GLOBAL EMERGING MARKETS

Emerging market growth has the quality to perform

MARTIN CURRIE
A Franklin Templeton Company

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2023 has been another interesting year for global equity markets. Growth stocks have dominated markets and headlines. In US markets the impact has been clear – 2023 is the second-best year ever for growth versus value (31.7% performance gap between growth and value in the US as of 10 November 2023).[1]

Meanwhile in emerging markets, growth lags by over 6% in the same time period, marking the third consecutive calendar year where value has outpaced growth.[2] Below we make the case why we believe it's time for the market to reward quality growth stocks once again.

Why has value outperformed in emerging markets (EM), while growth leads in the US?

The three-year period ending 30 September 2023 has been the most difficult period for growth relative to value in the history of the emerging markets asset class. Despite having a significant amount of technology stocks, MSCI EM Growth has failed to outpace MSCI EM Value. The key reasons for MSCI EM Value's outperformance are:

- **China's heightened regulatory environment that began at the end of 2020** – this has led to outperformance of shorter-duration, 'cheap' stocks
- **The aftermath of Russia/Ukraine conflict** – this resulted in a severe rotation toward state-owned enterprises in the energy sector, which represents a much larger allocation in MSCI EM Value vs. Growth.[3]

In the US market, we have seen a very different setting. While the market sentiment towards China, a dominant component of the EM asset class, remains lukewarm, US investors have looked inward for growth. Key beneficiaries and, indeed, drivers of growth's outperformance in the US include technology names, boosted by the optimism for innovation around artificial intelligence (AI).

Despite EM's significant exposure to global leaders in technology, the weakness in the region overall and the focus on shorter-duration value stocks has meant that their performance has not been commensurate with their US peers. But this cannot last.

The rotation has favoured stocks which are low quality. This means companies that typically lack robust balance sheets, strong business models, strong governance practices, effective management teams, or perhaps have unfavourable ownership structures or similar concerns. The share price performance of these companies does not align with the actual company performance and profitability. The market is due a correction which brings sentiment and company fundamentals back in sync.

[1] Source: Morningstar, 10 November 2023. US growth stocks represented by Russel 1000 Growth Index, US value stocks represented by Russell 1000 Value Index.

[2] Source: Morningstar, 10 November 2023. EM growth stocks represented by MSCI EM Growth Index, EM value stocks represented by MSCI EM Value Index.

[3] Source: MSCI. As at 31 October 2023, energy stocks represented 8.8% of MSCI EM Value compared to just 1.9% of MSCI EM Growth.

The next phase for EM should favour growth

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. We are especially excited about the following areas that we expect to play a key role in improving sentiment in EM in the coming months:

China

While misconceptions have driven divergence between share prices and fundamentals, China continues to make progress on supporting domestic companies. Relations between the US and China are improving and companies are exhibiting a positive trend for stronger fundamentals.

Inflation

Benign inflation combined with accommodative monetary policies in EM should be supportive of quality growth companies.

Technology

We expect to see a rebound in technology earnings. EM is home to several world-leading technology companies which are positioned to benefit strongly from a rebound and which are crucial components of the global technology supply chain. These companies provide investors with a diverse range of opportunities, currently trading at materially lower valuations than US peers[4].

