CITY OF LONDON
Investment Management Company Limited

EM Performance Over the Post-GFC Period[1]

June 2023

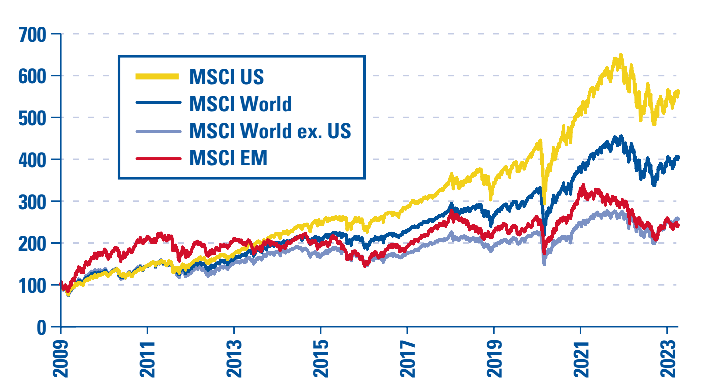
Key Takeaways:

- *DM (vs EM) outperformance was primarily driven by US equities.*
- *The US valuation premium is unlikely to disappear entirely in the coming years, but some of this premium may moderate while EM remains cheap.*
- *An elevated USD signals more downside risk for the currency, which may provide a better risk-reward for owning some EM exposure.*
- *Intra-EM, we continue to see attractive opportunities in EM Asia. EM equities also offer exposure to AI and the global energy transition.*

Performance

Over the post-GFC period, DM equities (MSCI World) have outperformed EM (MSCI EM). This outperformance is primarily attributed to the strength of the US market rather than EM weakness, as shown in Chart 1. The MSCI World ex-US Index's outperformance relative to the MSCI EM Index is less significant.

Chart 1: Equity Total Return (USD) (2009 = 100)

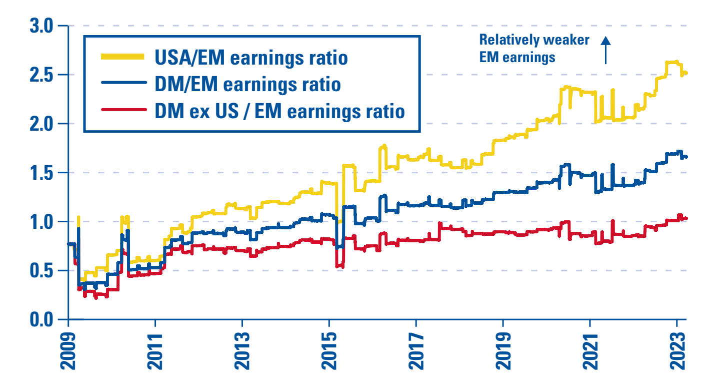


Source: Bloomberg

Why Was The US Performance So Strong?

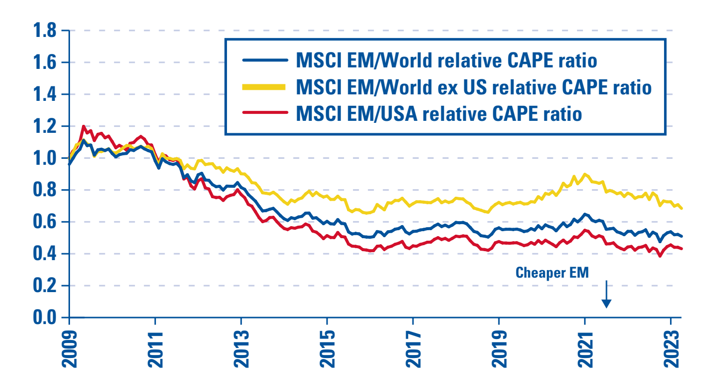
Several factors contributed to US outperformance. Chart 2 shows that US firms produced better EPS growth over the past decade due to higher US profit margins, share buybacks, and the low cost of debt financing. Chart 3 also shows the Cyclically Adjusted P/E (CAPE) multiple for US equities expanded more in the US, and the US continues to trade at a higher premium than DM ex-US and EM equities. The MSCI USA Index has a higher weighting to more interest rate-sensitive sectors like Technology, which tend to benefit from a lower interest rate environment. For reference, the US 10-year yield has averaged approximately 2.25% since 2010, which is a period encompassing over \$6trn of Fed balance sheet expansion. Before the GFC (2000-2007), the US 10y yield averaged approximately 4.62%. Looking ahead, we expect the US market to maintain some valuation premium, however the gap relative to international equities will likely narrow if inflation remains elevated and longer-term global rates reset to higher levels.

