Why Emerging Markets?

We all invest with a cloudy crystal ball. But there are times when various metrics lead us to feel a turning point could be ahead. We at Cartica are, of course, always scrutinizing the investment case for Emerging Markets (EMs) and right now we are seeing some positive signs and the beginnings of a potential market bottoming.

It is just possible that now is the peak for many things: peak negative sentiment, peak inflation, peak interest rate hawkishness, peak wage income pressure, peak US dollar, peak recession confusion, and peak EM outflows among them. If we are approaching a turning point and the world manages to escape a bad recession, this is a positive backdrop.

Year-to-date the EM equity index has outperformed the S&P 500…but with Russia going to zero and China knocked out from Zero Covid. So, EMs are essentially on the field with two players missing or injured.

If the market turns even moderately in favor of EMs, the shift could have huge repercussions. Global investors are very underweight EMs; a reversion could mean significant inflows in absolute terms.

The Current "Case for EM Investing" Rests on a Few Pillars:

1. **Cheap Valuations:** Current 12-month forward P/Es in EMs are 11 versus 14.5 for DM and 15.9 for the S&P 500. In short, EMs trade at a 31% discount to the S&P and 23.8% discount to DMs. As a friend of ours said, "Everything is on sale! It's Black Friday!" As of the end of Q1, EMs had only traded as cheaply compared to the S&P on a P/E basis 6.4% of the time since the end of Q1 2003.

   EM companies' Price/Book ratios offer a 9% discount to their 10-year average and a 62% discount to DM versus a 10-year average discount of 33%. EMs are almost at the levels of 2015 and earnings are being revised **up**. Meanwhile DM Price/Book ratios are at a 10% premium to their 10-year average and 15% above their 20-year average.

2. **Global Positioning Could Turn Big Time:** Investors are very underweight EMs. Positioning is 28% lower than the long-term average. Usually, EM equity allocations are about 8.9% of global investment. Currently EMs' share of global equity AUM is sitting at 6.4%.

   > Note: EMs represent 11% of the MSCI ACWI Index which includes 47 DM and EM markets. So, investors are chronically under-exposed to EMs to begin with.

   On a base of about $27.7 trillion in investments, that means EMs potentially could add another $700 billion if investors returned to their average allocation. It would look unwise for investors not to be at least partially positioned for a potential rush of funds this sizeable.

3. **Growth** this year for EMs could be around 3.8% versus 2.6% for DMs, a 1.6pp delta, according to Goldman Sachs estimates. Even more interesting, the **differential** for next year is expected to be 2.3pp with EMs growing 4% and DMs only 1.7%. Investors historically love this kind of differential.

4. Economic Management. The EMs have, in great part, been orthodox in their economic policies. The EM central banks were largely ahead of the curve in hiking interest rates, so should finish that cycle earlier than the US and Europe. The level of Covid relief differed widely but, in general, was much less generous in the EMs.

- On inflation, most EMs could get off relatively easy. The higher consumer prices in EMs generally do not have local monetary issues built in and much less fiscal push. So, we are not too worried about inflation lasting beyond the current cycle. Some observers have even used the word “transitory”.

- Most of the major EMs have Current Account Surpluses and India’s is roughly zero for the moment (“neutral is the new surplus” in India’s case). Where the dollar goes makes a difference for many countries. A softer dollar could be a plus for external balances.

5. USD Could Soften. It is possible that we are seeing near-peak dollar, although this is hard to bet on. Will the “weaponization of the West’s financial architecture” make Western assets, and especially the USD, less attractive versus EM assets as posited by the research firm, Gavekal?[i] Will digital currencies make FX markets more rational, and will we see currencies trading at Purchasing Power Parity or their Real Effective Exchange Rate without political factors thrown in the mix? It is hard to predict. But right now, the Brazilian Real, for example, is trading 45-50% below Fair Value and the interest rate will be close to R-star (the real interest rate expected to prevail when the economy is operating at its full sustainable level) after a small bit of hiking. Many EM currencies are trading cheap and many EM Central Banks are now independent and pretty reliable. Brazil is a top 5 Central Bank. India, China, Taiwan, Indonesia, and many others do a creditable job. (Turkey has it all backwards…the exception that proves the rule?)

6. Productivity Gains. Many EMs are setting the stage for future productivity gains. This is not true everywhere. We do have concerns: for example, will the new Chilean constitution depress productivity or will the Marcos era lead to slippage in the Philippines? That said, we see several potential sources of efficiency gains.

- *Accelerated Financialization* is a major EM theme. Fintech is lowering the costs of intermediation in many places. In Brazil, the oligopolistic hold of the few big banks is being broken. And government transfers are now being made through banks, not plastic cards. In India instant payments combined with the Aadhar program (that gives each person a personal identification number backed by biometrics) is leading to productivity gains and lower cost of float. Fintech should make underwriting of loans more precise and efficient which can introduce credit to more of the population.

- In Brazil, the reform of the interest rates charged by the enormous local development bank, BNDES, should spell the end to years of misallocation of capital. The new regime should allow the government to focus on infrastructure that it alone can do and allow the private sector to take care of sectors best for it. Finally.

