



Global  
Macroeconomic  
Investment  
Committee

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*Emerging market economies have experienced incredible growth over the past decade and a half. In 2000, emerging market countries accounted for 36% of global output and 37% of global growth. Today, those figures have grown to 50% and 75%, respectively, as emerging market countries' impact on the global economy now exceeds that of the developed world. This explosion of economic growth has also filtered into equity market performance, as emerging market equities have outperformed developed markets since 2000, albeit with much greater volatility. However, concerns remain. A potential pullback in global liquidity, slowing growth, decreased competitiveness, and heightened geopolitical risks have caused some to question if the emerging markets investment thesis has run its course. In this paper, we revisit the case for emerging markets, examine current economic fundamentals and valuation levels, and discuss both the near-term and long-term outlook for the asset class.*

### EMERGING MARKETS AND GLOBAL GROWTH

Since 2000, there has been a dramatic shift in the global landscape with respect to "developed" and "emerging" economies. More than three quarters of the world's population lives in countries broadly defined as "emerging markets." This large and growing population has helped steadily increase emerging markets' share of global output over the last fifteen years. Relative to developed markets, however, there still exists a rather large disconnect between population size and global output.

As illustrated in the table below, despite having only 11% of the world's population, developed markets ("G7" countries) boast almost half of the world's total output.

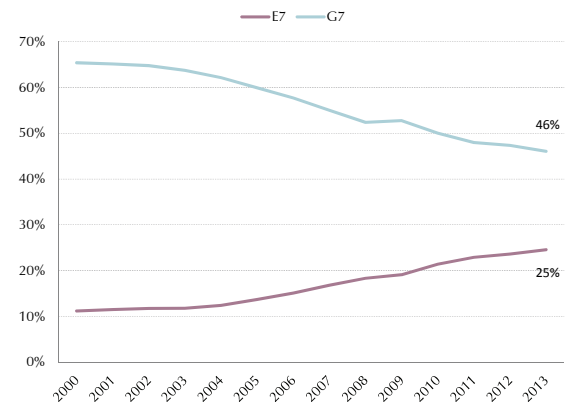
Country	Population (mm)	Nominal GDP 2013 (\$bn)	% World Pop	% World GDP
<b>E7</b>				
China	1,357	9,240	19	12
India	1,252	1,877	18	3
Brazil	200	2,246	3	3
Mexico	122	1,261	2	2
Russia	143	2,097	2	3
Indonesia	250	868	4	1
Turkey	75	820	1	1
		<b>Total</b>	<b>48</b>	<b>25</b>
<b>G7</b>				
United States	316	16,800	4	22
Japan	127	4,902	2	7
Germany	81	3,635	1	5
France	66	2,735	1	4
United Kingdom	64	2,521	1	3
Italy	60	2,071	1	3
Canada	35	1,827	0	2
		<b>Total</b>	<b>11</b>	<b>46</b>

Source: The World Bank

The opposite relationship is true for the "E7" emerging economies. This disconnect becomes more extreme when examining equity market capitalization, as emerging markets' share of global equity market capitalization was only 11% as of November 2014<sup>1</sup>.

While it has nearly doubled since 2000, emerging markets' share of equity market capitalization still has a long way to go to catch up to its share of every other relevant metric.

### Share of World GDP<sup>2</sup>



### LOOKING FORWARD

The historical investment case for emerging markets has been simple: growth. Economic growth is predominantly a function of two factors: population growth (i.e., how many people are working towards growing an economy) and productivity growth (i.e., how much more productive do those people become over time). On both measures, emerging market countries have been well-positioned with very favorable demographics and significant opportunities for productivity gains via improved education and technological advancement. Conversely, developed markets have largely experienced the opposite, with aging populations and limited opportunities for productivity gains as their economies are already "developed."