Chart 2: Trailing EPS Relative Growth (2009 = 100)



Source: Bloomberg

Chart 3: Cyclically Adjusted P/E (CAPE) Ratios



Source: Bloomberg

[1]*Post Global Financial Crisis (GFC) period beginning January 2009 to present.*
**The publication reflects asset performance up to May 31, 2023, and macro events and data releases up to June 5, 2023, unless indicated otherwise.*

DM Ex-US Equity Performance Relative to EM

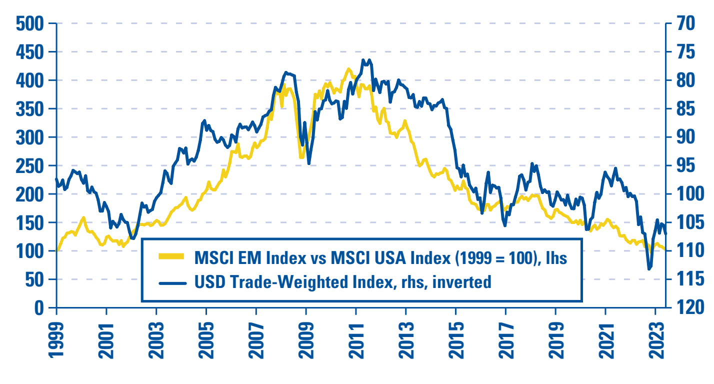
Over the post-GFC period, the MSCI World ex-US Index slightly outperformed the MSCI EM Index, as shown in Chart 1, but the performance differential is less significant than the MSCI USA Index. Stronger earnings growth from DM ex-US equities partially explains the EM index's relative underperformance (Chart 2). However, over the 2012-2022 period, relative earnings growth between DM ex-US and EM was flat. In addition, MSCI EM's CAPE continues to trade at a discount relative to the MSCI World ex-US Index, which is closer to historical lows (Chart 3). In other words, current prices discount a weaker growth outlook for EM relative to DM ex-US equities.

Some EM discount relative to DM ex-US may be justified. DM ex-US equities also offer investors a value opportunity relative to US equities and have historically been associated with lower political risk and better governance. In addition, DM ex-US earnings growth has outpaced EM over the past year. Furthermore, EM earnings growth could remain weak in the coming year. Inefficient state-owned enterprises (SOEs), sluggish commodities, USD strength, and domestic challenges are all factors that have weighed on EM at various points in time. Despite these headwinds, DM ex-US equities will also face equally challenging hurdles. For example, Europe's medium-term energy supply remains uncertain, and EU tensions could resurface around issues like fiscal consolidation. Japan's ageing demographic and high debt levels will limit potential growth. Finally, the UK index is closely tied to 'old economy' sectors, which may restrict earnings growth relative to EM.

EM Drivers: US Dollar

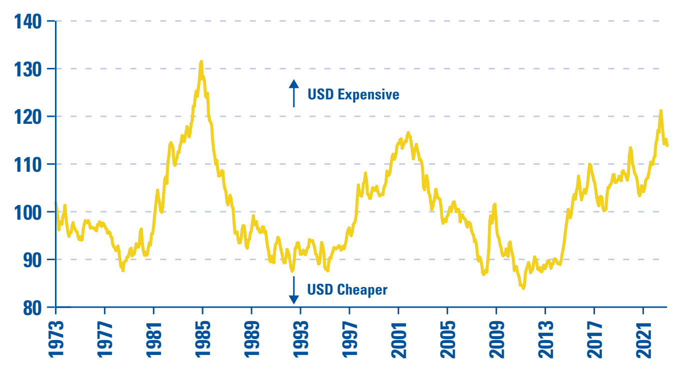
Chart 4 highlights that EM's relative performance is historically closely linked to the US dollar. The USD exchange rate directly impacts the cost of USD-denominated debt and the relative attractiveness of local currency debt for foreign investors. More broadly, capital inflows into EM assets are sensitive to exchange rates and influence EM monetary policy. Each country has unique drivers, but the broader EM index performs better in periods of USD weakness. Post-GFC was a period of USD strength. We do not expect an immediate reversal of this trend, but the risk-reward is starting to favour positioning towards USD weakness. Chart 5 is one valuation metric signalling that the USD is expensive based on a real effective exchange rate measure. US growth and rate differentials are around historic peak levels, which is typically an early catalyst for mean reversion.

