Sizing Up Opportunity in Emerging Capital Markets

This is an interactive brochure
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 markets1 and 24 as emerging markets2. If an investor restricts the investment universe to developed markets only, the number of investable companies would be around 5,8003. By including emerging markets, an additional 3,2004 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®) 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:

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.

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

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 semiconductor companies (110 vs 61) and electronic components companies (82 vs 35).

Source: MSCI, as of May 31, 2023

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.
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.

Source: IMF
Our research 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.

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. 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.

<table>
<thead>
<tr>
<th>Year</th>
<th>Country</th>
<th>1990 (millions)</th>
<th>2022 (millions)</th>
<th>2050 (forecast) (millions)</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>China</td>
<td>1,144</td>
<td>1,426</td>
<td>1,668</td>
</tr>
<tr>
<td></td>
<td>India</td>
<td>861</td>
<td>1,412</td>
<td>1,317</td>
</tr>
<tr>
<td></td>
<td>USA</td>
<td>256</td>
<td>337</td>
<td>375</td>
</tr>
<tr>
<td></td>
<td>Indonesia</td>
<td>181</td>
<td>275</td>
<td>375</td>
</tr>
<tr>
<td></td>
<td>Brazil</td>
<td>149</td>
<td>234</td>
<td>366</td>
</tr>
<tr>
<td></td>
<td>Russia</td>
<td>148</td>
<td>216</td>
<td>317</td>
</tr>
<tr>
<td></td>
<td>Japan</td>
<td>123</td>
<td>215</td>
<td>317</td>
</tr>
<tr>
<td></td>
<td>Pakistan</td>
<td>114</td>
<td>170</td>
<td>215</td>
</tr>
<tr>
<td></td>
<td>Bangladesh</td>
<td>106</td>
<td>145</td>
<td>213</td>
</tr>
<tr>
<td></td>
<td>Nigeria</td>
<td>94</td>
<td>127</td>
<td>204</td>
</tr>
</tbody>
</table>

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, 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.

<table>
<thead>
<tr>
<th>Instrument types</th>
<th>Non-domestic currency issuance</th>
<th>Domestic currency issuance</th>
</tr>
</thead>
<tbody>
<tr>
<td>Government/sovereign debt</td>
<td>Hard currency government/sovereign debt</td>
<td>Local currency government/sovereign debt</td>
</tr>
<tr>
<td>Corporate debt</td>
<td>Hard currency corporate debt</td>
<td>Local currency corporate debt</td>
</tr>
</tbody>
</table>

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.

**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)
## 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**


**EM Global Equity Markets Capitalization - Value**

EM Opportunity Set in the Context of Global Markets

EM: Equities and Fixed Income Markets

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.
The information contained herein (the "Information") may not be reproduced or redisseminated in whole or in part without the prior written permission of MSCI ESG Research. The Information may not be used to verify or correct other data, to create indexes, risk models, or analytics, or in connection with issuing, offering, sponsoring, managing, or marketing any securities, portfolios, financial products, or other investment vehicles. Historical data and analytics should not be taken as an indication or guarantee of any future performance. Analysis, forecasts, or predictions provided by MSCI ESG Research is provided by MSCI Inc.'s subsidiary, MSCI ESG Research LLC, a Registered Investment Adviser under the Investment Advisers Act of 1940. MSCI ESG Research materials, including materials utilized in any MSCI ESG Indices or other products, have not been submitted to, nor received approval from, the United States Securities and Exchange Commission or any other regulatory body. No representations or warranties, express or implied, are made with respect to the timeliness, accuracy, completeness, or reliability of the Information. None of the Information or MSCI index or other product or service constitutes an offer to buy or sell, or a promotion or recommendation of, any security, financial instrument or product or trading strategy. Further, none of the Information or any MSCI index is intended to constitute investment advice or a recommendation to trade (or refrain from trading) any kind of investment. None of MSCI Inc. or any of its subsidiaries or its or their direct or indirect suppliers or any third party involved in the making or compiling of the Information (each, an "MSCI Party") makes any warranties or representations, express or implied, to the maximum extent permitted by any applicable law, including but not limited to, the implied warranties of merchantability and fitness for a particular purpose, to the maximum extent permitted by any applicable law. None of MSCI Inc. or any of its subsidiaries or its or their direct or indirect suppliers or any third party involved in the making or compiling of the Information makes any warranties, express or implied, to the maximum extent permitted by any applicable law, including but not limited to, the implied warranties of merchantability and fitness for a particular purpose, to the maximum extent permitted by any applicable law. In no event shall any of the MSCI Parties have any liability regarding any of the Information for any direct, indirect, special, punitive, consequential, or any other damages even if notified of the possibility of such damages. The foregoing shall not exclude or limit any liability that may not by applicable law be excluded or limited. Privacy notice: For information about how MSCI collects and uses personal data, please refer to our Privacy Notice at https://www.msci.com/privacy-notice. The process for submitting a formal index complaint can be found on the index regulation page of MSCI’s website at https://www.msci.com/index-regulation. ©2023 MSCI Inc. All rights reserved