

Is short-term noise masking a long-term opportunity in EM Equities?

Emerging markets (EMs) are in the headlines on a regular basis—both with positive and negative news flow—but rarely do we hear the whole story.



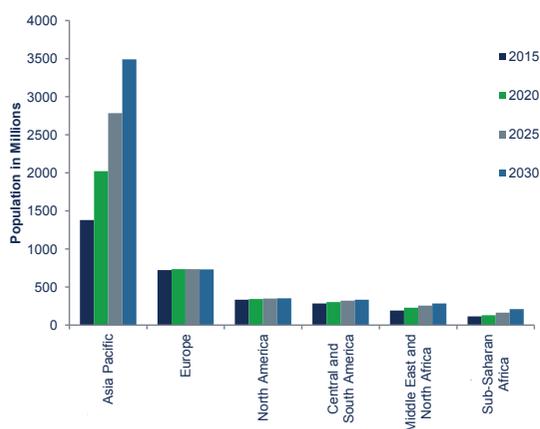
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The short-term focus often exhibited in markets today can and many times does mask a number of supportive secular growth trends with the potential to generate long-term opportunities in EM equities. EMs are already very significant in size, and growing at a much faster pace than developed markets. On a purchasing power parity (PPP) basis, which considers the relative standard of living, EMs account for more than half of the world's GDP.¹ Going forward, we believe this growth will continue to serve as a tailwind for EM companies, as it's fueled by three core drivers that show no signs of abating: demographics, technology, and ESG.

Demographics

By 2030, the United Nations estimates that 85% of the global population will reside in emerging markets. Even more noteworthy, between 2015 and 2030, almost all of the expected growth in the global middle class is predicted to come from the Asia Pacific region.

Figure 1: Forecast of the global middle class population from 2015 to 2030



Source: United Nations - Probabilistic Population Projections based on the World Population Prospects: (2017)

With this expansion comes an increased rate of urbanization, as people gravitate toward cities that offer greater employment prospects. Indeed, by 2050, about two-thirds of emerging markets are expected to be urbanized, compared with just under half today. Accompanying the burgeoning middle class, we expect to see greater spending power and, subsequently, a dramatic increase in consumption. By 2030, China and India in particular are forecast to dwarf

other nations in terms of purchasing power, expanding PPP consumption levels by threefold and fivefold, respectively.² Purchasing power in the U.S., by contrast, is expected to remain flat, and drop from first to third behind the world's two most populous nations.

Millennials are expected to account for much of this consumption—already, millennials account for about one-quarter of the global population, with almost 90% of that residing in emerging markets, particularly Asia and Africa. Given this growth, the global spending power of millennials is set to exceed other generations, and will certainly shape the direction of the world's economy in the years ahead. Anecdotal trends already demonstrate this, with increasing levels of sportswear sales, marathon participation and travel abroad revealing a confident, brand-aware and outward-looking population of middle class consumers.

Technology

At a high level, many EMs have effectively leapfrogged older—and now obsolete—technologies, skipping straight to newer technologies to drive production and consumption growth. The aforementioned growing EM middle class is digitally savvy, underscored by the significant growth in both internet and smartphone penetration in recent years. E-commerce is one area that has undergone significant growth as a result. In China, for example, roughly 17% of retail sales are online, with e-commerce growth rates since 2015 outstripping both Japan and the U.S. Across the broader EM landscape, total retail spend is forecast to double to \$8.3 trillion in the decade to 2022, with digitally-influenced spend expected to account for half of that.

Figure 2: E-commerce as a % of total retail sales



Source: Boston Consulting Group: Digital Consumers, Emerging Markets, and the \$4 Trillion Future, 2018

From a production standpoint, the EM workforce has been trained to sustain this digital economy—by 2016, China had more science, technology, engineering and mathematics (STEM) graduates than any other nation. Nearly 5 million students graduated that year, compared to nearly 3 million from India. The U.S. and Russia had closer to 500,000 STEM graduates, by contrast.³ This trend aligns closely with the pattern of China's research and development spend—the country's investment in R&D has doubled since the turn of the century, and now matches

that of the European Union. The impact is clear: China now accounts for more international patent applications each year than the U.S. and E.U. combined.⁴ The country is also home to one-quarter of the world's 100 largest unicorns—privately-owned enterprises valued in excess of \$1 billion—with the proportion rising to one-third when including all EM.

Environmental, Social, Governance (ESG)

ESG is a third component of the EM growth story, with the incentive to move toward greater sustainability two-fold. On the one hand, EMs are taking strides to match internationally-demanded standards. At the same time, improved ESG practices represent an optimal use of resources, and have the potential to maximize longer-term growth.

EMs are in various stages of implementing sustainable practices. China has generally taken the lead when it comes to considerations like combatting air pollution and increasing female workforce participation. The country's legislation is also catching up with developed markets, with disclosure requirements becoming increasingly transparent. Other countries face greater challenges—female labor force participation stands at just 23% in India, for instance—which suggests there is still some headway to be made across the broader EM landscape when it comes to optimizing resources and achieving higher-quality sustainable growth.

The Bottom Line

As these secular trends continue to play out across the EM landscape, some countries and companies will inevitably fare better than others. Looking across EMs today, we see opportunities in companies with agile business models—that are either disruptors themselves or not afraid of disruption—as well as in companies with improving franchises, unrecognized growth opportunities, operational efficiencies and other competitive advantages. We also favor companies with solid management, strong balance sheets, resilient capital structures and positive ESG dynamics and policies. While short-term events will likely continue to drive headlines, the real story—in our view—is in the compelling long-term growth opportunity.

FOOTNOTES

- 1 Barings, IMF, April 2019
- 2 United Nations - Probabilistic Population Projections based on the World Population Prospects: (2017)
- 3 STEM graduates based on World Economic Forum data 2018.
- 4 World Intellectual Property Organization (WIPO) Patent Report, 2016