Chart 4: MSCI EM vs MSCI USA Relative to the USD



Source: Bloomberg

Chart 5: USD Real Broad Effective Exchange Rate (REER)



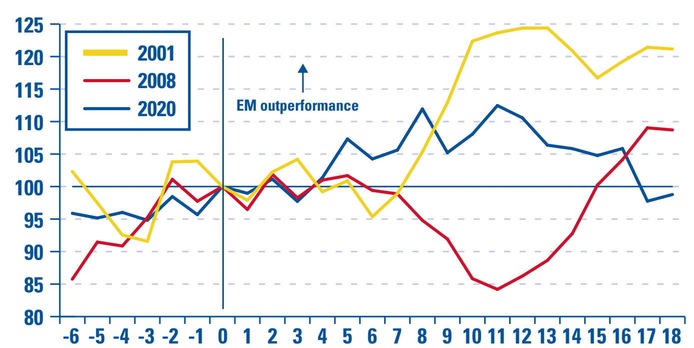
Source: Bloomberg

EM Drivers: The Business Cycle and US Recession

One should consider the direction of the US and global economy, given that equity markets and the US dollar have historically been sensitive to the business cycle. In our view, the US should experience a material growth slowdown later this year due to the effects of lagged monetary policy tightening. The economy has so far proven more resilient than earlier expectations. We attribute this resilience to excess pandemic savings, which have cushioned the consumer and services sector. However, we do not expect this resilience to persist as savings are eroded while policy and credit conditions remain restrictive. Therefore, the risk of a recession remains elevated over the next twelve months.

Historically, the US dollar tends to appreciate around US recessions and EM equities have tended to fall in absolute terms. For example, the peak-to-trough move for the MSCI EM Index in 2007-08 was -66%, coinciding with a +13% appreciation in USD strength (as measured by the US Fed Trade-Weighted Nominal Broad Dollar Index). With those relationships in mind, some investors may hesitate about an EM equity allocation if they place a high probability of a recession over the next year. We do not expect EM to behave as a safe-haven in the next downturn. However, EM may exhibit more resilience than previous recessions.

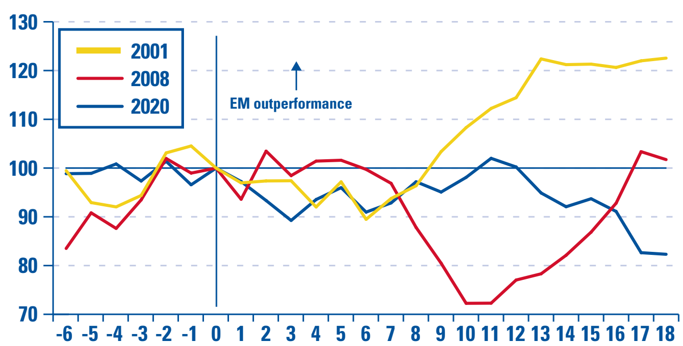
Chart 6: MSCI EM vs MSCI World ex-US Performance Around Previous US Recessions



Note: On the x-axis, "0" denotes the first month of the recession as defined by the National Bureau of Economic Research (NBER). We use April 2001, January 2008, and March 2020.

Source: Bloomberg

Chart 7: MSCI EM vs MSCI USA Performance Around Previous US Recessions



Note: On the x-axis, "0" denotes the first month of the recession as defined by the National Bureau of Economic Research (NBER). We use April 2001, January 2008, and March 2020.

