Reemergence of EM equities: The dawn of the EM consumer

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IN BRIEF

- Looking forward, the emerging market (EM) economic growth differential over developed markets will persist. This should continue to propel the emergence of the EM middle class, providing long-term investors with opportunities in EM equities. This includes not only consumer sectors but also financials and technology.
- EM equity performance can swing wildly in the short term as a result of big shifts in investor sentiment, which has an impact on multiples and currencies. However, in the long term, these sentiment waves are washed away and fundamentals determine the destination.
- Although the U.S. equity market has been the primary driver of strong investment returns over the last decade, we believe EM equities could be the next big driver going forward. Advisors are underweight emerging markets within their portfolios and may need to consider a larger allocation to take advantage of the demographic and economic trends.

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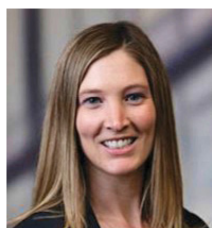

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LONG-TERM DRIVERS: KEEPING AN EYE ON THE HORIZON

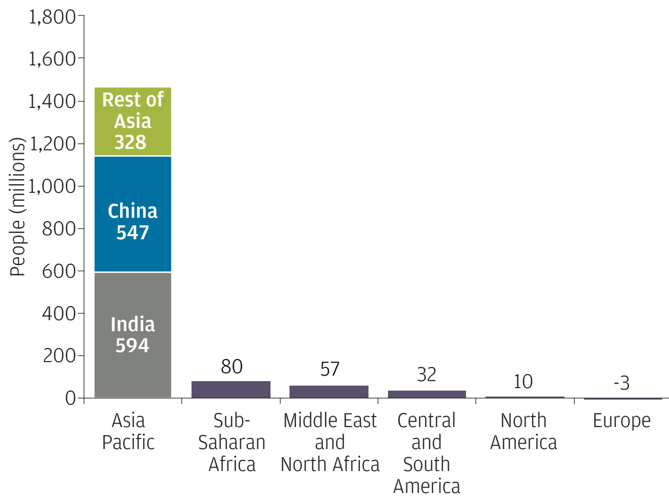
One of the most important drivers of emerging markets is the growth differential between emerging and developed economies. Emerging markets should continue to provide a substantial economic growth alpha relative to developed markets due to better demographics and a productivity catch-up. We estimate that EM economic growth should provide close to an annual 250bps bump over those in developed markets over the next 10 to 15 years.[1] This premium in economic growth should feed through to EM corporate revenue growth as well, translating into higher returns for investors over the next decade.

[1] Expected economic growth based on J.P. Morgan's 2020 Long-term Capital Market Assumptions (LTCMA).

Looking forward, this pace of EM economic growth will continue to increase the GDP per capita in many EM countries, which will result in many people entering the global middle class. Consumers have and will continue to emerge in emerging markets. Projections show that, while developed markets have mostly tapped their potential growth of the middle class, emerging markets still have a lot of room to run over the next 10 years (**EXHIBIT 1**).

Almost all the future growth in the global middle class will come from emerging markets

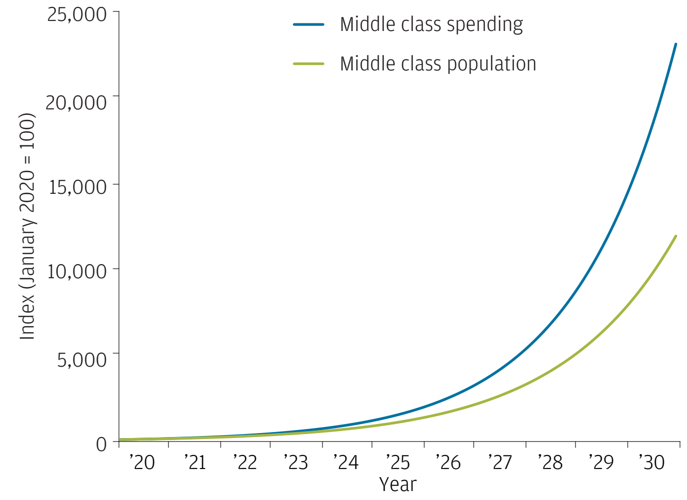
EXHIBIT 1: REGIONAL CONTRIBUTION TO THE MIDDLE CLASS: 2020 TO 2030 (MILLIONS OF PEOPLE)



Source: Brookings Institution, J.P. Morgan Asset Management; data as of October 15, 2019. Estimates for regional contribution are from Kharas, Homi. *The Unprecedented Expansion of the Global Middle Class, An Update*. Brookings Institution, 2017.

