Understanding investing: Emerging versus developed markets

Insight for charities

Rathbones
Look forward

The value of investments and the income from them may go down as well as up and you may not get back your original investment. Past performance should not be seen as an indication of future performance.

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An overview of some of the key factors charity investors should take into account when analysing the merits of emerging markets versus developed markets.

That emerging markets, particularly in Asia, are bursting with growth and should outperform developed markets is a popular idea. It is also supported by recent data: for the 12 months to the end of May 2021, Pacific (ex Japan) and emerging markets were up 38% and 30% respectively, versus the UK and the US, which were up 23% and 22%.

Analysts at J.P. Morgan have recently made the case that Asia "is an investment opportunity that's simply too big to ignore and warrants a larger place in many portfolios,"[1] based on favourable demographics. Indeed, the growth of the largest emerging market, China, has been scarcely believable: in just 25 years (1990-2015), China's GDP grew by a factor of 31; it took the UK nearly 70 years after 1830 to grow GDP by a factor of four (1834-1900).[2] And according to Bill Gates's blog, between 2011 and 2013, China consumed 6.6 gigatons of concrete – that's more than the US used in the entire 20th century.[3]

But to decide whether we should buy into this story, it's helpful to go back to first principles and break down the components of economic growth into the growth in labour, capital, and human capital (or know-how). The efficiency with which these components are used – i.e. productivity – also matters, and this is affected by many country-specific factors such as culture, institutions and government policy.

[1] https://am.jpmorgan.com/gb/en/asset-management/adv/insights/market-insights/on-the-minds-of-investors/asias-decade-getting-ahead-of-the-growth-opportunity/?email_campaign=300018&email_job=253084&email_contact=0033a00002HzLY4AAN&utm_source=clients&utm_medium=email&utm_campaign=emea-asia-growth-product-email-20210505&memid=7220927&email_id=49825&decryptFlag=No&c3ch=email&c3nid=300018&e=ZZ&t=&f=001j000000hdPpkAAE&utm_content=button-findoutmore2# 15 March 2021

[2] https://data.worldbank.org/country/china; https://ourworldindata.org/grapher/total-gdp-in-the-uk-since-1270

[3] https://www.gatesnotes.com/Books/Making-the-Modern-World

Population growth, labour and human capital

While emerging markets have historically boasted a better growth profile due to their faster population growth, burgeoning middle classes and convergence with the productivity levels of developed markets, their populations are no longer growing faster than developed markets. In fact, population growth in developed markets is forecast to outpace that in emerging markets beyond 2035.[4]

Furthermore, using labour as a component of growth assumes all labour is equal. But it is advances in technology - such as artificial intelligence and robotics - that are increasingly defining economic growth, and this 'knowledge economy' requires effective communication, problem-solving skills, the ability to learn and collaboration - the 'human capital' in the basic growth equation. Literacy is essential for the first three; a safe, secure society is essential for the last. Research by the Legatum Institute, a charity think-tank, measures prosperity in 167 countries and shows that the fastest growing populations have the lowest literacy rates and tend to have lower levels of personal safety and security.[4]

Such research echoes the work of the eminent Peruvian economist, Hernando de Soto, known for his work on the informal economy and the importance of business and property rights. He has argued that no nation can

[4] United Nations, Department of Economic and Social Affairs, Population Division (2019). Probabilistic Population Projections Rev. 1 based on the World Population Prospects 2019 Rev.1; http://population.un.org/wpp/

have a strong market economy without an adequate legal framework protecting business rights, property ownership and other economic information. For example, if many small entrepreneurs lack legal ownership of their property, it is difficult for them to obtain credit, sell a business or expand.

In particular, strong legal protection against property seizure is key to promoting investment, both domestic and foreign (foreign direct investment, or FDI), which in turn is crucial for economic growth. FDI affects growth by capital deepening (more capital per worker) and technology transfer, but also by fostering strong institutions and social capital, which in turn attract further FDI. There is a risk that this virtuous circle can turn vicious when institutions succumb to corruption, cronyism and media clampdowns.

Indeed, FDI into emerging markets grew rapidly during the 1990s and 2000s, but has been in decline since 2015, shifting to developed markets.