Source: Bloomberg

Our analysis suggests EM may be less vulnerable going into the next downturn. Chart 6 highlights how EM performed relative to DM ex-US equities around the previous three US recessions. In 2001, EM performance was relatively stable vs DM ex-US equities before eventually embarking on a multi-year rally. In 2020, EM had similar stability in the initial stages of the Covid pandemic, while the 2008 period was more challenging. It experienced stability versus DM ex-US in the initial stages of the GFC. Still, the Q3/Q4 2008 market collapse was a more substantial negative shock for EM assets before it eventually recovered in 2009. Each of these three periods had unique characteristics and is unlikely to be a perfect representation of how assets behave in the future. However, based on current valuation metrics, the 2008 reference is the least likely path for EM in the next recession. In January 2008, the MSCI EM Index CAPE traded at a 22% premium to the MSCI World ex-US Index, and the USD REER was 13% below its 10-year average. In other words, the GFC period was a catalyst for mean reversion, which did not bode well for EM equities. The opposite valuation signals existed in the 2001 and 2020 periods. In both cases, the MSCI EM Index traded at a discount to the MSCI World ex-US Index, and the USD REER was expensive relative to history. Current signals show a similar discount to EM equities and a premium for the USD (Table 1).

Table 1: MSCI EM and USD Valuation Metrics

	USD REER	MSCI EM Premium (+)/Discount(-)	
	(vs 10y avg)	MSCI World ex-US	MSCI USA
March 2001	17%	-15%	-30%
December 2007	-13%	22%	-30%
February 2020	10%	-28%	-56%
May 2023	13%	-31%	-59%

Note: USD Real Broad Effective Exchange Rate (REER) is compared to its 10-year historical average.
The MSCI EM premium/discount relative to the MSCI World ex-US Index and the MSCI USA Index is based on a Cyclically Adjusted P/E ratio.

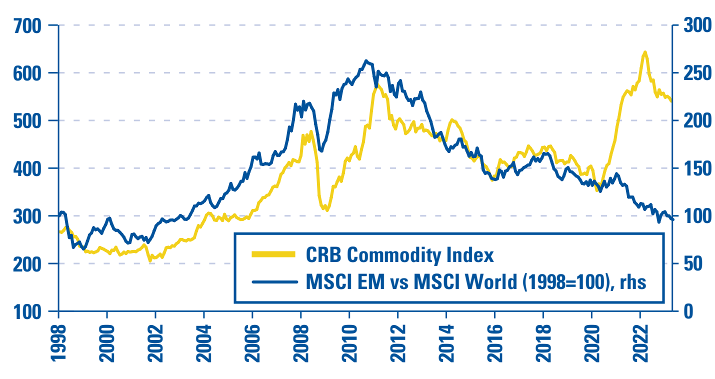
Source: Bloomberg

EM equities fared poorly relative to US equities in past downturns. Chart 7 shows the same reference periods but examines EM performance relative to the MSCI USA Index. Currently, the MSCI EM Index's CAPE is a 59% discount to the MSCI USA Index, a wider gap than in two of the previous three recessions. The 2020 period had a comparable 58% discount. A different result in the next recession will depend highly on US corporates' ability to weather the next demand shock. In addition, China's ability to maintain "around 5%" growth will also factor into EM's relative performance. We caution against positioning aggressively in favour of EM versus the US going into the next downturn. However, the current CAPE and USD REER metrics are more consistent with EM resilience than history. Given the challenges in timing and forecasting recessions, EM equities offer attractive value to position for the market's upside scenarios.

EM Drivers: Commodities

An important EM driver pre-2011 was broad commodity strength. The CRB commodity index rose 170% over the period 2001-2011 (coinciding with EM outperformance), while it only briefly touched above previous highs in 2022, as shown in Chart 8. The MSCI EM Index remains positively correlated to the broader commodity trend; however, its importance has declined this past decade due to smaller weights to commodity exporters like Brazil, South Africa, and Russia. China's index weight has grown significantly (20% in 2012 and 30% in 2022), resulting in lower exposure to Materials and Energy in the overall EM index. Despite this smaller commodity weighting, we expect EM to remain positively correlated to commodities.

