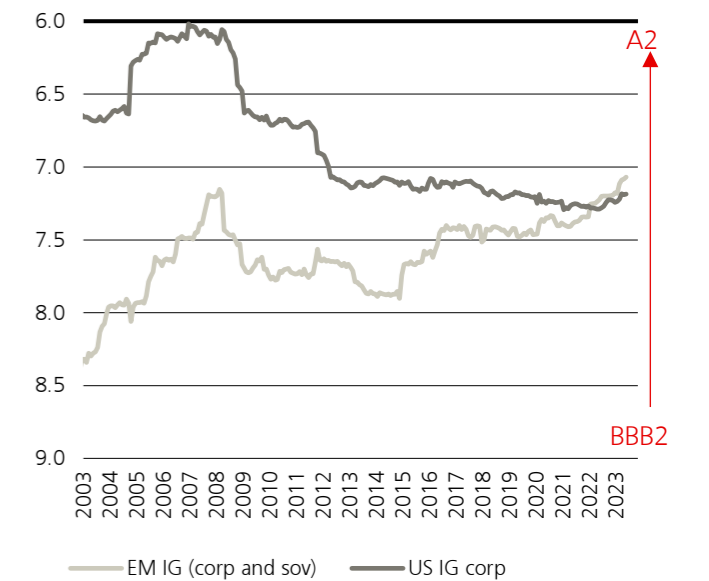
Other EMs across Latin America, Central and Eastern Europe, Middle East and Africa also adopted a similar response: on average, EMs increased rates by a cumulative 780 basis points (bps) against the 400 for advanced economies. As a result, exchange rates, stock prices, and sovereign spreads fluctuated in a modest range and most importantly, foreign investors did not leave EM bond markets en masse as in previous episodes of global interest rate volatility.

**Better creditworthiness**

Improved macroeconomic stability and better macro policy management has improved the credit profile of EMs. Credit ratings have improved not only for sovereigns, but also corporate debt. The recent inclusion of higher-rated Gulf Cooperation Countries (GCC) has further boosted the upward trend in ratings.

Since January 2021, the share of single-A and above ratings has risen in both EM IG and US IG Indexes. However, the increase is much greater for EMD (EMBI IG Index): single-A and higher rated countries now comprise 47% of the index (from 39% in Jan 2021). For US IG the figures are 52% versus 49%.

Exhibit 4: Credit ratings EM IG and US IG Corporates



Source: UBS Asset Management, as of March 2024





### Deglobalization, a threat for EMs?

The slowdown in globalization that started in the last decade amid rising protectionism and geopolitical tensions is often perceived as negative for EMs as export-led economies face rising barriers to exports and find it more difficult to access vital Western technology. However, the reality is that we are entering a new phase of globalization rather than deglobalization. First, the reconfiguration of international value chains to reduce Western dependency on China is a long and complicated process with uncertain outcomes. Many international corporations have signaled their willingness to stick to their international production model and, so far, evidence of major pull-outs from China and other emerging markets is scarce.

What is certain is that there will be winners and losers in this new era of globalization. Economies with better demographics (e.g., India) and cost advantages – for instance better access to energy sources (e.g., Saudi Arabia) – should be in a good position to benefit from the reconfiguration of global values chains. Some economies will benefit from their proximity to large Western consumer markets (e.g., Mexico, Turkey) and some others can tap into the global pool of talents (e.g., Malaysia, China, and the Philippines). In this new phase of globalization, investors will have to be more selective across markets and regions as there will be more dispersion in terms of competitiveness and economic performance.

Figure 1: Globalization shocks: winners and losers

Overall rankings reflect the average performance of each country on the given dimensions

Rank	Country	Cost-advantage potential	Labor cost potential	Nearshoring potential	Skilled migration potential
		Year-over-year change in relative prices of exports and imports, July 2022	Percentage-point change in share of working-age population, 2022-2032	Foreign markets covered by free-trade agreements, % of GDP	Global Talent Competitiveness Index, 2021 (0-100)
1	Malaysia	1.9	1.7	8.5	60
1	Mexico	0.5	2.6	25.7	46
3	Argentina	0.3	2.1	5.1	48
4	Colombia	1.7	0.8	6.5	44
5	Philippines	-1.4	2.2	8.3	45
6	Peru	-2	1.9	49.4	40
6	S. Arabia	10.9	-0.7	2.2	54
8	Egypt	0.7	1.3	5.8	40
9	India	-0.9	3.3	6.9	40
9	Poland	0.1	-2.2	28.3	56
9	Turkey	-0.4	0.2	22.2	43
9	Vietnam	0.6	-0.7	39.6	41
13	Indonesia	3.3	0.7	2.8	42
14	S. Africa	0.0	0.3	1.1	46
15	Brazil	-1.3	0.6	1.2	43
15	Chile	-5.6	-1.5	7.5	60
15	China	0.3	-2.2	1.3	57
15	Pakistan	-0.6	3.8	10.9	32
19	Thailand	-1.8	-3.7	5.7	45
20	Nigeria	5.2	2.1	0.8	31
20	Russia	7.7	-3.5	0.4	52
22	Sri Lanka	-1	-0.2	12	39

