Sizing Up Opportunity in **Emerging Capital Markets**

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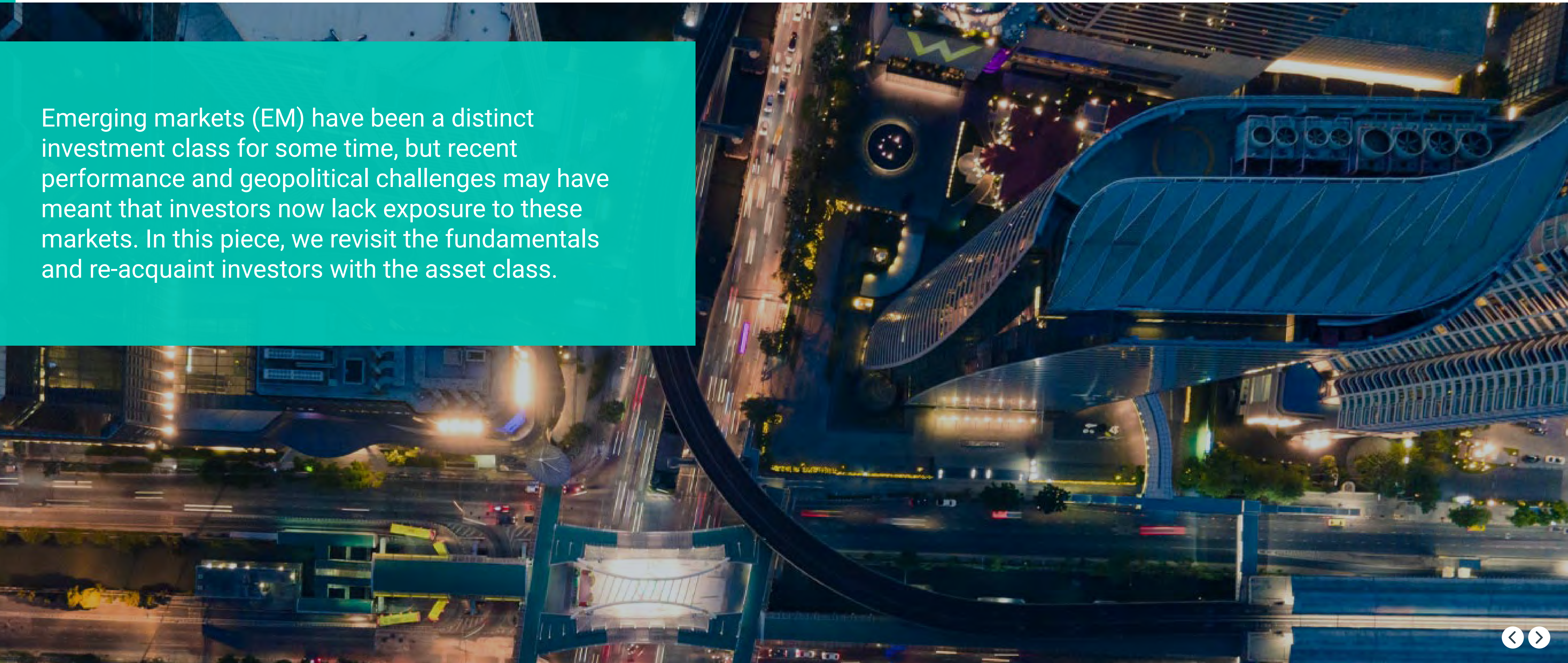
Emerging markets (EM) have been a distinct investment class for some time, but recent performance and geopolitical challenges may have meant that investors now lack exposure to these markets. In this piece, we revisit the fundamentals and re-acquaint investors with the asset class.