<sup>1</sup> Source: MSCI

<sup>2</sup> Source: The World Bank





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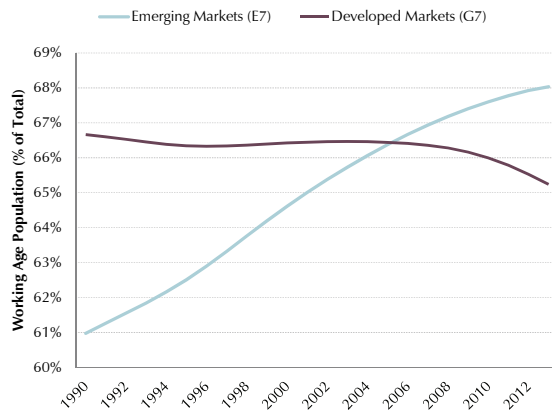
Shane Enete

Demographics are a critical component of the long-term growth forecast for any country. Perhaps the most important factors in determining a country's future growth are the future size and age of its population. Future demographic trends are relatively easy to forecast, as the majority of people that will occupy an economy's working age population in the investable future are already living today. Similarly, the demands of demographic trends can be reliably forecasted over the long-term, even though they may evolve slowly and can be interrupted by exogenous factors. While short-term deviations are inevitable, over the long-term, the gravitational pull from demographics tends to overpower most other economic factors and sets the path for future growth. Emerging markets, particularly in South Asia, Latin America, Africa, and the Middle East, continue to experience positive demographic trends, while the developed world becomes increasingly hampered by aging populations.

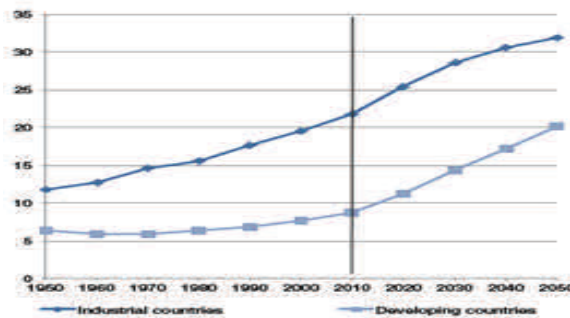
While more difficult to forecast than demographics, future productivity gains also appear to heavily favor emerging economies over their developed counterparts. Productivity growth comes from a variety of sources, including the use of new technologies, improved education systems, and better infrastructure. Emerging markets can implement productivity enhancing technologies much faster than developed countries. This is largely because developing countries are importers of technology, whereas developed countries are exporters. In other words, it is much faster for emerging markets to adopt new technologies than it is for developed markets to invent them. For example, high adoption rates of cell phone technologies in emerging and developing countries have enabled more efficient communication and order processing for consumers and producers.

Continuing with the second major component that contributes to growth, productivity, the following table shows "total factor productivity growth" over various periods. Total factor productivity is the portion of output not explained by the amount of inputs used in production (i.e., labor and capital), in short, making each unit of labor and capital better. In mature economies, limits to productivity growth have been observed over the last decade while productivity growth has soared across emerging market and developing countries. Likewise, labor productivity growth has declined over the last thirteen years in mature economies, whereas emerging market and developing economies have experienced increasing labor productivity growth.

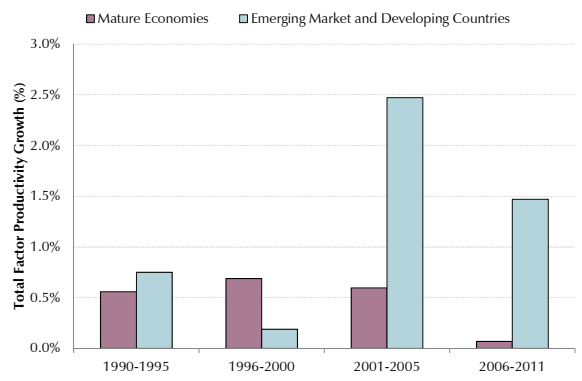
**Working Age Population<sup>1</sup>**  
(Population ages 15-64, Percent of Total)