Higher potential
  Lower potential

Sources: IMF, World Bank, United Nations, INSEAD



# 3

## The asset allocation case

Better risk-adjusted returns over 5 and 10 years

### EM assets could deliver strong risk-adjusted returns

EM assets are expected to deliver good returns according to UBS-AM Capital Market Assumptions. In terms of expected returns over the next five years, EM debt in hard currency is expected to generate higher annual returns than global equities with less volatility. As a result, its expected Sharpe Ratio is 0.6 compared with 0.29 for equities. On the equity front, EMs are expected to deliver a return of nearly 10% compared with 7.5% for global equities. The “premium” of EMs over AEs is expected to remain intact also over the next 10 years: 2.5% in equity and 3.0% in fixed income.

Figure 2: Asset class results

Asset class	5 years GRR	10 years GRR	5 years A SR	10 years A SR
EM Eq U	9.96	9.26	0.36	0.35
EMD Hard H	8.88	6.70	0.60	0.40
Global Eq U	7.58	7.13	0.29	0.29
Global Agg H	5.16	4.71	0.23	0.22
Dev Mkt Eq U	7.24	6.82	0.27	0.27

Source: UBS Asset Management as of February 2024.

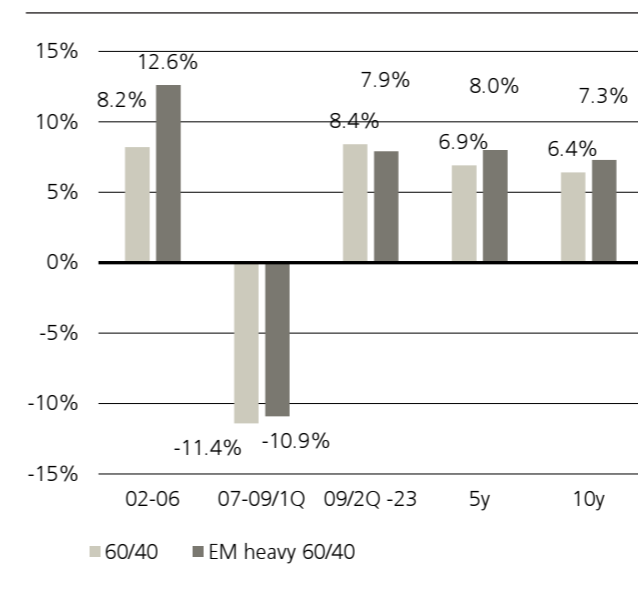
### Increasing the weight of EM assets in global diversified portfolios boost the returns of global diversified portfolios

In order to analyze the impact of higher allocations to EM assets in global portfolios, we start with a plain vanilla 60/40 portfolio (60% MSCI World net and 40% Global Agg<sup>1</sup>) and then tilt it towards higher EM allocations. In equity, we reduce allocations to the MSCI World from 60% to 40%, and 20% of EM equity is added (MSCI Emerging Markets net). In fixed income, allocations to Global Agg are reduced from 40% to 25%, and 15% of EM hard currency is added (JPM EMBI Global index).

### Historical returns

From a historical perspective, we look at three sub-periods: a) 2002-2006; b) 2007-2009 (GFC); and c) 2010-2023. As you can see in Exhibit 6, the “standard” 60/40 portfolio showed average annual returns of around 8% in the periods before and after the GFC, results that are notably lower than for the portfolio with higher EM allocations. In 2002-06, the EM-heavy portfolio outperformed the standard 60-40 portfolio with a 4% higher return on average. In 2009-2023, however, the EM-heavy portfolio underperformed the standard 60/40 portfolio by around 0.5%. The strong performance of the standard 60/40 portfolio in the post-GFC years is particularly remarkable because it was achieved with a lower standard deviation of 10.7% compared with 11.9% for the EM-heavy portfolio. However, the EM-heavy portfolio suffered smaller losses during the GFC period.

Exhibit 6: Historical returns and expected returns of 60/40 portfolio compared with EM-focused portfolio



Source: UBS Asset Management as of February 2024.

