3D Reset and Emerging Markets: Risks and Opportunities

While emerging markets have faced a tough decade, the 3D reset may now be paving the way for new opportunities.

Insight from sub-adviser Schroders Investment Management

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Key Points

- While slower growth and economic headwinds present challenges for China, the country remains competitve, integrated, and flexible.
- Supply-chain diversification and the energy transition could create opportunities in Latin America, Central Europe, and Southeast Asia.
- A slowing economy in the US could lead to a softening US dollar, which in turn, may benefit EMs.

Emerging markets (EM) enjoyed a turbocharged period of growth during the 2000s, led by China. It was a decade of globalization, urbanization, the commodity "super cycle," and a rising middle class. Manufacturing, commodities, and consumption all benefited strongly.

However, the decade following has been a disappointment. Persistent US dollar appreciation has dragged on EM financial conditions and nominal growth. Globalization leveled off as the loss of manufacturing jobs in developed markets (DM) added to populist pressure. Chinese property, infrastructure, and debt have become increasingly developed and, more recently, geopolitical tensions have intensified with both economic and market implications.

So where now for EM? How are the 3Ds of demographics, deglobalization, and decarbonization causing risks and opportunities? Let's begin with the structural, starting with China—which currently accounts for 30% of the MSCI Emerging Market[1] Index benchmark.

Don't Write Off China

China faces slower growth in the coming decade, and its economy may need to transition away from an investment-led growth model. The investment share of GDP is unsustainably high: Infrastructure is considerably built out, but a years-long real-estate boom has led to oversupply in many parts of the country and debt levels remain high. Demographic trends are also acting as an increasing drag as China faces a shrinking working-age population, a marked fall in its birth rate, and a rapid increase in its dependency ratio as the population ages.

What's more, China is facing the "middle-income trap." As wage costs have risen, China has become less competitive in low-end manufacturing and needs to continue to move up the value chain.

In addition, geopolitical tension with the US is adding to economic headwinds. This tension contributes to supply-chain diversification, hinders access to advanced technology and knowledge transfer, has triggered aggressive US industrial policy, and impedes foreign direct investment (FDI). Despite these obstacles, China remains an $18 trillion economy, with a very large domestic market and the scale to support its own industrial policy. Since China is highly integrated and highly competitive, the impact on supply-chain diversification could take years to play out.

The country is innovative and is a major potential beneficiary of decarbonization. It manufactures 80% of the world's solar panels, sold two-thirds of the world's electric vehicles in 2022, controls 75% of the world's battery-cell production capacity, and dominates large parts of the renewables supply chain. It has a high savings rate and a controlled capital account so it isn't reliant on external capital for growth. Together with its control of the financial system, this gives China significant policy flexibility. Finally, in such a broad and deep market, we see opportunities at the company level.

Demographics Among Drivers of India's Inexorable Rise

India is the counterpoint to China in many ways. Having been outstripped by China over the past 40 years, it may be India's turn in the sun.

India is coming off a low base: Urbanization is low and represents a significant medium-term productivity opportunity. Returns from infrastructure investment are high, demographics are supportive, and labor is abundant and cheap. Government policies to improve fiscal efficiency, increase infrastructure investment, reduce friction for trade between Indian states, and drive import substitution have improved the prospects for growth. Meanwhile, digitization and smartphone penetration create opportunity to improve economic formalization and improve financial intermediation, education, and price discovery.

However, caveats are required: Issues of infrastructure; bureaucracy; protectionism; labor skills; and labor code persist, and, despite its scale, India isn't necessarily the first choice for export manufacturing FDI. But India's prospects for the next decade look promising.

Decarbonization and Deglobalization Beneficiaries

As the world becomes increasingly digitized, our structural view on technology is positive, and both Korean and Taiwanese markets enjoy exposure to trade and technology. As of October 2023, technology comprises 70% of Taiwan's benchmark, while in Korea it accounts for 50%. Meanwhile, Korea also has strong battery companies with excellent long-term growth prospects from decarbonization.

There are other countries in EM that are beneficiaries of supply-chain diversification. While India might not be a first-choice destination for export manufacturing FDI yet, a mix of infrastructure, skilled labor, and geographic proximity supports the prospects for Mexico, Central Europe, and the Association of Southeast Asian Nations.

Manufacturing in DMs can be very expensive both to build and operate. For example, reshoring chip and battery production to the US requires enormous fiscal support. Hence, deglobalization may be more about near-shoring and friend-shoring than it is about reshoring. It's also more about de-risking supply chains.

The impact of commodities in EM has diminished markedly. But the investment requirements of the energy transition will strongly support certain commodities to the benefit of some markets (primarily in Latin America).

Finally, even though the Middle East will face challenges from the energy transition due to its economic dependence on oil production, interesting opportunities derive from a strong government focus on economic diversification, with significant fiscal support and reform in Saudi Arabia and the United Arab Emirates.