**Percent of Population Age 60 and Over<sup>2</sup>**  
(Industrial Countries vs. Developing Countries)



**Total Factor Productivity Growth<sup>1</sup>**



<sup>1</sup> Source: The World Bank

<sup>2</sup> Source: UN, World Population Prospects: The 2010 Revision





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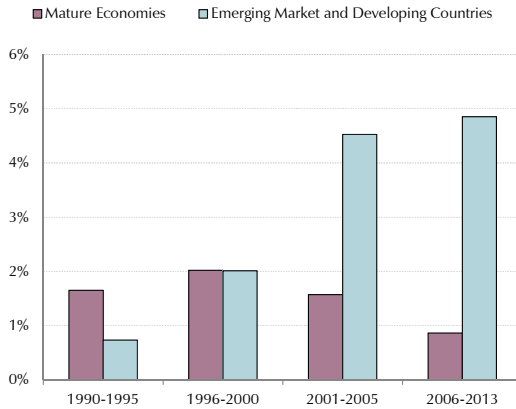
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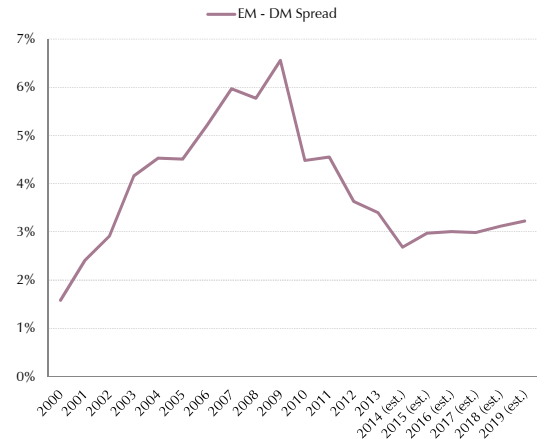
**Labor Productivity Growth<sup>1</sup>**  
(GDP per Person)



With the key variables still intact, it is reasonable to expect growth in the emerging markets to continue to outpace that in developed markets for the foreseeable future. According to the IMF World Economic Outlook, global GDP grew at a rate of 3.0% in 2013, with emerging markets growing at 4.7% and developed markets growing at 1.3%. In 2014, global growth is expected to be 3.3%, with emerging markets expected to grow at a rate of 4.4% and developed markets at 1.8%.

Declining growth rates in the emerging markets, both in an absolute sense as well as relative to developed markets, have grabbed a lot of negative headlines recently. However, it is important to keep everything in the proper perspective. While absolute levels have declined and the spread to developed markets has narrowed, economic growth in the emerging markets is still expected to materially outpace that in the developed world through at least 2019 (see charts below/above right).

**Emerging and Developed Markets GDP Growth Spreads<sup>1</sup>**

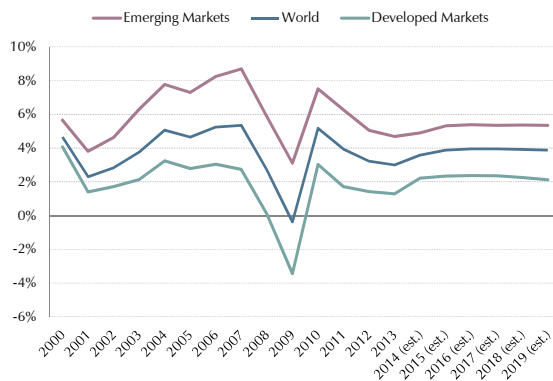


**AVOIDING THE “MIDDLE-INCOME TRAP”**

Some observers have pointed to slowing GDP growth rates in emerging markets as an indication that some of these countries are falling into the “middle-income trap.” The middle-income trap occurs when a country’s per capita gross national income becomes trapped at “middle-income” levels following initially strong growth off of a low base. This trapped middle-income class is then unable to reach the next plateau of growth and development for a variety of structural reasons. The World Bank defines middle-income economies as those with gross national income per capita of more than \$1,045 but less than \$12,746. By this definition, Brazil (\$11,690) is close to graduating to high-income status, but India (\$1,570) and China (\$6,560) still remain far below high-income status and significantly below the per capita GNI levels of the United States (\$53,670) and Japan (\$46,140).

To avoid the middle-income trap, economies must pivot from resource-oriented growth to growth based on high productivity and innovation. A successful pivot requires the introduction of new processes, both in the form of infrastructure and education investment, structural and financial reforms, and the identification of new export markets. While many countries have failed to make this difficult transition, a number of current examples, including Mexico, China, and India, are implementing

**Actual and Estimated GDP Growth Rates<sup>1</sup>**



<sup>1</sup> Source: The World Bank





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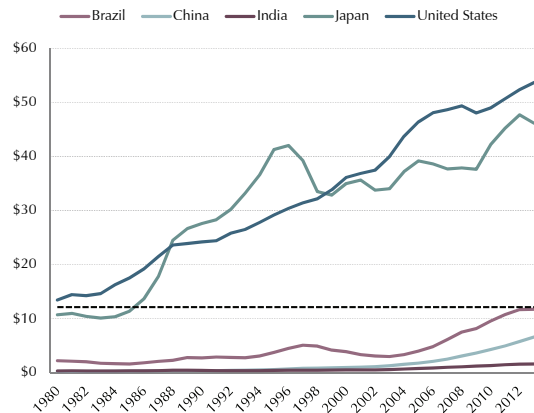
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reforms to support continued economic expansion. In recent years, South Korea stands out as a success story of a country that transitioned from low to high income with the help of political and economic reform. Today, South Korea's per capita GNI is approximately \$25,920 converted to U.S. dollars.<sup>1</sup>