Greater Set of **Investment Opportunities**

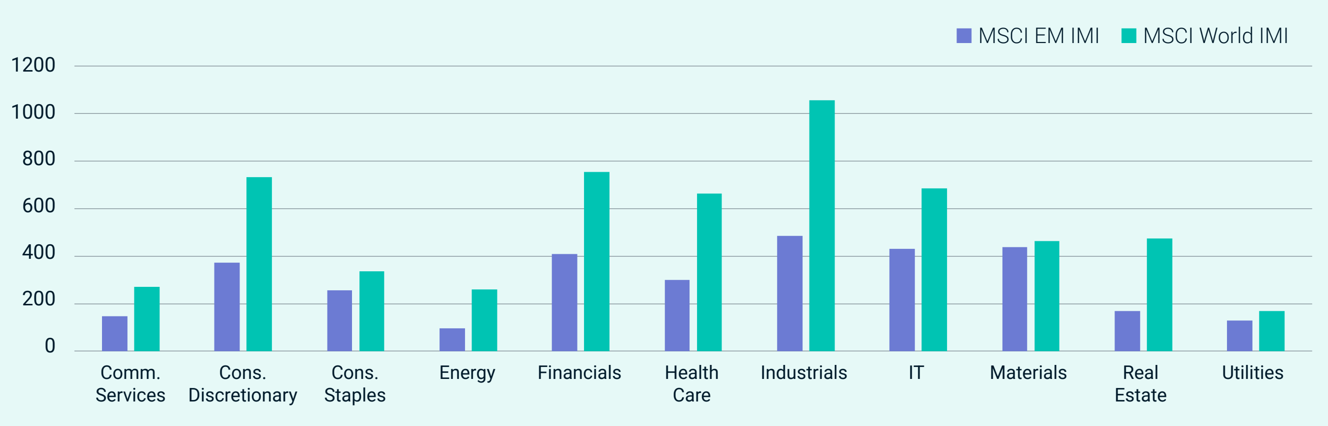
One reason to consider an investment in emerging markets is a simple mathematical one. By adding emerging markets to the investment opportunity universe, an investor is increasing the number of companies, countries and sectors which can be potential sources of return.

Currently, MSCI has classified 23 countries as developed markets[1] and 24 as emerging markets[2]. If an investor restricts the investment universe to developed markets only, the number of investable companies would be around 5,800[3]. By including emerging markets, an additional 3,200[4] companies would be added to the universe.

The expansion of the investable universe also means potential opportunities that may not be found in developed markets.

Another way to measure opportunity is to look at the distribution of companies by sectors or industries. A sector classification like Global Industry Classification (GICS®[5]) is quite granular and may allow investors to understand the main business areas and revenue drivers for any company around the world.

Comparing the MSCI World IMI Index to the MSCI EM IMI Index reveals that there are more listed companies in developed markets across the top sectors:



Source: MSCI, as of May 31, 2023

However, digging deeper into the market classification system, the story changes somewhat. The industry opportunity set is larger within emerging markets than that of developed markets.

Sector Name	Industry Name	MSCI EM IMI	MSCI WORLD IMI
Communication Services	Wireless Telecommunication Services	23	21
Consumer Staples	Tobacco	10	9
Industrials	Industrial Conglomerates	49	31
Industrials	Transportation Infrastructure	40	19
Information Technology	Semiconductors & Semiconductor Equipment	162	113
Information Technology	Technology Hardware, Storage & Peripherals	42	30
Materials	Chemicals	218	174
Materials	Construction Materials	60	28
Utilities	Independent Power & Renewable Electricity Producers	56	42
Utilities	Water Utilities	16	11

Delving even further, we find more differences at the sub-industry level. For example, there are more diversified banks in emerging markets (169) than in developed markets (90) and a lot more semicondutor companies (110 vs 61) and electronic components companies (82 vs 35).