Chart 8: CRB Commodity Index Relative to MSCI EM vs World Index



Source: Bloomberg

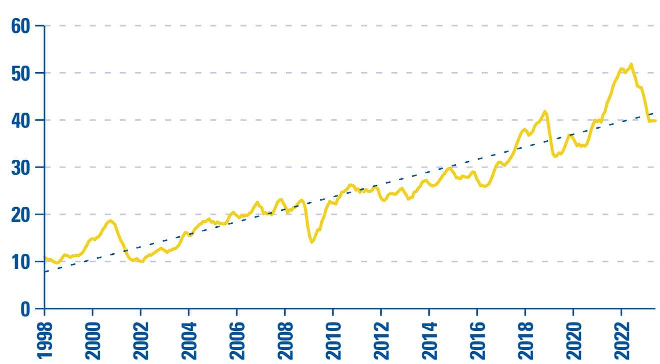
A structural decline in China's trend growth may limit longer-term demand for industrial commodities like steel and iron ore. As a result, some commodity exporters (e.g. Brazil and South Africa) may struggle to lead the index higher, similar to history. However, a global energy transition will likely shift commodity demand and produce new 'winners' in EM. J.P. Morgan's recent Long-term Copper Outlook (April 2023) projected that refined copper net supply will tip into a deficit around 2026 and the deficit will widen out to 2035. A similar copper deficit projection is found in other commodity research. Chile and Peru host some of the world's largest copper mines. In addition, Mexico and Indonesia also each have a major copper mine. These countries are also endowed with critical battery components like nickel and lithium. Our medium-term views are mixed on these indices in our current allocations, but their exposure to essential commodities is an upside risk as the energy transition accelerates.

Hydrocarbons will also remain an important driver of EM. Saudi Arabia, a major oil exporter, is currently the sixth largest index constituent in the MSCI index at 4%. While renewables are becoming a growing share of global energy supply, fossil fuels are expected to provide a large portion of global energy consumption. The International Energy Agency (IEA) estimate that fossil fuel demand has accounted for 80% of total global energy demand in recent decades. Based on stated policy objectives from various governments, they estimate this share to fall to less than 75% by 2030, and closer to 60% by 2050. Absolute demand for fossil fuels is projected to grow out to 2030, while renewable energy will gradually become a more significant share. Different commodity forecasters debate the exact numbers, but major Gulf Cooperation Council (GCC) countries will remain strategically crucial for global energy consumption and national security for the foreseeable future.

EM Drivers: Semiconductors

Semiconductors sales are navigating a downcycle following a sharp upcycle over 2020-21 (Chart 9). Despite this trend, the downcycle is likely closer to a trough within a structural uptrend in demand. Given that the two key exporters (Taiwan and South Korea) make up a combined 25% of the MSCI EM Index, we view this long-term trend as an essential driver of EM equities. Taiwan produces 90% of the world's advanced semiconductors and should be a prime beneficiary of growth in the AI space. South Korea remains the leader in the global memory semiconductor market. The industry is strategically critical in driving the global economy (e.g., computers, smartphones, automobiles, and weapons), and its proprietary manufacturing techniques are difficult to replicate by competitors. Geopolitics are a primary risk for these markets (e.g., the US Chips Act), but the industries' strategic importance to the global economy also serves as a "silicon shield".

