EM equities: evolving and transforming

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The conflict and humanitarian crisis in Ukraine has increased volatility in global equity markets—at a time when uncertainty surrounding supply chain bottlenecks, elevated commodity prices, tight labor markets, central bank policy and localized COVID outbreaks were already unnerving investors. In the near term it is reasonable to assume that equity market volatility may remain elevated as investors continue to digest the short- and long-term impacts of these factors. But quite often, periods of volatility can provide very attractive entry points for investing in solid companies. As disciplined, bottom-up investors, our focus remains on identifying which companies have the vision and ability to navigate these risks and convert uncertainty into opportunity.

More broadly, looking across the EM equity landscape today, there are a number of longer-term trends unfolding, which are creating opportunities for many EM companies to significantly grow their earnings base over the medium term.

EMs dominating some fast-growing sectors

Emerging markets are undergoing a seismic shift. While they have traditionally been perceived as dominated by 'old economy' industries, many EM economies have transitioned from 'primary' and 'secondary' industries toward more 'tertiary' or service-based industries over the past decade.[1] In fact, new economy sectors, including consumer discretionary, information technology, communication services and health care, now account for over half of the EM benchmark equities index, nearly double the weighting of a decade ago. And, while the shift toward the new economy is indeed global, EM companies are at the forefront of some of these fast-growing but highly concentrated sectors.

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EV battery industry

Amid the push toward green investment globally, the electric vehicle (EV) battery sector has been one of the primary beneficiaries—due largely to government subsidies for cleaner alternatives, which have helped narrow the price gap between EVs and traditional internal combustion vehicles. Mindful of the growing disruption to their traditional lines of business, auto companies across the world are also investing heavily in new EV designs, which should lead to a continued ramp-up in new model launches. Combined with the expected narrowing of the price gap, this is likely to drive EV unit sales and market penetration even higher over the next decade. This bodes well for EV battery producers—four out of the top five of which are based in EM and have a combined global market share of more than 60%.[2]

Memory and foundry industries

Memory and foundry are further examples of new economy sectors that are dominated by EMs and look well-positioned to benefit from the long-term growth in this space going forward. The memory storage industry has experienced steady consolidation over the last 20 years, which has caused the number of key players to decline from 24 to just three today. Of these, the two largest are EM companies that enjoy more than 70% global market share.[3] Further, the foundry sector, which manufactures microprocessors that control electronic devices from your washing machine to your car, has also undergone significant evolution. While Silicon Valley-based companies were the market leaders a decade ago, similarly to memory, EM companies now sit at the forefront.

While both the memory and foundry sectors are well established, the outlook remains positive given the strong secular demand drivers at play, which we believe will continue to underpin growth for many more years. For instance, governments, companies and individuals are generating an increasing amount of data every year, fueling demand for memory and advanced microprocessors to process, analyze and store data. At the same time, an acceleration in 5G adoption and advances in artificial intelligence and virtual reality will provide additional demand support.

Traditional industries forced to adapt

As technologies evolve and consumer behavior shifts, businesses in more traditional industries are facing pressure to adapt—which in and of itself has the potential to create opportunities for those willing to embrace change. This is taking place in many industries ranging from manufacturing, to retailing, to financial services. Areas of interest include automation, pivot to local brands and evolving distribution models.

ESG on the rise

ESG is another theme transforming the long-term opportunity in EM equities. While at the current juncture commitment to ESG policies by EM companies remains below their developed market counterparts, progress is accelerating. This positive momentum is partly influenced by the introduction of government-mandated ESG practices and industry regulations, but also by a growing understanding from companies that a greater commitment to ESG considerations can positively impact funding costs and equity valuations.

At Barings, ESG is integrated into every step of our investment process, as we believe it allows us to better understand all the risks and opportunities associated with each company. In addition, we actively engage with company management teams to improve sustainability-related disclosure and advocate for better practices, thus further contributing to EM's accelerating ESG momentum.

Key takeaway

While ongoing risks will likely keep volatility elevated in the near term, we believe the long-term opportunity in EM equities remains compelling. Moreover, the current environment may provide an attractive entry point in companies that are exposed to, or are enablers of, the secular shift taking place across EM—particularly those with sustainable franchises which have flexible business models and a growing commitment to ESG considerations.

FOOTNOTES

1 Primary industries involve acquiring raw materials, while secondary industries focus on manufacturing these raw materials into products. Tertiary industries refer to the commercial services that support the production and distribution process.

2 Source: HSBC; European Automobile Manufacturers Association. As of March 31, 2022.

3 Source: Barings, Morgan Stanley: Asia Pacific Insights, 2022.

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