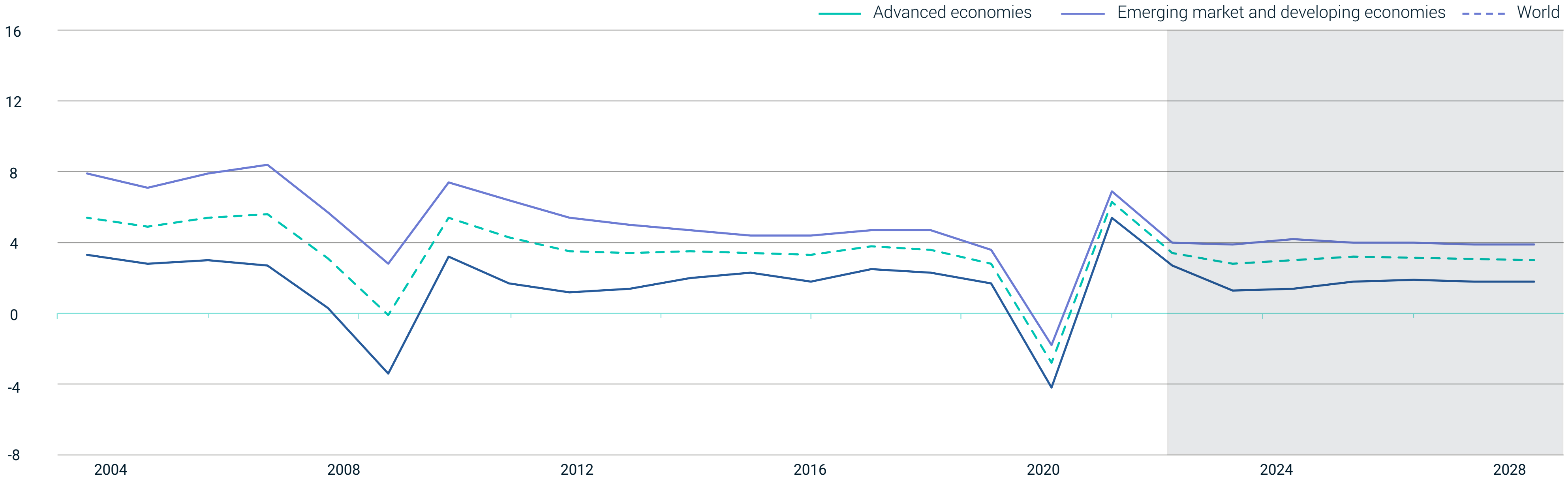
1. Developed markets as of May 31, 2023: Australia, Austria, Belgium, Canada, Denmark, Finland, France, Germany, Hong Kong, Ireland, Israel, Italy, Japan, Netherlands, New Zealand, Norway, Portugal, Singapore, Spain, Sweden, Switzerland, UK and US.
2. Emerging markets as of May 31, 2023: Brazil, Chile, China, Colombia, Czech Republic, Egypt, Greece, Hungary, India, Indonesia, Korea, Kuwait, Malaysia, Mexico, Peru, Philippines, Poland, Qatar, Saudi Arabia, South Africa, Taiwan, Thailand, Turkey and United Arab Emirates.
3. MSCI World IMI number of constituents as of May 31, 2023
4. MSCI EM IMI number of constituents as of May 31, 2023
5. Global Industry Classification System, GICS®, is a four-tiered global industry classification standard jointly developed by MSCI and S&P Global Market Intelligence to provide investors with consistent and exhaustive industry definitions. The four tiers are: Sectors, Industry Groups, Industries and Sub-Industries.

Macroeconomic **Outlook**

The most recent World Economic outlook by the International Monetary Fund (IMF) showed a slowdown of global growth from 3.2% in 2022 to 2.7% in 2023. This is one of the weakest growth forecasts since 2001. It has been impacted by high inflation, the cost-of-living crisis, tightening financial conditions in most regions, Russia's invasion of Ukraine, and the lingering COVID-19 pandemic. However, growth projections are not uniform around the world.

For 2023 and 2024, the expectation is that emerging economies will experience a higher economic growth rate than advanced or developed economies. Looking at the country level, growth is expected to be higher in Asian emerging markets (China: 5.2%, India: 5.9%) relative to other regions[6].

Real GDP Growth (% Annual Change)