- Covid also accelerated the trend. In Colombia, for example, the government had a 10-year plan to go from 45% banked (in 2017) to close to fully banked. In Covid, this was all done in a matter of months as the government needed a way to get support payments out the door. With more people banking comes data; with data, comes artificial intelligence and big-data analysis; and with that comes better, faster underwriting and more credit availability. And when people start saving in bank accounts, these savings can be used efficiently to translate into capex and economic growth the way they cannot be when kept under the mattress or in other stores of value like gold.

- *Lower Logistics Costs.* Indians we have spoken to have said the country is planning to reduce its logistics costs from 13-14% of GDP to 10%. The new Goods and Services Tax (GST) regime, which unified taxes state-to-state and eliminated stops at state borders to pay taxes should contribute 2pp. Another 2pp perhaps could result from use of electronic payments. In addition, India is looking for more gains from investments in better roads, railroads, and ports. India ranks #44 on the World Bank's Logistics Index while China is at #26. But India knows that improvements in logistics could be central to moving from a services-driven to a manufacturing-driven economy.

- *Data on Logistics Progress Is Difficult to Assess.* It is obviously easier for smaller countries to rank well on logistics; distances are per se shorter. Hong Kong and UAE both rank above the US, for example. Korea, China, Taiwan, Poland, Qatar, Hungary, Thailand, South Africa, and Chile are EMs that also rate in the top 20% of countries. This represents good progress.

- *Better Infrastructure.* Countries are understanding that the Chinese miracle was in great part attributable to good infrastructure. Swiss Re estimates that the EMs will spend about 3.9% of GDP per annum on infrastructure over the next 20 years. The Indian government is now finally spending as much as 5.5% of GDP on infrastructure, up from low previous levels. China is at 7% and Brazil only 2%, but recent reforms give hope of an expansion. Better ports, roads, and sewage bode well for future productivity.

  Note: Speaking of roads, work-from-home has been a productivity fillip for knowledge workers in crazy-traffic cities like Jakarta, Karachi, Bogota, Sao Paulo, etc. Will this endure?

- *Increased Formal Sector Share.* The labor productivity of <u>informal</u> firms is about one-quarter that of <u>formal</u> firms, a World Bank study of about 125 countries found.[ii] Covid-era data are hard to come by, but anecdotally we hear of some big increases in formality levels, which is positive for productivity. Colombia, a country with a history of informality, is now 55% formalized. In India, a (somewhat controversial) State Bank of India report claimed the informal sector dropped from 50% to 15-20% (!) in just two years now that GST has been enacted. Even if this figure is off by magnitudes, it is still huge.

- *Digitization.* While we have seen the productivity effects of digitization in China, it is hard to quantify these for the other countries catching up and working to cross the digital divide. Anecdotally e-Government has made administrative interactions faster and less open to corruption in places like India, which underwent the "cheap mobile phone" revolution. Brazil and other LatAm countries are moving in that direction but do not seem to have reaped measurable benefits yet. Southeast Asia including Indonesia should also move ahead. To take advantage of digitization opportunities many countries need more investment in education and much better educational outcomes.

7. New business models. There are those who say that the more advanced DMs "invent" but EMs and indeed most countries only "innovate". What we at Cartica have seen is companies adapting business models to the needs of their environment. This allows innovative companies to expand markets that barely exist, to disrupt and disintermediate inefficient sectors, and to find better ways of using the world's scarce labor, capital, and inputs.

    - In our analysis of EM firms, we have seen a Latin American financial services company which was the driving force in developing its local capital markets by designing market-traded credit products that were cheaper than bank loans. When they began operations only US$30 bn per day was traded in local equities, and now US$100-150bn per day is traded; and they take credit for much of this. They were the first to set up a large network of tech-enabled stockbrokers. Deepening capital markets has been a lifelong passion of ours as we believe vibrant markets are foundational to supporting enterprise and economic growth.

    - An Indian company created the first tech platform for consumers to shop for insurance products. With only 2% of insurance sold efficiently online in the country, they have a huge runway for increasing penetration and bringing productivity to a needlessly high-touch segment.

    - One Latin American company is an innovative payments player that allows merchants to enter EM countries and accept a broad suite of payment methods with a single API configuration. They can manage the range of cross-border transactions with minimum friction.

    - An Asian healthcare player has consolidated segments that are typically siloed elsewhere. Hospitals, diagnostics, pharmacies, and digital health platforms are consolidated, generating superior data, customer service, and efficiency.

    - We nod to the leading Asian semiconductor chipmaker which commands 50% gross margins where others are scrambling to keep their fabs full. Its processes and corporate culture/management style are unique and earn them their unique place as the only place on Earth actively producing 5 nanometer chips and the only place capable of producing 3 nanometers.

We still pride ourselves on our realism and healthy cynicism. We are just tempering that with cautious optimism that EMs could turn the tide. And if they do, there could be major inflows to support the reversion to more geographically balanced portfolios.

[i] *Gavekal June 23 "The Age of Weaponization, Part Two". See also https://research.gavekal.com/article/the-end-of-the-unipolar-era/ for fuller discussion.*

[ii] *Amin, Mohammad. Ohnsorge, Franziska L., Okou, Cedric "Casting a Shadow Productivity of Formal Firms and Informality." World Bank Group. Macroeconomics, Trade and Investment Global Practice & Development Economics Global Indicators Group. July 2019 https://www.enterprisesurveys.org/content/dam/enterprisesurveys/documents/research-1/Casting-a-Shadow-Productivity-of-Formal-Firms-and-Informality.pdf*

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