Valuations

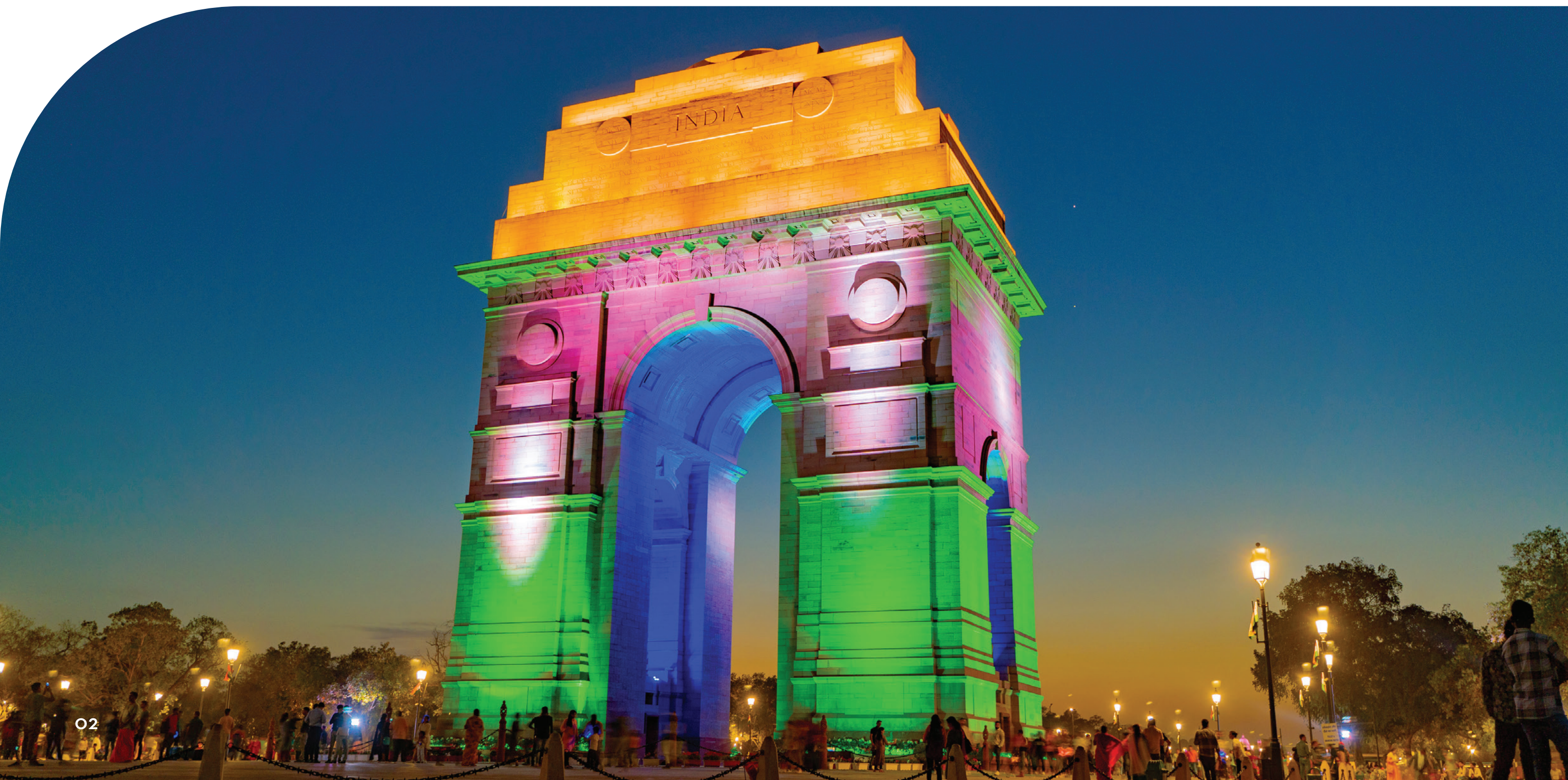
Due to recent weakness in EM, companies are trading at attractive valuations compared to US peers[4]. Coupled with the expected return of a growth environment and the persistence of strong company fundamentals, this presents a great opportunity to add to positions, not exit them.

India

India's time has come. It is seizing its demographic dividend but importantly there is a rich opportunity set within the country - companies with long-term structural growth potential and well-regarded management teams. We expect these companies to continue to ride the wave of the Indian economic opportunity.

The opportunity set in EM is wide and deep, with the areas above only a snapshot of reasons to be excited. EM is home to innovators, global leaders, and beneficiaries of structural change. These companies pose a unique opportunity to investors in their unbounded potential to deliver sustainable, long-term growth at an attractive valuation. Time to strike while the iron is hot.

[4]Source: FactSet, November 2023. Valuation calculated using Price Earnings of MSCI Emerging Markets versus MSCI USA.



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