Source: MSCI, as of May 31, 2023

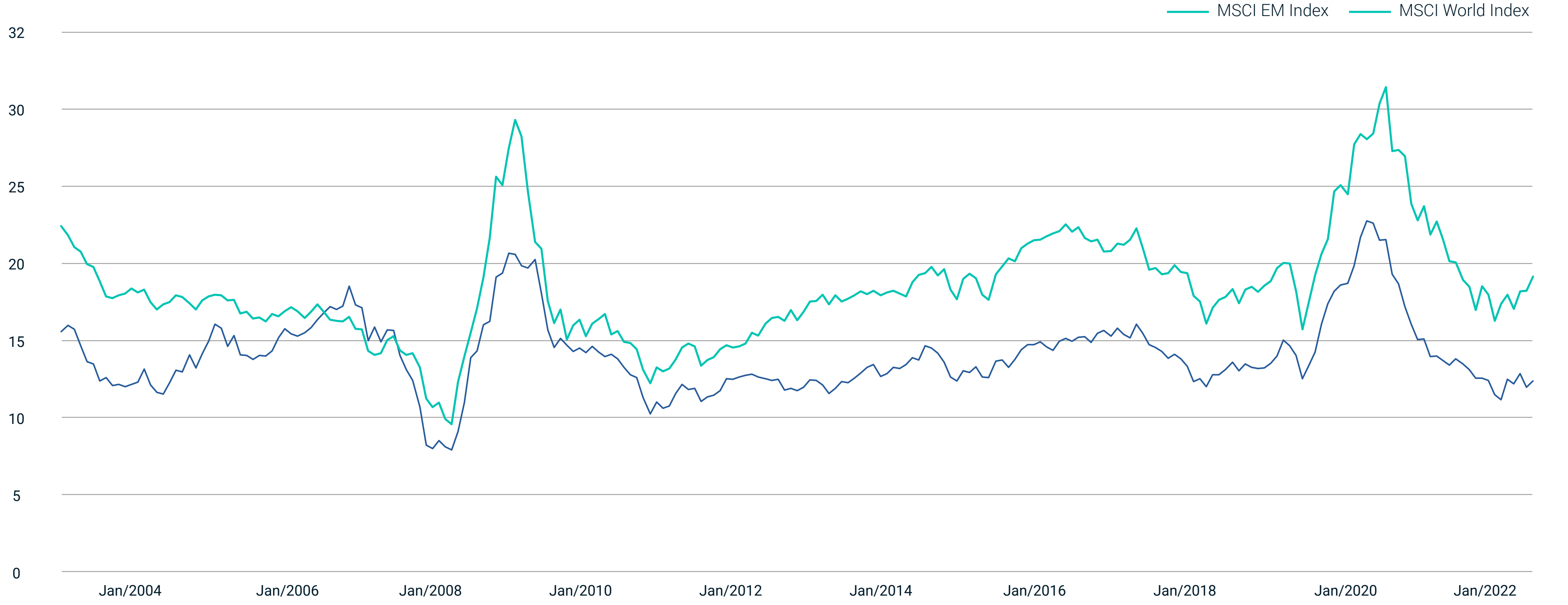
6. Source: IMF

Valuations

Our research[7] establishes a relationship between relative valuations and subsequent performance. This is particularly relevant for emerging markets, which over time, have found themselves at a significant discount relative to their developed markets counterparts.

We found that over the short-term the relationship was negative, meaning that lower valuations were not associated with higher short-term performance. However, over the longer-term the relationship was stronger, and cheaper names tended to outperform more expensive names.

Price/Earnings



7. "The Future of Emerging Markets: 30 Years On from the Launch of the MSCI Emerging Markets Index", April 2019

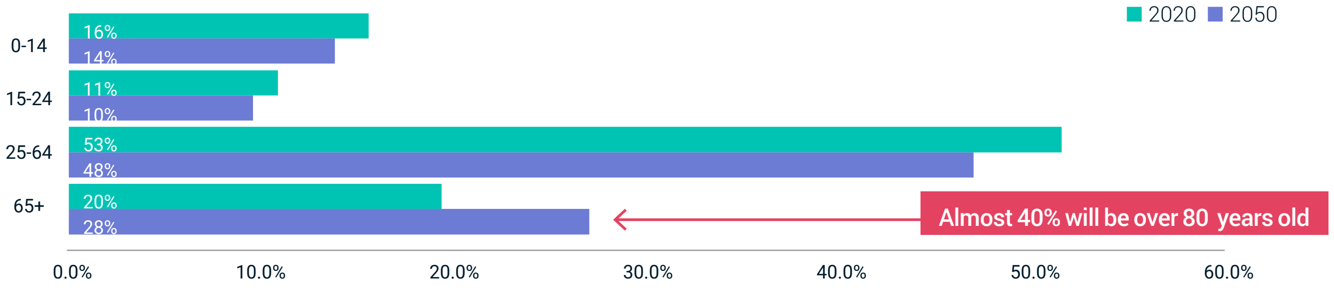
Demographics

The world population reached 8 billion in November 2022 and is expected to grow to 8.5 billion by 2030 and 9.7 billion in 2050[8]. Most of this growth is expected in emerging and developing economies in Asia and Africa. The table below shows the ranking of the 10 most populous countries. Early in 2023, India surpassed China as the world's most populous country.