Per Capita Gross National Income<sup>1</sup>  
(in US\$ in thousands)



The most notable transition occurring today is happening in China. Led by Xi Jinping, the newly anointed leaders have put in place measures to tackle these very issues. In their twelfth Five-Year Plan, Chinese leaders have recognized the need for economic reform and have, among other goals, emphasized investing in emerging strategic industries, increasing domestic consumption, enabling higher levels of innovation, and improving the legal system.

By contrast, South Africa, with its strict labor laws, high minimum wages, lack of infrastructure, poor education system, and unskilled workforce, is struggling to make the transition out of middle-income status. So far, South Africa has been unable to implement the needed reforms to spur the country's pivot towards a more innovative, productive, and entrepreneurial economy.

#### THE EFFECTS OF DEBT

One effective method for stimulating near-term growth is debt. Debt growth (the issuance of new loans or credit) is the primary means of money creation within the global financial system. As more debt is issued, more money is supplied, which can be circulated within an

economic system through increased transactions. But as we will detail, while debt can pull forward future growth, it potentially comes at the expense of future growth.

Debt-fueled growth enables economies to spend more than they produce, providing a boost to short-term growth. As more money is spent, more goods are produced, enabling economies to grow quicker than they otherwise would (i.e., above their organic growth rates). This becomes a positive feedback loop as more growth attracts more capital, which drives down interest rates (i.e., cost of capital), further enabling leverage to build within the system, allowing the debt-cycle to continue.

However, debtors are eventually obligated to pay back both principal and interest. As such, in order to make good on their obligations, excessive debtors must eventually spend less than they produce. Specifically, monies that could otherwise be spent on productive investments are spent on debt service instead.

In contrast to the virtuous part of the cycle, the effects are now reversed. At this point, the cyclical effects can come in the form of higher unemployment, lower capacity utilization, and stunted economic growth. If the stock of debt grows too large and interest rates rise too high, either because of solvency or inflation risk, debt service costs can become particularly onerous.

The cyclical effects of debt-fueled growth can be particularly harmful with the introduction of foreign capital (i.e., external debt), even more so if denominated in a foreign currency. Having previously described the cyclical effects of debt-fueled growth, the scenario is the same, but with the added element of foreign exchange risk. Because external debt is issued in a different currency, in the event of rising interest rates and in the absence of sufficient foreign currency reserves or domestic means of financing, central bank intervention makes paying back debts more difficult due to currency depreciation. This cycle can be self-fulfilling, as foreign investors seek to exit the depreciating home currency, leading to increased selling, which can prove debilitating for an economy.

<sup>1</sup> Source: The World Bank







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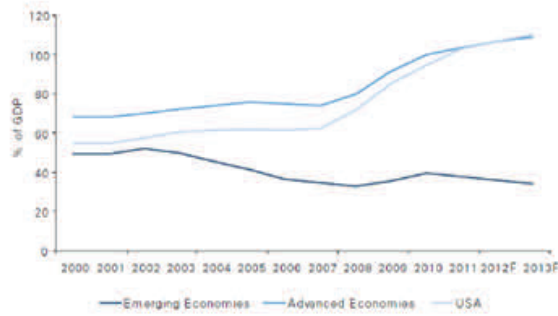
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The external debt-fueled growth storyline was ubiquitous in emerging markets during the 1990's, with the Mexican "Tequila Crisis" in 1994-95, the Asian Financial Crisis in 1997, and the Russian Financial Crisis in 1998. As seen in the following charts, both gross public debt and net external debt has been in decline across the emerging markets since 1997. Although external private sector bond issuance has increased significantly over the past few years in emerging markets, the total size of this market is yet to reach even the size of the U.S. high yield bond market alone. Stabilizing governments and broadening capital markets have enabled emerging markets economies to issue more debt in local currency, which should serve as a long-term stabilizer for growth since the external risks are somewhat mitigated.