Cyclical Opportunities: China, Brazil, and Technology

Despite the structural opportunities that abound in EM, investing in this universe is as much about the cyclical as the structural. This is one of the reasons why we believe style-agnostic active management is so important. India represents a compelling medium-term structural growth opportunity, but valuations in that market are currently very high and we see stronger opportunities elsewhere—including China.

Sentiment in China is currently very negative. The structural and geopolitical headwinds are much discussed, while weak economic momentum adds to shorter-term concerns. However, this is now reflected in cheap valuations and positioning has adjusted markedly. The government has the policy flexibility to support growth, while there's a visible push to stabilize US-China relations. Although the market is not without risk, we think there may be excessive pessimism at this time.

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We also see potential opportunities in the trade cycle, particularly in technology where we have a material overweight. The inventory cycle is inflecting as inventories run down and production and capacity expansion are constrained. While soft DM demand in 2024 may mute the upcycle, we have positions in companies and markets that trade at attractive valuations and could benefit from the upcycle while also having good medium-term prospects.

Monetary cycles may provide opportunity as well. Central banks in EMs are generally obliged to be orthodox. In some countries, there's now room for significant monetary easing following aggressive rate hikes and disinflation. For example, in Brazil, interest rates are currently 12.25%, while inflation in 2024 is expected to be below 4%. The central bank is expected to continue to cut rates, benefiting a market in which equities are broadly cheap and the yield curve[2] is elevated.

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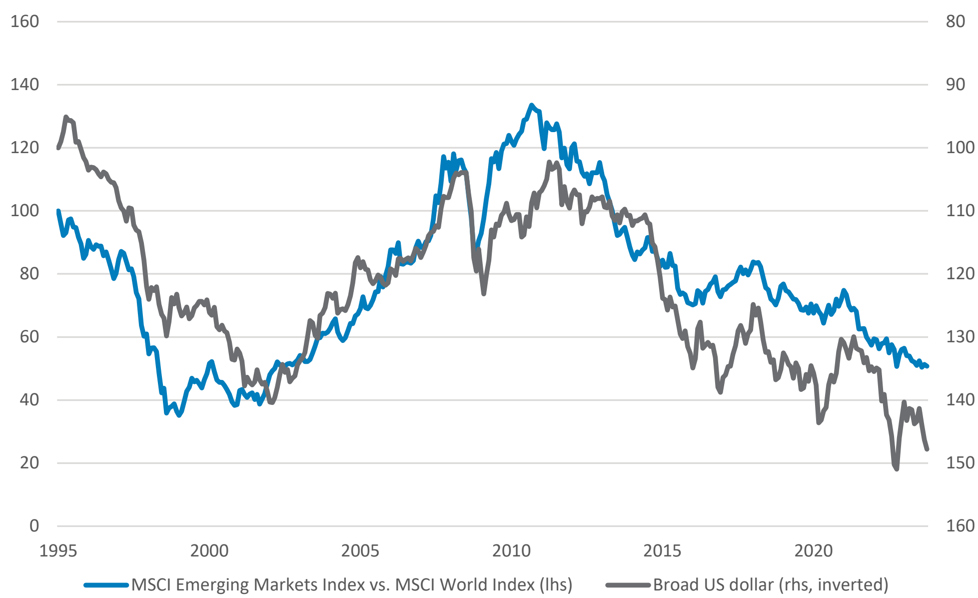
The Fourth D: The US Dollar

Finally, we can't speak of global EMs without referring to the fourth D—the US dollar. A decade of dollar appreciation has been a headwind for EMs, and this remains the case in the near term.

However, the dollar now looks richly valued, while the US carries significant fiscal and current-account deficits. A slowing economy, which triggered monetary easing and relaxed the yield curve, could potentially soften the dollar, which would improve financial conditions in emerging countries. In combination with valuations that are broadly attractive, this could be very supportive of EM equity returns.

FIGURE 1

The Importance of the US Dollar in EM Equity Performance



As of 10/31/23. **Past performance does not guarantee future results**. MSCI World Index is a free float-adjusted market capitalization weighted index that is designed to measure the equity market performance of developed markets. Data Sources: LSEG DataStream, MSCI, and Schroders Strategic Research Unit.

Talk to your financial professional to learn more about positioning your portfolio for a changing investment landscape.

[1] MSCI Emerging Markets Index is a free float-adjusted market capitalization-weighted index that is designed to measure equity market performance in the global emerging markets. MSCI index performance is shown net of dividend withholding tax.

[2] The yield curve is a line that plots interest rates of bonds having equal credit quality but differing maturity dates; its slope is used to forecast the state of the economy and interest-rate changes.

Important Risks: Investing involves risk, including the possible loss of principal. • Foreign investments may be more volatile and less liquid than US investments and are subject to the risk of currency fluctuations and adverse political, economic, and regulatory developments. These risks may be greater, and include additional risks, for investments in emerging markets. Investments linked to prices of commodities may be considered speculative. Significant exposure to commodities may subject investors to greater volatility than traditional investments. Diversification does not ensure a profit or protect against a loss in a declining market.