GLOBAL EMERGING MARKETS

MARTIN CURRIE
A Franklin Templeton Company

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For institutional, professional and wholesale investors only

GROWTH IS THE TORTOISE, VALUE IS THE HARE

Despite the headwinds we currently face, emerging market growth is the place to be in the long term. Although it appears that growth is out of favour, we put this into historical context to show you that emerging market growth stocks are well placed to succeed going forward.

Introduction

The emerging market (EM) asset class is often defined by its differences from developed markets: higher growth, transformative economies, and at times elevated volatility. But EM, like developed markets, has experienced several phases of style leadership including the outperformance of Value in the 2000s and Growth in the 2010s. Enter the 2020s and inconsistency reigns. Growth leads in the US, but Value is ahead in EM and Developed International markets. EM investors will rightly wonder at the divergence and question what is next for the asset class.

The phases of style leadership bring to mind Aesop's Fable *The Hare and the Tortoise*. The steady, growing compounders of the 2010s are the tortoise, while the lower quality cyclical value stocks are the hare. The hare's head start in the 2000s was driven by unsustainable companies. The hare fell asleep in the 2010s as the sustainable compounders led the way. The hare has taken the lead so far in the 2020s, but we argue that the tortoise will ultimately win the race.

The hare takes an early lead in the 2000s

While value outperformed broadly across global equity markets in the 2000s, the decade was marked by severe weakness for US equities compared to international markets. In fact, the S&P 500 returned 0.4% annualised over the period while emerging markets posted a 10.9% annualised return.[1] During that period though, EM was driven by energy and materials while information technology (IT) and communication services lagged the most.

We observe the following about EM performance in this period:

(i) Commodity strength drove energy outperformance

(ii) State-owned assets were a core driver of emerging market value performance

(iii) China's property development boom supported companies levered to Chinese fixed asset formation (iron ore, steel, mining)

[1]Source: Morningstar, 31 December 1999 to 31 December 2010.

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The tortoise (growth) redefines EM in the 2010s

This second phase saw a dramatic shift in sector allocations within the market. Energy, materials and industrial sectors went from a group representing 37% of the MSCI Emerging Market Index to just 17% at the end of the period.[2] This was complemented by substantial increases in weight towards IT and consumer discretionary sectors. This captures the evolution of the asset class, the 'new' emerging markets (global leaders in innovation) versus the 'old' (reliant on manufacturing and raw materials).

Emerging markets growth stocks have a heavier allocation to IT and consumer discretionary than value and, during this period, MSCI Emerging Markets Growth delivered cumulative returns of 54% against the (20%) returned by MSCI Emerging Markets Value.[2]

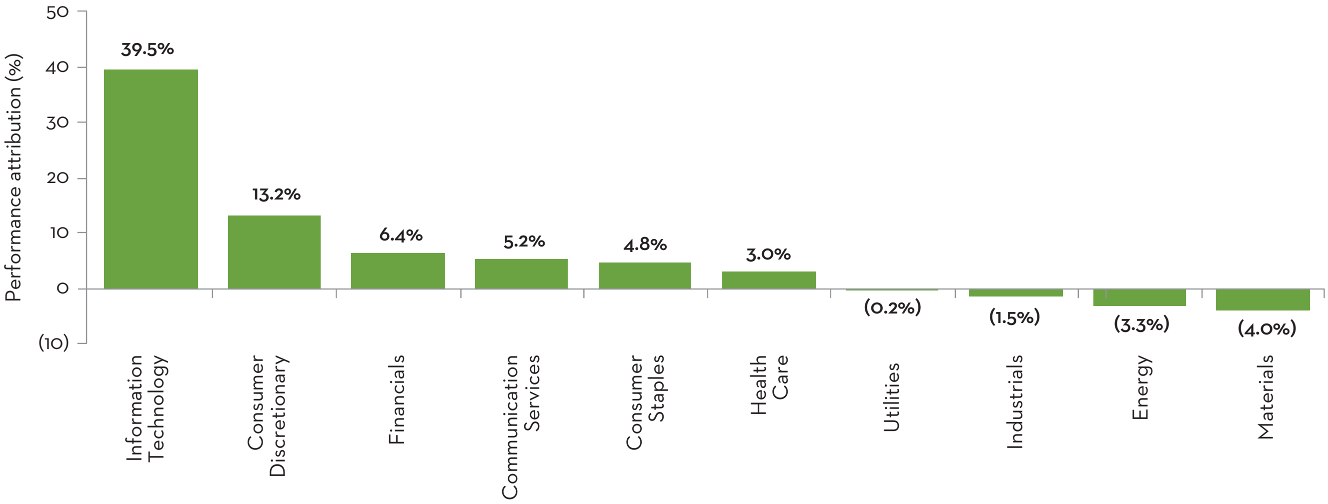
The strong outperformance of typically 'growthy' sectors relative to typical value ones in this period is visible by decomposing the index performance. Three sectors dominated performance contribution within MSCI Emerging Markets Index from December 2010 to December 2020, while lacklustre returns were seen by 'old' EM sectors materials, energy and industrials.