**Gross Public Debt<sup>1</sup>**  
(Emerging Markets vs. Developed Markets)

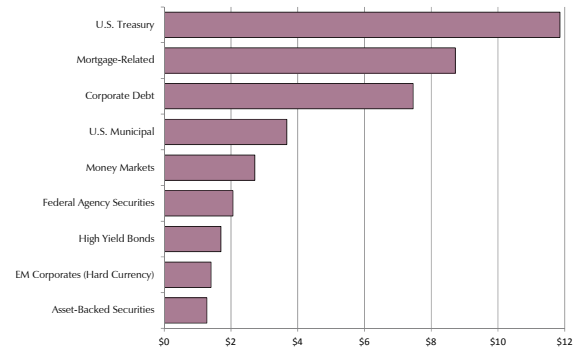


**Emerging Markets Net External Debt<sup>2</sup>**  
(as a percentage of GDP)



*"emerging market countries have spent the last 14 years accumulating 70% of the world's currency reserves"*

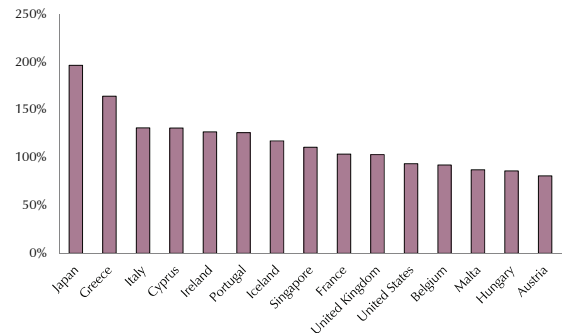
**Market Size in Terms of Debt Outstanding<sup>3</sup>**  
(US\$ in trillions as of 3Q2014<sup>4</sup>)



If a debt crisis does occur, leading to a mass exodus of foreign capital, one tool central banks have at their disposal is foreign currency reserves. Central banks can use reserves as a monetary policy tool to prop up the value of their home currencies, buying precious time for a country to properly manage their respective economic situation. This is executed by selling foreign currency reserves against their home currencies, which in turn supports the exchange rate of the home currency.

Having painfully experienced this situation during the Asian Financial Crisis, emerging market countries have spent the last 14 years accumulating 70% of the world's currency reserves. While China holds roughly half of these reserves, emerging markets are, on balance, better positioned to combat capital outflows than they have ever been. In the same way that low levels of debt can serve as a support for future growth, foreign currency reserves can serve as a macroeconomic stabilizer as well.

**Debt to GDP by Country<sup>1</sup>**



<sup>1</sup> Source: The World Bank  
<sup>2</sup> Source: Emerging Advisors Group  
<sup>3</sup> Source: JP Morgan, Bank of America, SIFMA  
<sup>4</sup> Some values are estimates.





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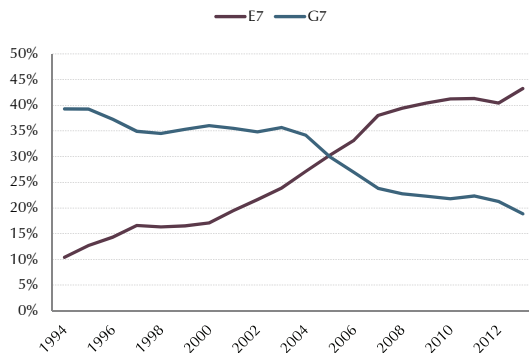
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## E7 and G7 Share of World Reserves<sup>1</sup>



## DOES GDP GROWTH TRANSLATE TO STOCK MARKET PERFORMANCE?

The “growth” thesis for investing in emerging markets really only works if higher economic growth actually translates into better stock market performance. This cause and effect linkage ultimately depends on gains from GDP growth accruing to holders of capital in the form of company earnings growth. Studies have attempted to show that there is no reliable correlation between GDP growth and equity market returns. These studies argue that gains from GDP growth accrue directly to labor and the consumer instead of the holders of capital.<sup>2</sup> Clearly this theory has broken down in the United States, where recent gains from GDP growth have disproportionately benefited

holders of capital (and by extension, equity investors) at the expense of labor.

These same studies suggest that the most important aspect with respect to equity market returns is valuation (specifically earnings yield), as opposed to growth rates. While valuation is important, these studies fall short by overlooking the fact that equity markets are inherently forward-looking price setting mechanisms. Therefore, it is not *observed* growth rates, but rather investor’s expectations of *future* growth rates, that are priced into equity markets. Consequently, while observed GDP growth and equity returns do not correlate over longer periods of time, they should not be expected to.