The growth of the middle class population will be fast, but the growth in spending will be even faster

EXHIBIT 2: SPENDING GROWTH VS. POPULATION GROWTH OF THE MIDDLE CLASS

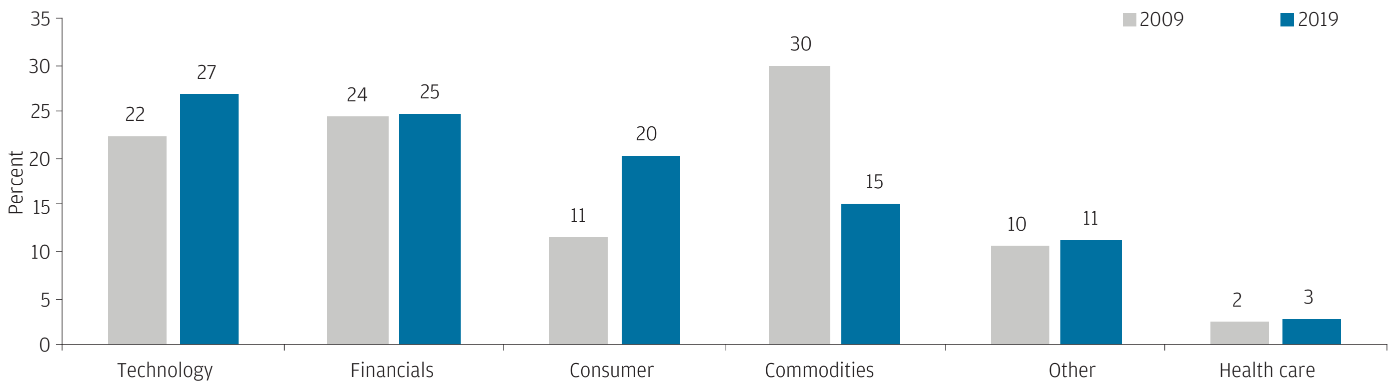


Source: Brookings Institution, J.P. Morgan Asset Management; data as of October 15, 2019. Middle class population and spending growth are based on calculations from Kharas, Homi. *The Unprecedented Expansion of the Global Middle Class, An Update*. Brookings Institution, 2017.

This phenomenon will be particularly strong in EM Asia, from where almost 1.5 billion people are expected to enter the middle class from 2020 to 2030. This makes up nearly 90% of the total population that will leave the lower class to join the global middle class, compared to only 10 million people in North America. Crucially, as these individuals become wealthier, they will have more disposable income to spend on goods and services. In fact, the spending growth from the middle class will be at a higher speed than the growth of the population itself (**EXHIBIT 2**).

EM equities in 2019 are not the same as in 2009

EXHIBIT 3: MSCI EMERGING MARKETS BREAKDOWN BY SECTORS



Source: FactSet, MSCI, J.P. Morgan Asset Management; data are as of October 15, 2019. "Other" is comprised of the Industrials, Real Estate and Utilities sectors. Values may not sum to 100% due to rounding.

WHICH EM SECTORS BENEFIT FROM THE EMERGENCE OF THE MIDDLE CLASS?

Sector weights in EM equities have changed significantly over the last decade. In the past, the largest sectors were related to commodities, which tend to be very volatile and represented 30% of the equities index. Today, this weight has shrunk in half, giving space to other sectors, in particular the consumer one, which increased from 11% to 20% in the last 10 years (**EXHIBIT 3**).