(i) Information technology stocks led outperformance, especially semiconductor manufacturers and software services

(ii) Communication services was strong as this time period captured the explosive growth of global demand for PCs, smartphones and other digital technologies

(iii) Consumption names linked to middle class growth (discretionary spending) outperformed, with limited contribution from classic 'bread and butter' stocks in the consumer staples sector

Chart 1. Sector performance attribution for MSCI Emerging Markets



Source: Martin Currie, 31 December 2010 to 31 December 2020.

[2]Source: MSCI, 31 December 2010 and 31 December 2020.

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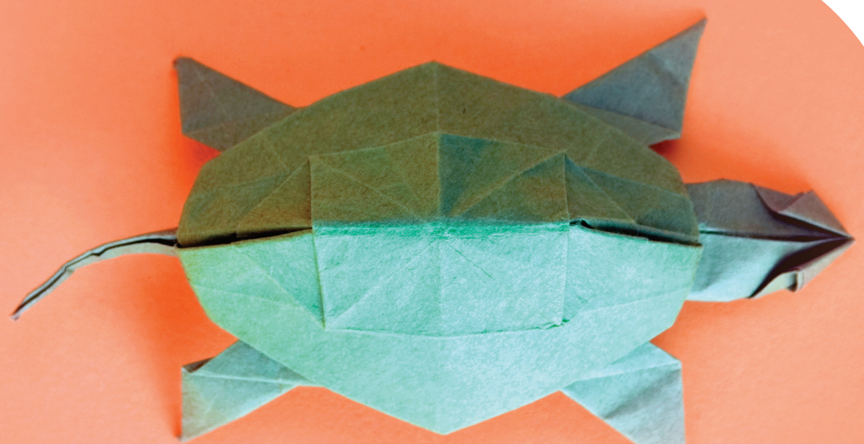

The hare is back, but not for long

The third and current phase has seen a significant and rapid style leadership shift away from growth and towards value. A key characteristic of this shift is that companies at the lower end of the quality scale have significantly outperformed.

The phase 2020 to present has seen a global pandemic, the invasion of Ukraine by Russian troops and continued conflict in the region, ESG scandals and geopolitical uncertainty in many emerging market countries. China has been a key determinant of emerging market performance more broadly, owing to its prominence in the region and large weighting in MSCI Emerging Markets (30%).[3]

Our key observations about the current style shift are:

(i) There has been a material divergence between market sentiment and company fundamentals

(ii) The market has favoured companies exhibiting shorter duration (value stocks) and low quality characteristics, in favour of longer duration quality growth stocks

(iii) There has been a recent sentiment change and volatility concerning 'clean' stocks, which has led to underperformance of stocks linked to strong environmental, social and governance characteristics

[3]Source: MSCI, 31 October 2023.

What next? Tortoise wins the race

We believe that the persistent outperformance of low quality, value stocks within emerging markets is not sustainable indefinitely. The market must ultimately return to fundamentals. The fundamentals of companies which exhibit high quality and growth characteristics remain intact despite the market's shift in style leadership. These companies are well positioned to withstand the uncertainties which remain around monetary policy, inflation and geopolitics, while benefiting from structural drivers of growth.

Although style shifts between growth and value are not infrequent, we observe that in the long term, quality and growth characteristics outperform value. Just as the steady and consistent tortoise beat the hare, we are confident that quality growth companies will outperform value stocks in the long term.

Chart 2. Price performance of Emerging Market Equity, Growth, Quality and Value segments

Source: MSCI, 31 December 1999 to 30 September 2023. Emerging market equities represented by MSCI Emerging Market Index. Style segments represented by MSCI EM Growth Index, MSCI EM Value Index, MSCI EM Quality Index.

Furthermore, the outperformance of value in the current period and the divergence of market sentiment from company fundamentals has opened up opportunities for emerging market investors. While quality growth is out of favour, companies with robust financials and sustainable growth potential may be attractively valued relative to history. This is the time to add to positions, not exit them.

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MARTIN CURRIE
A Franklin Templeton Company

Martin Currie Investment Management Limited, registered in Scotland (no SC066107)
Martin Currie Inc, incorporated in New York and having a UK branch registered in Scotland (no SF000300), 2nd Floor, 5 Morrison Street, Edinburgh EH3 8BH

Tel: (44) 131 229 5252 Fax: (44) 131 222 2532 **www.martincurrie.com**