Technology and globalisation

The final element of the economic growth equation relates to the efficiency and productivity of the three components - with technology playing an increasingly important role for human capital.

Technology was one of the key driving forces of globalisation as it enabled the management of complex global supply chains. In turn, globalisation helped foster growth within many emerging markets.

But, with recent advances in technology and automation significantly reducing the costs of manufacturing processes, developed markets are no longer incentivised to outsource production to emerging markets and their cheaper labour economies.

Using local manufacturers also helps to reduce costs associated with logistics, the environmental impact and some of the risks associated with extended supply chains. For example, even the classic 'cheap labour' good - training shoes - is seeing a return to local production in high cost Germany due to robotics and 3D printing.

GDP and equity returns

More fundamentally, it's a common assumption that high GDP growth results in strong returns for equities. However, the correlation between stock market returns and the per capita GDP growth rate is actually negative, as evidenced by US academic Jay Ritter.

Ritter demonstrated a correlation of -0.39 between equity returns and GDP growth for 19 countries with continuously operating stock markets between 1900 and the end of 2011[5]. In other words, investors in 1900 would have been better off investing in the slower growing countries.

The correlation between returns and GDP growth has been found to be low for both very long and shorter time periods. A 2014 study[6], covering 22 developed and 22 emerging market countries from 1997 to 2013, shows no meaningful correlation between real stock market returns (for large, mid or small cap companies) and real GDP growth, apart from a small positive correlation between small cap stock returns and developed market GDP growth. In fact, there have been extended periods of high relative emerging market returns amid poor relative growth, for instance during the 1990s, and vice versa during the 2000s.

[5] Jay R. Ritter, 'Is Economic Growth Good for Investors?', Journal of Applied Corporate Finance, Vol 24 No3, summer 2012.

[6] Joachim Klement, Wellershoff & Partners Ltd., 'What's Growth Got to Do With It? Equity Returns and Economic Growth', 7 February 2014.

Financial assets, generally, are claims on the earnings of private, productive entities. An economy with high population growth - that drives overall GDP growth higher - but with little increase in capital employed or productivity, is unlikely to generate higher sustained rates of return on private assets. In other words, fast growth in aggregate GDP is not the same thing as growth in earnings per share, which is what drives equity returns. Furthermore, faster growing economies need more capital, so companies have to raise capital to fund growth, which in turn dilutes earnings per share.

Capital flows and the US dollar

It’s also important to bear in mind that asset returns from many emerging markets depend on factors beyond their control, for example the strength of the US dollar and capital flows.

Take for example capital inflows. Large inflows of foreign money increase the value of local currencies, bonds and equities; banks lend more, property prices boom, inflation goes up, competitiveness goes down and current account balances worsen. This has happened repeatedly in Latin America, and notably in Thailand in 1997.

Some of these inflows of foreign money into emerging markets may be ‘structural’ but generally they have been highly correlated with global risk appetite. Reversals are common and regular in emerging markets and are always exacerbated by the strength of the US dollar. A weak dollar coincides with emerging market strength, and vice versa.

Emerging markets: caution required

Of course developed world equities are also correlated to the dollar, but much less so than emerging market equities. If emerging market returns are simply a 'risk-on' trade, they have been a poor one, given that their actual returns from the end of 2009 to May 2021 have been lower than those from developed markets. This holds true for risk-adjusted returns using the Sharpe Ratio, which measures the amount of return per unit of risk.

Finally, with the ever-increasing focus on environmental, social and governance factors, there are growing questions around the ethics of doing business with oppressive regimes (which prevail in several emerging market countries) and indeed whether investors should invest in them at all.

The fundamentals of investing

This guide accompanies one of our charity investment training webinar series: Equities - which markets? You can watch the full webinar by following this link.

Our training webinar series is designed to provide trustees and senior finance staff with an understanding of the fundamentals of charity investment as well as highlighting their responsibilities.

Please visit:
rathbones.com/charities to find out more about the training series or to read our other guides.

To find out more about Rathbones' approach to portfolio construction and investing for charities, please contact:

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