Emerging Markets Have Outgrown Their Index

Nearly half of the emerging markets benchmark now sits in two advanced East Asian economies. The long-term opportunity lies in what has been crowded out.

By Andrew Dalrymple and José Manuel Silva

The emerging markets index has changed markedly over the past two years. Demand for AI infrastructure, data centre build-out and memory chips, has reshaped the weightings as well as the returns. Geopolitical tension and trade disputes have added volatility, but the more consequential change has been in the composition of the benchmark itself.

At the end of August, Taiwan and South Korea had a combined weight of 48% in the MSCI Emerging Markets Index, and whether either country still belongs there is a fair question. FTSE Russell has classified South Korea as developed since 2009, while rating Taiwan as Advanced Emerging. MSCI declined again in June to place Korea on its developed market watchlist, citing won convertibility and thin foreign exchange liquidity outside domestic hours. Those are questions of market plumbing. On income, institutional maturity and industrial sophistication, both countries look closer to Japan than to Indonesia.

An investor buying the index today is buying, to a substantial degree, two advanced East Asian semiconductor economies. That is the trap: mistaking the part of the asset class that has performed for the asset class itself.

Around half the world's population lives in emerging markets. Roughly 1bn millennials are entering their prime earning years, with a further 1bn Gen Z consumers behind them. These are people opening their first bank accounts, buying their first homes, moving from motorcycles to cars and shopping online for the first time, none of which turns on the semiconductor cycle.

The businesses serving them attract less attention than the semiconductor complex, but are no less interesting. They include banks lending to first-time borrowers, mortgage providers and consumer finance companies, along with the vehicle manufacturers, retailers and logistics networks behind them. Their growth is largely a function of how many people cross an income threshold each year, which is a more forecastable variable than a commodity price.

We do not know what copper or oil will cost next year. We do know there will be more people in India owning property, riding their own motorcycle or driving a car. That is close to guaranteed, and it compounds over a decade rather than a quarter.

This matters for anyone holding the index. Several of the leading technology companies are exceptional businesses, and plenty of investors have done well from the chip cycle. But an index position now carries a semiconductor weighting that price momentum has set, and that few investors would have arrived at by judgement.

A region priced on its history

The same argument applies to a part of the asset class investors still tend to assess on its past. Latin America has over 620 million people and an economy of $7trn, and decades of structural reform have left it more integrated than most portfolios reflect.

Central banks across the region have been unusually orthodox. Several raised rates ahead of developed market peers in the last inflationary cycle and have since eased with discipline. Monetary credibility rarely generates headlines, which is part of why it stays underpriced. Institutions are stronger, fiscal policy is tighter, and equity valuations remain undemanding relative to both regional history and global peers.

The region's economic role is changing too. Demand for critical minerals in the energy transition has renewed attention on Chilean and Peruvian resources. Brazil has consolidated its position as an agricultural and energy exporter, while Mexico's manufacturing base has expanded as supply chains have shortened. Together these are the foundations of a more diversified economy than the commodity cycle characterisation allows.

Volatility will persist. Latin America will continue to produce political events that unsettle markets, and anyone investing there should expect drawdowns. The question is whether the region is being judged on what it is now or on what it was in the 1990s. For much of the market, it is still the latter.

Tomorrow's leaders

Emerging markets do not stand still. The companies driving returns today will in all likelihood be displaced by another cohort in the future, as has happened repeatedly over the past thirty years. These economies sit at different stages of development, and the forces lifting a first-time borrower into a mortgage have little to do with the price of memory chips.

Set the semiconductor complex aside and analysts still expect double-digit emerging markets earnings growth next year, whatever happens to demand for AI hardware. An index weighted by what has already performed will always describe the last cycle. The harder work, and the more rewarding, is identifying the companies that will define the next one.

Andrew Dalrymple is Founder and Investment Manager at Aubrey Capital Management. José Manuel Silva is Chief Investment Officer at LarrainVial Asset Management.

Important Information

This document has been issued by Aubrey Capital Management Limited which is authorised and regulated in the UK by the Financial Conduct Authority and is registered as an Investment Adviser with the US Securities & Exchange Commission. You should be aware that the regulatory regime applicable in the UK may well be different in your home jurisdiction. This document has been prepared solely for the intended recipient for information purposes and is not a solicitation, or an offer to buy or sell any security. The information on which the document is based has been obtained from sources that we believe to be reliable, and in good faith, but we have not independently verified such information and no representation or warranty, express or implied, is made as to their accuracy. All expressions of opinion are subject to change without notice. Any comments expressed in this presentation should not be taken as a recommendation or advice. Please note that the prices of shares and the income from them can fall as well as rise and you may not get back the amount originally invested. This can be as a result of market movements and of variations in the exchange rates between currencies. Past performance is not a guide to future returns and may not be repeated. Aubrey Capital Management Limited accepts no liability or responsibility whatsoever for any consequential loss of any kind arising out of the use of this document or any part of its contents. This document does not in any way constitute investment advice or an offer or invitation to deal in securities. Recipients should always seek the advice of a qualified investment professional before making any investment decisions.