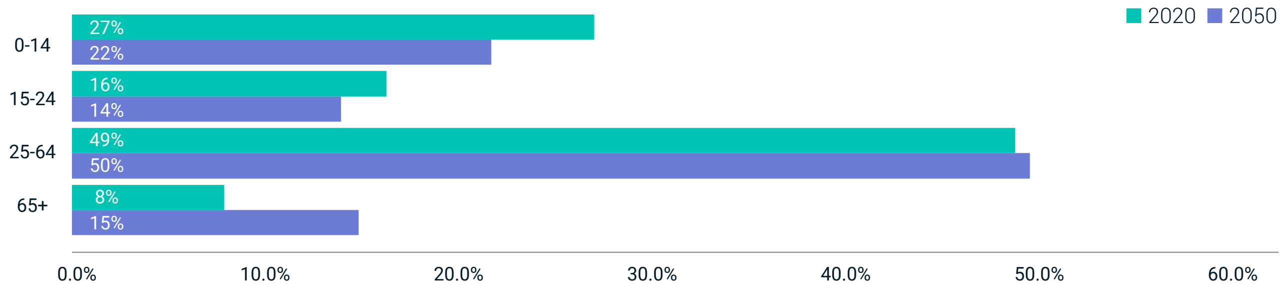
1990	(millions)		2022	(millions)		2050 (forecast)	(millions)
China	1,144	↔	China	1,426	↘	India	1,668
India	861	↔	India	1,412	↗	China	1,317
USA	256	↔	USA	337	↔	USA	375
Indonesia	181	↔	Indonesia	275	↘	Nigeria	375
Brazil	149	↘	Pakistan	234	↔	Pakistan	366
Russia	148	↘	Nigeria	216	↗	Indonesia	317
Japan	123	↘	Brazil	215	↔	Brazil	317
Pakistan	114	↗	Bangladesh	170	↘	Congo	215
Bangladesh	106	↗	Russia	145	↘	Ethiopia	213
Nigeria	94	↗	Mexico	127	↘	Bangladesh	204

The world population will be older on average, but this will be felt more in developed economies, where almost a third of the population will be over 65.

Developed Regions Population Distribution



Developing Regions Population Distribution



While developed countries will see a decrease in the share of their working-age population, most developing regions will remain stable, and some will even see this cohort grow. This "demographic dividend" may provide an opportunity for accelerated economic growth and social development.

8. Source: UN World population to reach 8 billion on 15 November 2022 | United Nations

Broaden Your Investment Universe **With EM Debt**

Investors contemplating investing in emerging markets may consider both equity and fixed income markets. While there seems to be greater familiarity and demand for equity investment options, as indicated by the number of available funds[9], considering bonds may broaden an investor's universe even further.

With emerging markets debt, the currency in which a bond is issued will play a part in the classification and categorization of fixed income instruments.

Instrument types	Non-domestic currency issuance	Domestic currency issuance
Government/sovereign debt	Hard currency government/sovereign debt	Local currency government/sovereign debt
Corporate debt	Hard currency corporate debt	Local currency corporate debt

Bonds issued in currencies such as the U.S. Dollar or Euro are referred to as "hard currency" bonds. The repayments will be made in the currency the bond was issued, regardless of what may be happening with the exchange rate of the "hard currency" vs. the domestic currency.

While issuance in "hard currency" both at the government and corporate level tended to be the norm in the 1990s, over the last two decades we have seen an increase in the issuance of local debt, which now is several times larger than hard currency debt.

Over the past 20 years, the EM debt market has expanded rapidly, surpassing USD 24 trillion in 2020 (with roughly 85% in local currency and 15% in external currency), and it now accounts for over 25% of the global bond universe, up from just 2% in 2000[10].

Defining EM in Fixed Income

Classifying countries as emerging or developed in the fixed income space is similar to equities but there are some fundamental differences. While an equity classification starts from economic development criteria and then adds asset class specific characteristics (size and liquidity, market accessibility), a fixed income classification tends to be restricted to economic development criteria.

For the economic development criteria to classify a country as an emerging market, investors may consider the World Bank's or IMF's definitions:

- **World Bank:** middle-income economies (110 countries) and low-income economies (27 countries)
- **IMF:** emerging and developing economies (156 countries)

This compares to just 24 countries classified as emerging markets in the equity space.