Chart 9: Global Semiconductor Sales, USD bn

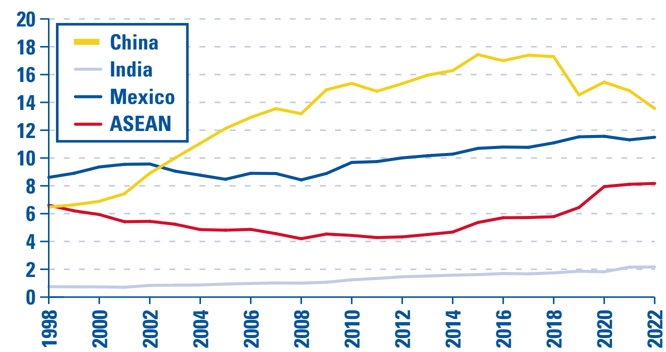


Source: Bloomberg

EM Drivers: China, India, and Other Manufacturing Hubs

China represents c.30% of the MSCI EM Index, which exposed the index to a discount based on growing geopolitical tensions. However, the MSCI EM Index is already trading at a lower CAPE multiple than the MSCI World and the MSCI World ex-US Index (Chart 3), which implies some of this risk is already priced in. We think investors are underappreciating the upside risks to the overall index. Geopolitical tensions between the US and China will ebb and flow, but both sides remain economically incentivised to seek opportunities to cooperate given close linkages (e.g., China still represents 14% of US imports from a peak of 17% in 2015, as shown in Chart 10). While we currently prefer other opportunities in EM Asia, China will continue producing world-leading companies in the future and present new opportunities for foreign investors.

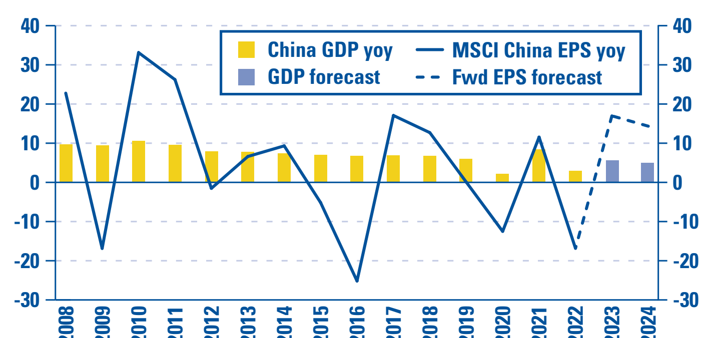
Chart 10: Country Share of US Imports, %



Source: Bloomberg

Trend growth in China is in structural decline. A shrinking population and slowing productivity growth are two long-term headwinds. The annual growth rate has averaged 7.1% since 2009, and policymakers now target "around 5%" growth. The IMF estimate that without structural reforms to address declining productivity growth, GDP growth will likely fall closer to 4% over the next five years, boosting the relative attractiveness of other EMs with higher economic growth prospects (e.g., India and Indonesia). China's policymakers may still succeed in implementing reforms and lifting household consumption to produce strong growth longer-term. But more importantly for equity investors, GDP and earnings growth are only loosely correlated historically (see Chart 11).

Chart 11: China GDP yoy vs MSCI China EPS yoy



Source: Bloomberg

China's internet platform companies are a large portion of the MSCI China Index. As such, the digital economy remains a primary driver of returns for Chinese stocks. An easing in China's regulatory clampdown on internet platform companies provides some renewed support for the major technology platform stocks in the index. Longer-term, some of these companies will become more closely aligned with the Chinese Communist Party's interests, which may not maximise shareholder value. This conflict is a legitimate concern for investors. On a more optimistic note, China's internet giants are leaders in AI research and development and own vast amounts of data to monetise AI. The current path for AI is highly speculative, but we would emphasise that the MSCI China Index could become a leader in this trend. New sectors will also grow in the index. China's economic and political goals are closely aligned with an energy transition making EV, renewable power, and battery storage potential areas of growth. Indeed, China is already leading in EV exports and accounted for 60% of global EV sales in 2022. In addition, China hosts most of the world's battery manufacturing and refining. The outlook for China's stocks is far from certain. But at a 9.7x forward P/E multiple, current pricing may be overly pessimistic.

Finally, investor concerns surrounding China's growth model, geopolitical risks, and ageing demographics are valid. If these risks intensify over time, other EM countries will likely benefit. For example, as Chart 10 highlights, reshoring trends linked to US-China tensions will likely shift US manufacturing to ASEAN countries, India, and Mexico. India has also overtaken China as the most populous country in the world, with a young demographic and a stable pro-business government. India's solid growth prospects are a widely held view reflected in its 20x forward P/E multiple for the MSCI India Index. Therefore, our medium-term outlook is more cautious. However, the long-term earnings prospects are promising, which should attract strong inflows when value opportunities emerge.

Conclusions

Overall, the MSCI EM Index is attractively priced relative to history, and we continue to see attractive opportunities within the index. EM exposure comes with risks (e.g., US recession and geopolitics), but investors can expect to gain exposure to long-term growth trends such as AI and the global energy transition at compelling valuations.

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