Strong correlations do exist between equity market returns and *expected* GDP growth rates. The table at the top of Page 7 shows the correlation between GDP growth rates and equity market returns (one-year lagged) across various countries over varying periods of time. As illustrated, correlations are strongly positive over all time periods and countries, albeit to varying degrees.

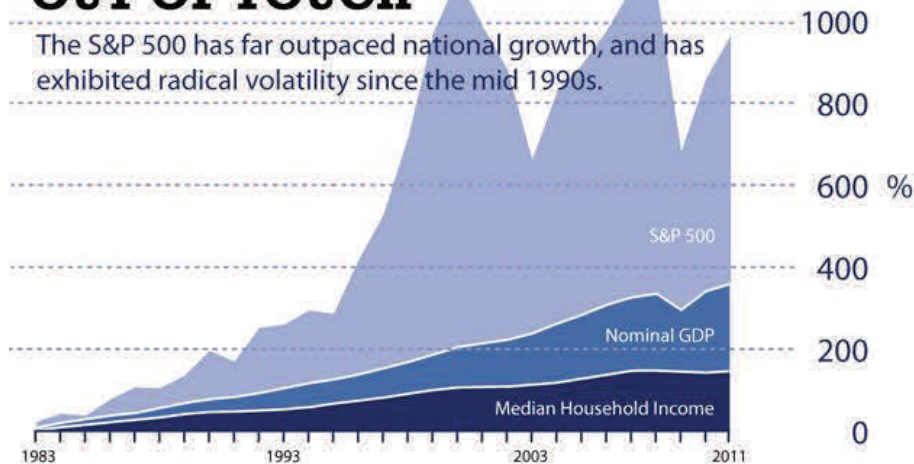
<sup>1</sup> Source: The World Bank

<sup>2</sup> Source: Ritter, Jay R., 2004. Economic growth and equity returns. *Pacific-Basin Finance Journal* 13 (2005) 489-503.

<sup>3</sup> Source: International Business Times

## OUT OF TOUCH<sup>3</sup>

The S&P 500 has far outpaced national growth, and has exhibited radical volatility since the mid 1990s.



The chart to the left shows year-over-year percentage growth starting in 1983. The nominal GDP figure is from the Department of Commerce’s Bureau of Economic Analysis; the annual growth in median household income is from the U.S. Census Bureau; the S&P 500 performance is from Google Finance.



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### Correlation Between GDP Growth Rates and Equity Market Returns<sup>1</sup>

Period	Brazil	China	France	Germany	Hong Kong	Italy	Japan	Mexico	U.K.	U.S.
6 Years	0.96	0.70	0.82	0.83	0.42	0.90	0.62	0.81	0.91	0.85
12 Years	0.94	--	0.72	0.62	0.43	0.74	0.49	0.80	0.58	0.63
24 Years	0.41	--	0.73	0.57	0.35	0.61	0.39	0.59	0.51	0.70

### VALUATION

Of course, investors should be cautioned that markets should not be expected to outperform simply based on high growth expectations alone. Of critical importance is the relationship between growth and *expected* growth as expressed through valuation. While growth estimates may signal the expected path over time, this doesn't mean markets will perform that way in the short-term.

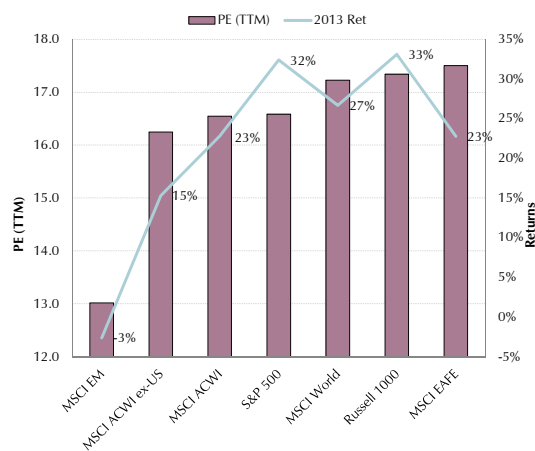
We saw this dynamic in 2013 and 2014, with developed markets handily outperforming emerging markets, despite higher absolute expected growth rates of the latter. Although valuations were still higher for developed markets in all cases, in some markets, growth surprised to the upside and provided one of many supports to outsized returns. Above all, however, sentiment was the largest driver of returns. In the U.S. in 2013, price-to-earnings multiples expanded by 23%, while emerging markets experienced the opposite, with price-to-earnings multiples decreasing by 6%.

Despite lower valuations and higher expected growth rates, emerging markets underperformed global equity markets over the 2013 and 2014 calendar years.