9. Source: ETFGI, as of March 31 2023 (2,229 Equity ETFs, 335 Fixed Income ETFs)
10. State Street Global Advisors "Emerging Market Debt Enhancing a Global Bond Portfolio", March 2022

Potential Risks in **EM Investments**

While investing in any asset class carries some degree of risk, an investment in emerging markets, be it with equities or fixed income, will carry some additional and specific risks.

Political risk

Emerging markets have historically had more unstable political structures compared to developed markets. This can be felt through unexpected changes to regulatory framework and investor protection or even higher civil unrest which may disrupt local company operations.

These risks may limit investors' ability to fully capitalize on their investment and capture any returns.

Currency risk

This type of risk will impact both equities and fixed income.

At the company level, fluctuations in exchange rates may lead to higher costs and lower revenues, if a company is highly engaged in global trade and the local currency depreciates relative to foreign currencies. This may impair its future growth and may negatively impact equity returns.

On the fixed income side, the currency risk will be felt more acutely for those bonds, sovereign or corporate, issued in hard currency, since any repayments will have to be made in the currency in which they were issued.

Liquidity risk

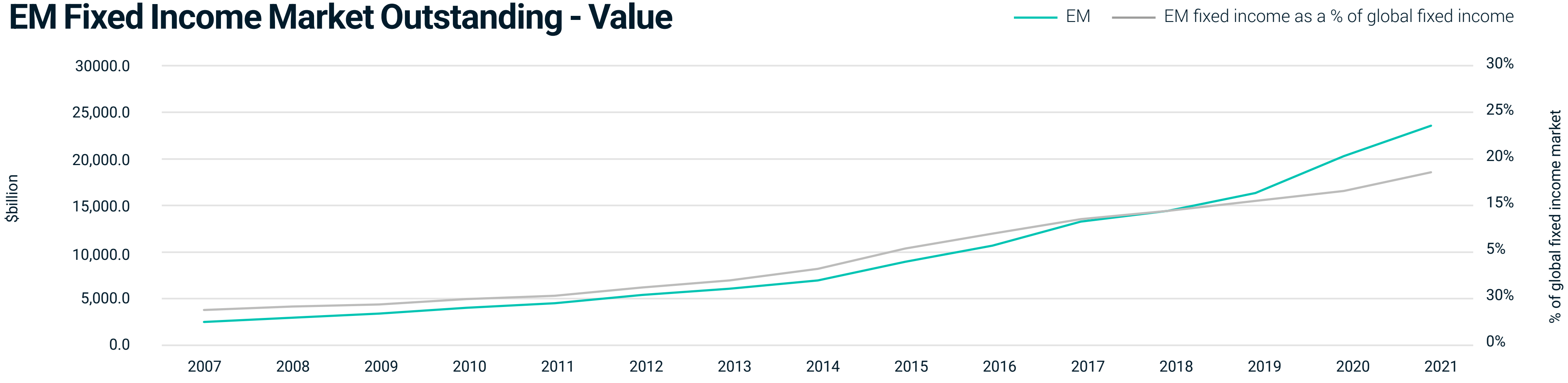
Liquidity risk is linked to the availability and accessibility of a given security. If there are limits to that availability, it may be more costly for investors to acquire that share or bond, which will increase their overall investment costs and will potentially reduce their returns.

Credit risk

This type of risk is specific to fixed income instruments and is defined as the possibility of a loss from a failure to repay the outstanding debt. This means that the bond issuer would have failed to meet its contract obligations. While hard currency bonds are issued under the regulatory framework of the hard currency country and any disputes will be handled by the courts of those countries, a local currency bond will be regulated by a domestic framework. In the latter case, a non-domestic investor may have less sway and less protection.