### Expected returns over the next five and 10 years

While the period 2009-2023 was marked by an outperformance of portfolios heavy in allocations to advanced economies as measured by the standard 60/40 portfolio, we expect this to revert and EM-heavy portfolios to outperform over the next five and 10 years. The underperformance of the EM-heavy portfolio in the post-GFC years is largely due to very loose monetary and fiscal policy conditions prevailing in most AEs. Unorthodox

monetary policy and rising public debts fueled a massive rally in asset prices across AEs. These conditions are now reverting with much stricter monetary policy conditions, and eventually also public debts will have to be reduced to more sustainable levels. As a result, the expected return of the standard 60/40 portfolio is expected to be nearly 2% lower over five and 10 years. EM-heavy portfolios are expected to return to pre-GFC returns over the next five years, outperforming the standard portfolio by more than 1%.

Figure 3: Portfolio results

	Statistic	60/40	EM heavy 60/40
Equilibrium	GRR	6.49%	6.69%
	ARR	7.02%	7.35%
	Std dev	10.66%	11.91%
	Sharpe ratio	0.39	0.38
5 years baseline	GRR	6.89%	8.01%
	ARR	7.41%	8.66%
	Std dev	10.66%	11.91%
	Sharpe ratio	0.31	0.38
10 years baseline	GRR	6.44%	7.25%
	ARR	6.96%	7.90%
	Std dev	10.66%	11.91%
	Sharpe ratio	0.31	0.36
	Geo sharpe ratio	0.26	0.30

Source: UBS Asset Management as of February 2024.

1 Note that the Global Agg index already includes allocations to EM bonds (at the time of writing around 9.60% to China for example).



# 4

## The market case

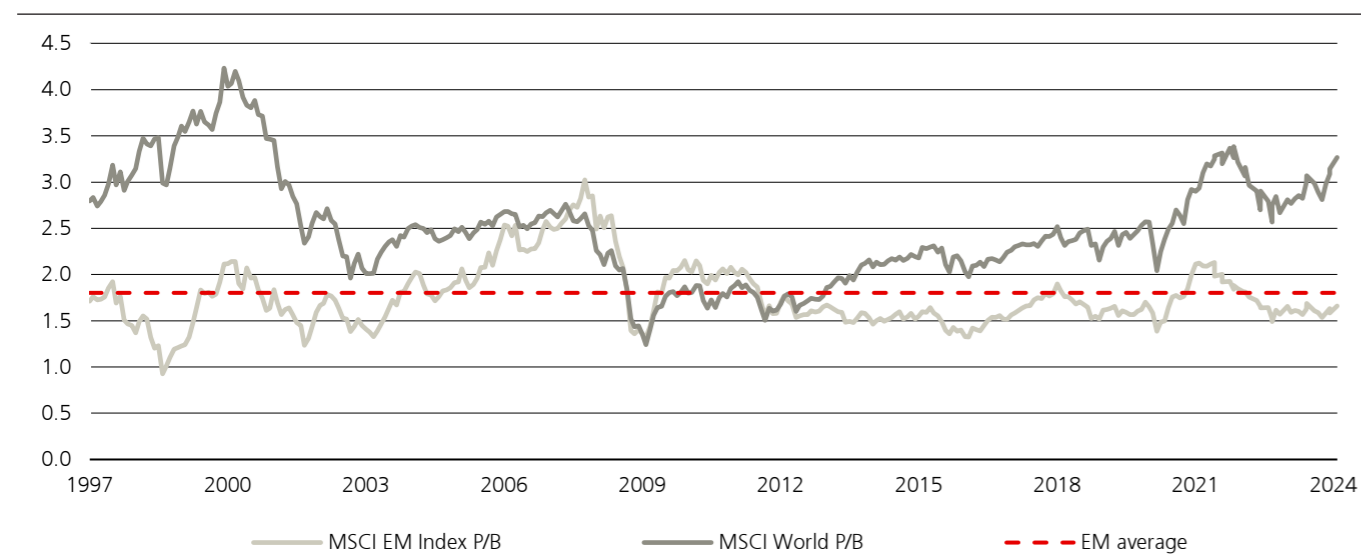
EM assets are attractive in valuations terms and offer long-term opportunities

### Emerging markets offer more attractive valuations compared to advanced economies

EM assets currently provide an attractive opportunity from a valuation perspective. With a forward P/E ratio below 14 for the MSCI Emerging Markets Index, valuations are considerably lower compared to AEs (in particular the US). In addition, a comparison of the price-to-book ratio shows that EMs are valued towards the lower end of the 25-year range, while the MSCI World Index is climbing towards highs last seen in the late 90s and early 2000s. This gap in current valuations between EMs and AEs equities is the result of underperformance of EMs experienced in the 2010s and post-Covid years when EMs

did not participate in the global equity rally. The poor performance in the Chinese equity market has undoubtedly played an important role, but the widespread pessimism over EMs in general has reduced the appetite of investors. This widespread pessimism was also visible in the more recent rally in global equities markets in 2023. The outperformance of the "Magnificent 7" and US equity markets in general has further reduced the appetite for EM equities. We believe that this "dominance" is likely to fade away in the future as a result of a weakening of the USD and the catching-up potential for EMs assets, particularly equities, could therefore be significant.