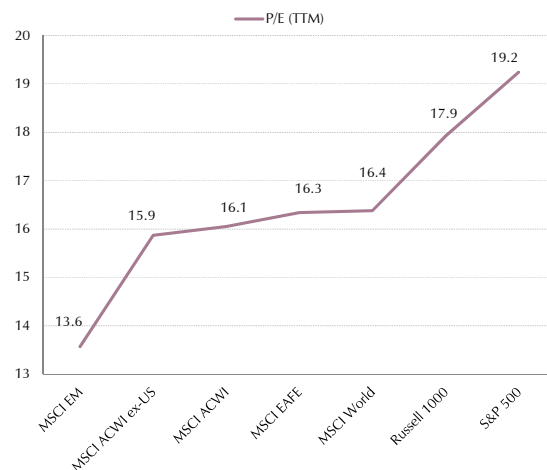
of above average returns over the long term. The preceding chart illustrates the pitfalls of valuation as a short-term market timing tool. At the beginning of 2013, the MSCI Emerging Markets index had the lowest price-to-earnings ratio (13.0x) and subsequently had the lowest returns over the 2013 calendar year (-3%). Conversely, the Russell 1000 index had one of the highest price-to-earnings ratios (17.3x) and subsequently had the highest returns over the 2013 calendar year (+33%).

Today, valuation spreads between developed and emerging markets are now even wider than they were at the beginning of 2014. Continued multiple expansions in the developed world would suggest investors are surer of continued earnings growth in these markets, despite record profit margins, relatively weak sales growth, and what appears to be some tightening in labor markets. On the other hand, emerging markets valuations would suggest that earnings growth in these markets will be only slightly higher than that of the developed world, despite cyclically low profit margins and stronger sales growth.

### January 2013 Valuation & 2013 CY Returns<sup>2</sup>



### Emerging Markets vs. World Valuations<sup>1</sup> (P/E TTM; as of December 2014)



Nonetheless, the purpose of value investing is not rooted in short-term market timing. On the contrary, valuation serves to increase the chance

<sup>1</sup> Source: The World Bank, MSCI

<sup>2</sup> Source: MSCI, Standard & Poor's, Russell Investments





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Changes in earnings per share can be driven by factors other than economic growth. Share buybacks, where companies repurchase outstanding shares of their own stock, reduce the number of shares on the market. This corporate action is essentially “financial engineering” and has the effect of increasing the per share value of a stock simply by reducing its supply. In 2013, companies within the S&P 500 index bought back approximately \$500 billion of their own shares, which accounted for roughly 60% of cash returns to investors. In emerging markets, where dividends tend to be more popular, companies have been less engaged in buybacks.

From an earnings per share standpoint, emerging markets stocks have not received the benefits of financial engineering in the same way that developed markets have.

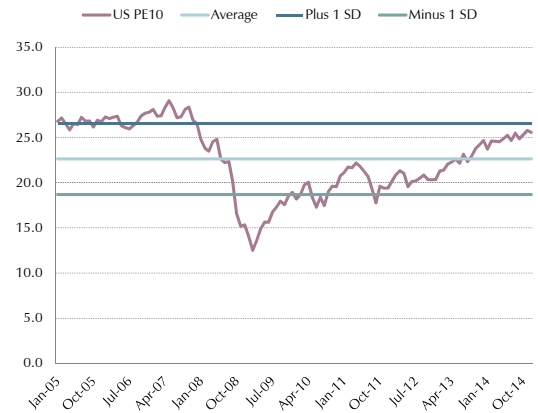
It is also important to note that price-to-earnings ratios can be misleading proxies for value due to variations in earnings over business cycles. To control for the cyclical nature of earnings, some investors use what is called a cyclically-adjusted PE, also known as CAPE, or PE10. This metric is calculated by taking the current stock price divided by the ten-year average per share earnings of the stock.

As illustrated in the following charts, on a cyclically-adjusted basis, the MSCI Emerging Markets index is currently trading at more than one standard deviation below the average PE10. That is contrasted with the Russell 1000 index trading near one standard deviation above the index’s average PE10.

**MSCI Emerging Markets PE10<sup>1</sup>**



**Russell 1000 PE10<sup>1</sup>**



Current valuations illustrate that equity risk premiums have gone up in emerging markets, while going down in developed markets. Said another way, markets are nearly as uncertain about the forward looking prospects as they were at the trough of the Great Financial Crisis in 2008-2009, despite the economic transformations that have occurred and are expected to continue across many emerging market economies.