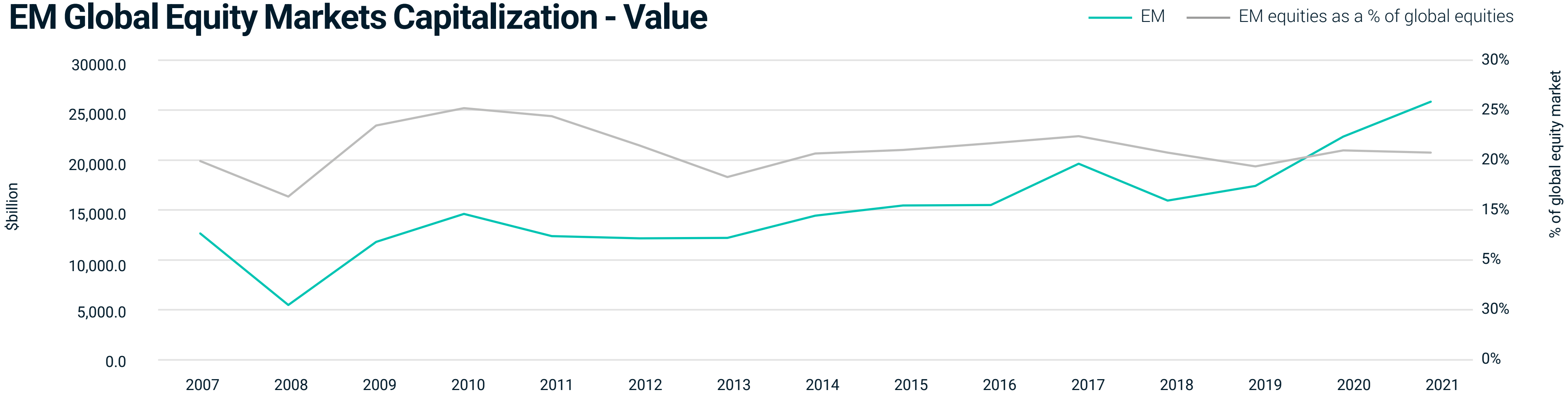
EM Opportunity Set in the **Context of Global Markets**

EM Fixed Income Market Outstanding - Value



Source: Securities Industry and Financial Markets Association (SIFMA) Capital Markets Fact Book

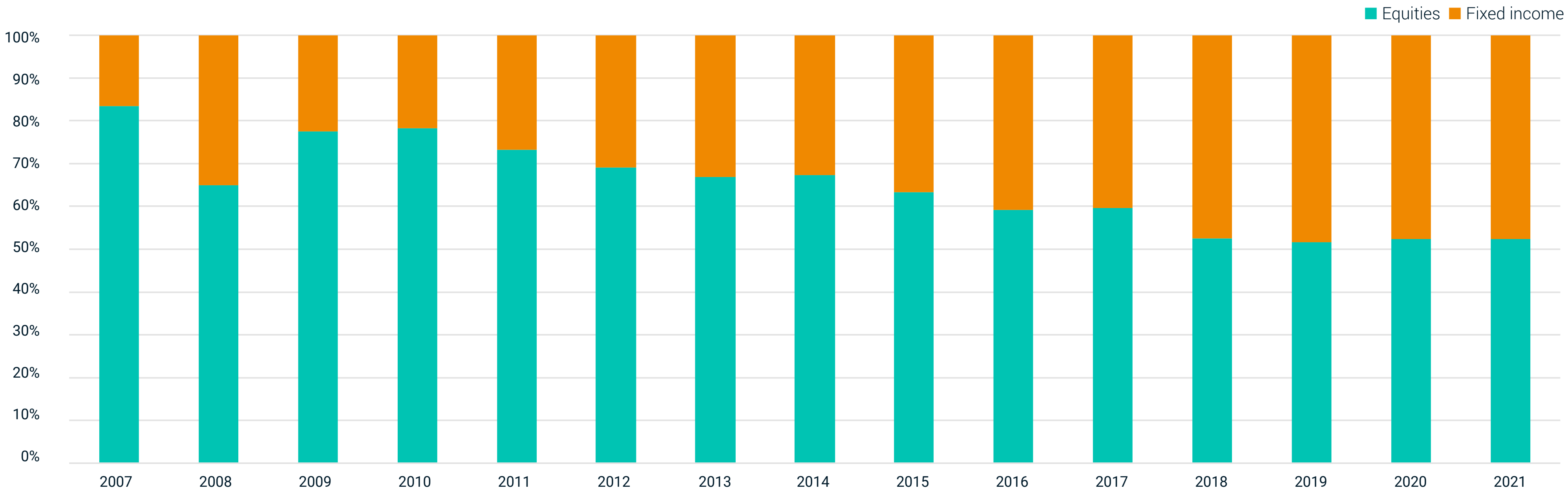
EM Global Equity Markets Capitalization - Value