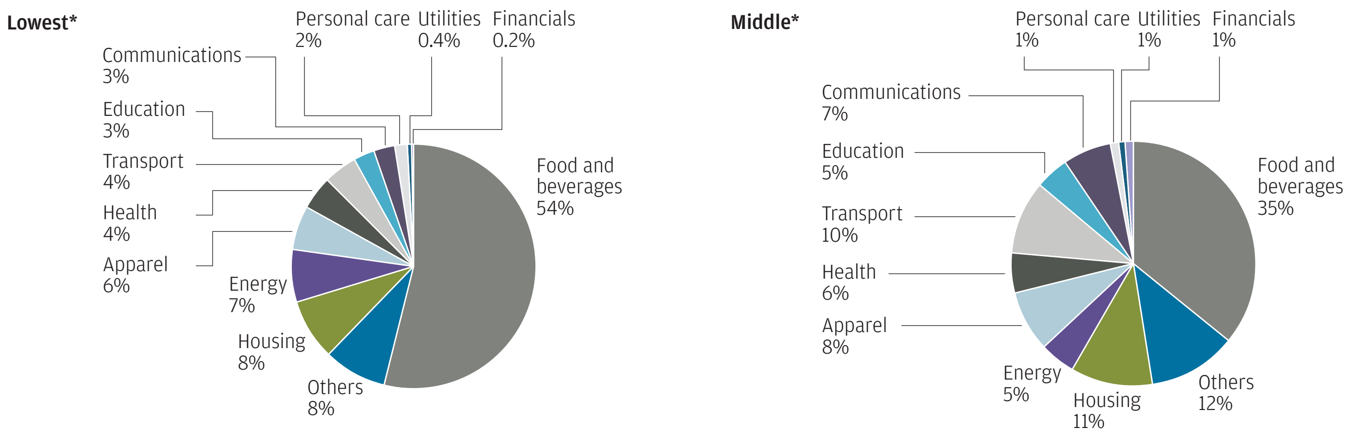
However, this does not necessarily mean that investors should focus exclusively on consumer sectors. As people enter the middle class, they will not only increase their spending on consumer goods but also on other products and services that will benefit different parts of the market. As individuals earn higher incomes, the portion spent on basic needs decreases relative to total consumption. Data from the World Bank shows that between the lowest and middle classes the share of consumption on food and beverages is reduced from 54% to 35% of total consumption. In contrast, expenses related to apparel, housing, education and health care, among others, all tend to rise (**EXHIBIT 4**).

Financials is also a sector that should benefit from the growth of the middle class. As income rises, individuals will need more banking services as they will open more accounts to deposit their money or take mortgages to buy houses. For example, in India, 700 million people are underbanked, but this should change dramatically over the next decade as more Indians join the middle class. In addition, a rise in wealth means that there will be a higher need for insurance. For instance, in China, most people have not needed insurance so far, but as more people enter the middle class, they will need to purchase insurance to protect their families and assets.

Another example of a sector that should perform well over the next few years is technology. While the sector has been the best performer in emerging markets over the past five years, it still has a lot of potential to grow further. So far, companies in EM Asia that have introduced ground-breaking innovations that have disrupted various industries have driven returns in the sector. Deficiencies in traditional areas, such as retail and banking, gave enormous digital opportunities to tech companies in e-commerce and online payments in that region. Still, data show that digital penetration is still at around 50% to 60% of the population in EM Asia countries, compared to 95% in the U.S. As the middle class grows and more people have access to telecommunication services, greater digital infrastructure should be created.

Consumption patterns change as income rises

EXHIBIT 4: SHARE OF CONSUMPTION BY SECTOR AND CONSUMPTION SEGMENT



Source: World Bank, J.P. Morgan Asset Management; data as of October 15, 2019.

*The lowest consumption segment is defined as the population with income below $2.97 per capita a day, while the middle consumption segment is the population with income between $8.44 and $23.03 per capita a day.

SHORTER-TERM DRIVERS: SENTIMENT WAVES ROCK THE BOAT

It is not uncommon for EM equity performance to experience large swings over short periods of time. These are caused by sharp shifts in investor sentiment, which are reflected in multiple expansion/contraction and currency strength/weakness. In particular, the asset class tends to underperform during periods of decelerating global growth, which causes a deterioration in risk appetite and an appreciation of the U.S. dollar relative to EM currencies.

During moments of concern about global growth, investors tend to position their portfolios more defensively. The main place they look for safety is in U.S. assets, which are less geared to the global cycle and seen as more defensive as a result. In order to do so, the first place investors trim their exposure is in EM assets. As a result, EM equity multiples fall and EM currencies weaken versus the U.S. dollar, both dragging on returns.

Eventually, global growth does improve and sentiment does turn, with EM equities going through a period where multiples and currencies significantly add to returns. Unfortunately, these turning points tend to be very hard to time. Over the last 15 years, EM equities have had an annualized return of 8.3%; however, if investors missed the 10 best days, their return would have been cut by more than half to only 3.5% (**EXHIBIT 5**).