*Although many risks loom, including a double-dip recession in the Eurozone, deflation risk, low labor force participation rates in the United States, tapering and the withdrawal of liquidity, rising interest rates, aging societies, China's debt "bubble," and the so-called "Fragile Five" countries in the emerging markets, relative to developed markets, it would appear at least some of these risks are priced into emerging markets stocks, whereas developed markets are seemingly priced for perfection.*

<sup>1</sup> Source: The World Bank







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### CONCLUSION

On the back of favorable fundamental underpinnings, emerging markets have undergone a tremendous transformation over the past 15 years. Given that these markets are contributing to global economic output at record levels, global growth is more dependent on emerging markets than ever before.

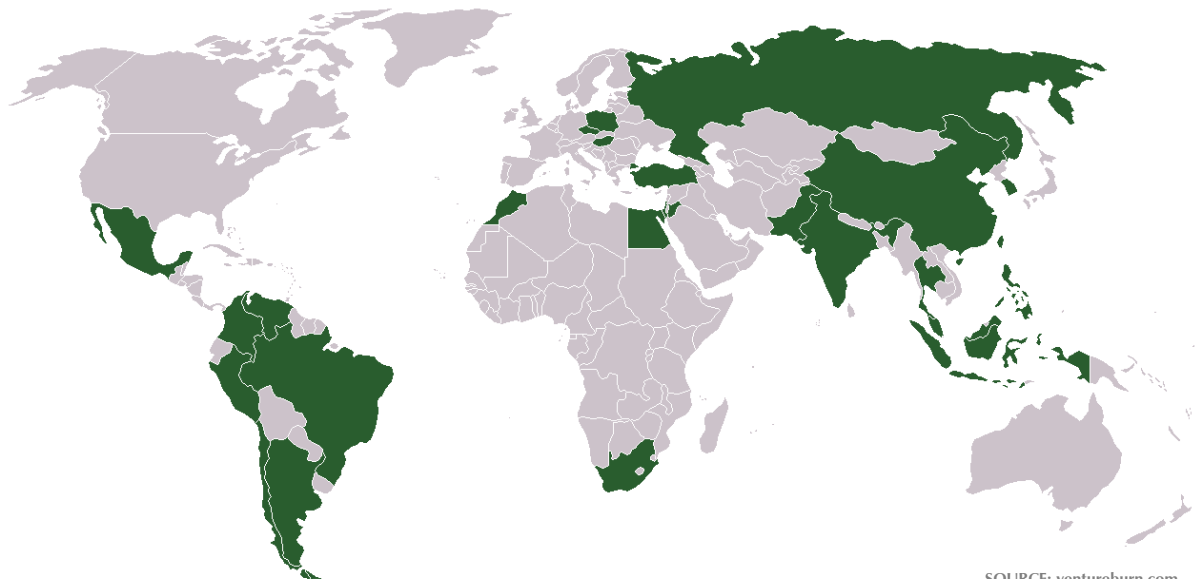
Together, favorable demographics and opportunities for productivity gains continue to be supportive of secular growth trends in these markets, notwithstanding short-term cyclical pressures. Although the growth differential between emerging and developed markets has narrowed recently, emerging markets are still expected to grow in excess of developed markets for the foreseeable future. At the same time, relative valuation is supportive of emerging markets stocks versus developed markets stocks, which should both decrease risk and increase the likelihood of above average returns over the long-term.

In the global economy, risks are omnipresent. However, it appears these risks are priced into

the emerging world, but are not fully recognized in the developed world, where markets appear to be more optimistic despite more stagnant growth and less favorable economic fundamentals. Although, in aggregate, absolute growth levels are expected to be higher in emerging markets, divergent outcomes across emerging market countries are also likely, as social and fundamental distinctions have increased. Investors can no longer lump all emerging markets into one category. As a result, the selection of a top-tier active manager within the asset class could potentially be more valuable than previous periods.

Meketa Investment Group continues to advocate for emerging markets as a strategic investment destination within client's overall asset allocations. The combination of expected excess GDP growth, and likelihood of the sustainability of growth over time, would suggest investors hold a market allocation to emerging markets at a minimum, while potentially suggesting an overweight allocation, given current valuation levels, depending on the investor's risk tolerance. ■

World Map of Emerging Market Countries



SOURCE: ventureburn.com