Source: Securities Industry and Financial Markets Association (SIFMA) Capital Markets Fact Book

EM Opportunity Set in the **Context of Global Markets**

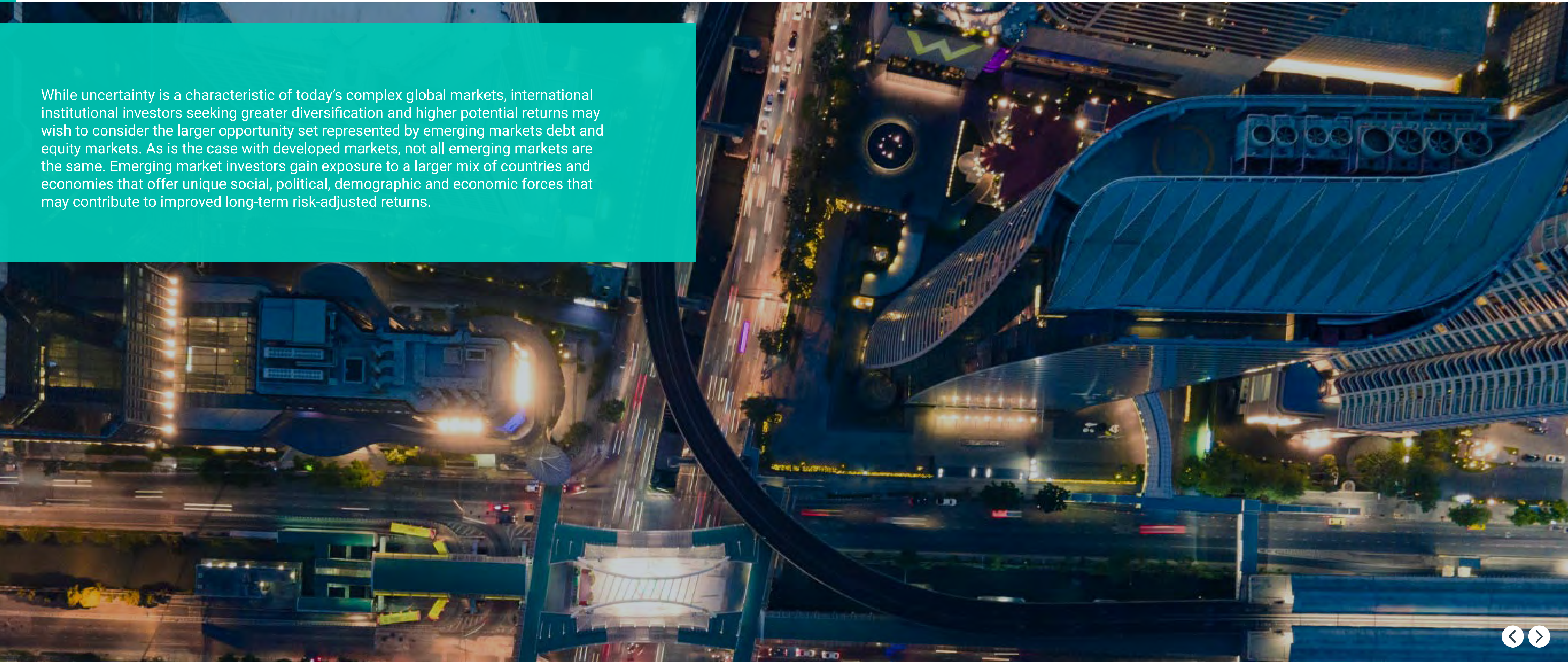
EM: Equities and Fixed Income Markets



Source: Securities Industry and Financial Markets Association (SIFMA) Capital Markets Fact Book

Conclusion

While uncertainty is a characteristic of today's complex global markets, international institutional investors seeking greater diversification and higher potential returns may wish to consider the larger opportunity set represented by emerging markets debt and equity markets. As is the case with developed markets, not all emerging markets are the same. Emerging market investors gain exposure to a larger mix of countries and economies that offer unique social, political, demographic and economic forces that may contribute to improved long-term risk-adjusted returns.



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