Exhibit 7: EM and AE valuations - MSCI EM P/B vs MSCI World P/B (1997 – February 2024)



Source: UBS Asset Management, as of March 2024



### The case for Chinese equities

The underperformance of Chinese equities since the lifting of Covid-related restrictions has been significant. This is largely due to the slower than expected recovery in the Chinese economy, reflecting the crisis in the real estate sector, a regulatory crackdown on the technology sector and the lack of a comprehensive and robust policy plan to stabilize the economy. Ongoing concerns over geopolitical tensions, a strong US dollar and selling pressure from derivative products linked to the country's equity indexes were additional factors.

We believe the market is overly pessimistic on Chinese equities as current valuations have already accounted for widespread pessimism. The Chinese government acknowledged the challenging market environment and introduced measures such as Reserve Requirement Ratio cuts, reductions in interest rate for small and medium enterprises and the agriculture sector, and relaxation of house purchase restrictions in major cities. The government's direct support for the equity market also

ramped up as there were notable inflows into onshore ETFs. There is a higher chance for a meaningful rebound rather than downside surprises.

In the long term, we note that China is in a different growth stage and economic environment, facing considerable challenges, but it remains on a growth trajectory with sizeable investment potential. China is still home to a large number of high-quality companies and some of them have made breakthroughs in expanding their businesses overseas. These companies are no longer producing low-end processing trade products or primary processed goods, but successfully compete with well-established global brands in international markets. They are adapting to various external challenges in the volatile geopolitical environment and continue to invest in technology and R&D, control costs and grow their market share. In particular for bottom-up investors, Chinese equity markets could hold significant opportunities for active investing.





### **Beyond China: Be selective in the face of ongoing challenges for EMs**

The negative impact from China on EMs is likely to fade away in the future. Still, investors are increasingly adopting an EM ex China approach and have become more selective. When it comes to positive fundamentals in 2024 for select EMs, we would highlight India and Indonesia, where domestic demand has shown relative strength. India's economy has continued to produce robust broad-based momentum supported by cyclical and structural tailwinds, while the macroeconomic environment in Indonesia remains stable given well-supported domestic demand and a healthy commodity trade surplus.

Tech-heavy Taiwan and Korea also performed well in 2023 as signs of a cyclical bottoming in certain segments are becoming evident. Outside of Asia, the Middle East should benefit from structural reforms despite the current conflict in the region. Most GCC countries are now part of the EM index in both fixed income and equities and market-friendly reforms over the last few years have attracted foreign investors. The most notable case is Saudi Arabia which is now home of one of the largest companies in market value, Saudi Aramco.

Latin America and other Eastern European economies like Poland are expected to lead the way with respect to rate cuts in the medium term, which could help to maintain the economic momentum. Brazil outperformed the broader market due to favorable inflationary dynamics that allowed its first interest rate cut in August.

### **Long-term opportunities for EMs**

We see various long-term themes that could be attractive drivers for EMs in the years ahead; while some of these

trends will only play out over years or decades, long-term investors are advised to position for these trends by taking advantage of current valuation levels.

#### **The evolution of Asian consumers**

India's and South East Asia's middle classes are expected to more than double from ~700 million in 2022 to ~1.5 billion in 2030. A rising middle class will drive higher consumption levels, boosting the trend towards premiumization and discretionary spending.

#### **De-globalization and geopolitics**

As outlined in the economic section of the paper, an analysis of global FDI developments shows that emerging economies (in particular in Asia) are expected to benefit the most from the ongoing reconfiguration of manufacturing and supply chains, in particular a shift to "China Plus One" diversification.

#### **Financial deepening**

Credit penetration is low in many EMs, even when adjusted for per capita GDP. Low private sector leverage in several EM countries should create growth opportunities for investors.

#### **Artificial intelligence and digital transformation**

Semiconductors are likely to become an essential good with geopolitical features, and large parts of the production value chain are located in Asia.

#### **Energy transition**

With most of the battery manufacturing capacity in EMs, countries are likely to benefit from the ongoing surge in capex into the electric vehicle supply chain; from raw materials (e.g., nickel ore) to batteries and electric vehicles fully manufactured in EMs.

#### **Demographics and health care**

With demographic trends favoring EM over DM over the coming decades, a higher working age population will likely drive growth and create opportunities in emerging economies. Still, an increasing share of elderly in the population will undoubtedly add to the rise in healthcare spending.

#### **Structural changes and reforms**

Long-term reforms of institutions and measures to improve macro conditions could improve export competitiveness cushions that current account deficits (e.g., India, Indonesia) or allow higher female participation giving a boost to non-commodity producing sectors of the economy and achieving greater diversification away from oil (e.g., Saudi Arabia).

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