In the short term, these big swings in investor sentiment rock the EM boat; however, longer term these waves end up fading from view and the final destination is driven by fundamentals, not by sentiment. Looking at EM equities' annualized return over the last 15 years, multiples and currencies have had a negligible contribution to returns over this time period. Instead, the bulk of returns came from dividends and earnings, the fundamentals. Therefore, for investors who are not focused on short-term performance, but are instead invested for the long run, focusing on the long-term EM story is the best route to take.

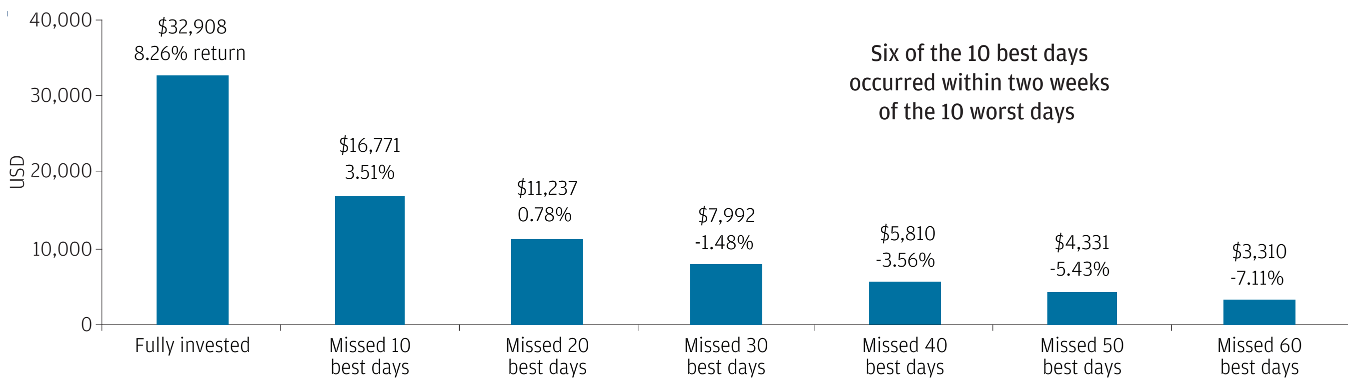
PORTFOLIO IMPLICATIONS: LOOKING FORWARD NOT BACKWARD

Over the last decade we have been fortunate to experience strong market returns. Clients invested in a basic moderate portfolio have likely generated close to a 10% annualized return. A large contributor to this has been the incredible returns of U.S. equities, averaging over 13% annually. Most in the industry agree, these results will likely not repeat over the next 10 years. J.P. Morgan is forecasting 5.6% annualized return over the next 10 to 15 years in U.S. equities.[2] The bottom line: the tailwind investors have benefited from recently is likely dwindling and therefore we need to look elsewhere to help clients achieve their goals.

[2] Expected return based on J.P. Morgan's 2020 Long-term Capital Market Assumptions (LTCMA).

Turning points in emerging markets are very hard to time

EXHIBIT 5: PERFORMANCE OF 10,000 IN MSCI EMERGING MARKETS BETWEEN JANUARY 1, 2004 AND DECEMBER 31, 2018, USD

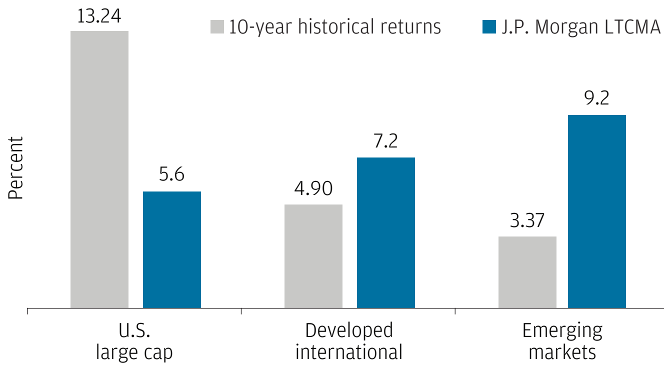


Source: FactSet, MSCI, J.P. Morgan Asset Management; data as of October 15, 2019. Returns are based on the MSCI Emerging Markets Total Return Index in U.S. dollars.

So where is the next opportunity that can help drive investor returns? We believe all of the trends and demographic shifts detailed throughout this paper suggest it could be EM equity. J.P. Morgan is anticipating a 9.2% annualized return in EM equity over the next 10 to 15 years (**EXHIBIT 6**).

Trends and demographic shifts suggest EM equity is the next opportunity to drive returns

EXHIBIT 6: HISTORICAL VS. EXPECTED RETURNS



Source: Morningstar, J.P. Morgan Asset Management; as of September 30, 2019.

Expected risk and returns are based on J.P. Morgan's 2020 Long-term Capital Market Assumptions (LTCMA). J.P. Morgan's LTCMA provide risk and return expectations, over a 10- to 15-year horizon, for more than 50 asset and strategy classes. The product of in-depth analysis and J.P. Morgan's best thinking, our assumptions are designed to inform asset allocation decisions. Past performance is not indicative of future results. For illustrative purposes only.

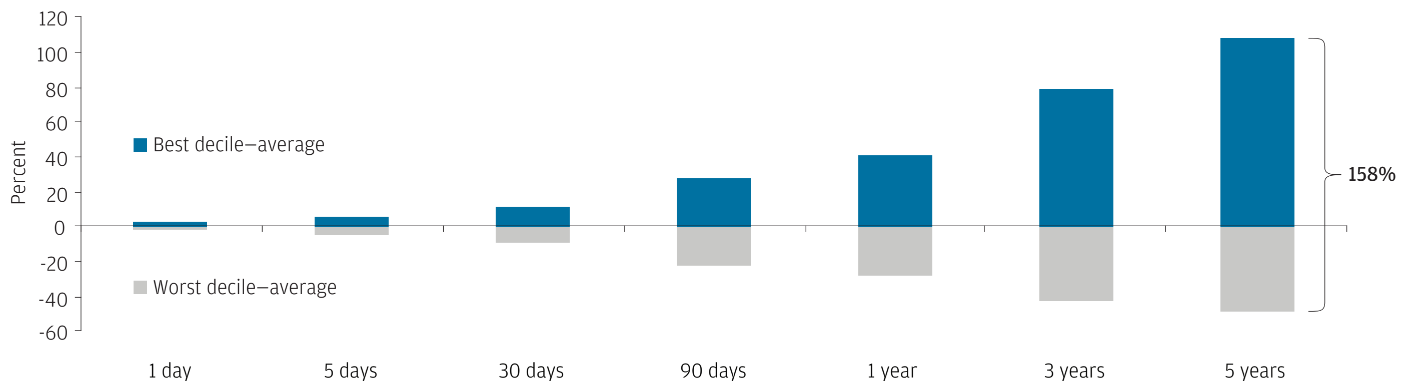
Unfortunately, however, we are noticing sizeable under-allocations to the international equity market. Through thousands of portfolio analytics and consultations, we have uncovered that most advisors have approximately an 80–20 split between U.S. and international equities, with both developed market (DM) and EM equities underrepresented. One of the common reasons advisors tend to be underweight emerging markets is due to its high volatility. Although the asset class does generally experience wide swings in performance over the short run, when added to a diversified portfolio, it can actually help improve the risk-adjusted returns through correlation benefits and improved performance. In spite of the higher volatility, we believe going forward a larger allocation to EM equity is likely warranted.

The focus then shifts to what type of strategy to invest in. During the last few years, we've observed a sizeable shift in advisors using lower-cost passive strategies for their equity allocations. We would argue, however, that EM equity is not the place to go cheap. As seen in **EXHIBIT 7**, the average return differential between top and bottom decile stocks in the MSCI EM Index over the last five years is 158%. Given the massive amount of dispersion and the opportunity to lean into certain sectors more so than others, we believe an active manager in this space can add significant value over time.

To summarize, advisors and clients have been spoiled with strong returns, driven largely by the U.S. market. Going forward, however, we don't expect history to repeat itself and therefore we need to look elsewhere. The demographic shifts taking place in emerging markets are undeniable and, if the trade tensions end in a positive resolution, we could see global growth pick up again. EM equity is still cheap relative to its 25-year history, so today represents a good opportunity to balance out global exposures and ensure an appropriate allocation to what we believe could be the next big driver of portfolio returns.

EM equity is not the place to go cheap

EXHIBIT 7: AVERAGE RETURN OF TOP AND BOTTOM DECILE STOCKS IN THE MSCI EMERGING MARKETS INDEX



Source: Bloomberg; data from 2011–2019, MSCI Emerging Markets.

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