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Is it Time to Revisit Emerging Market Equities?

INSIGHTS

EM equities have faced significant headwinds over the past decade, but recent developments suggest a turning point may be in progress. So far, 2025 is proving to be promising, as EM equities have delivered double-digit absolute returns and have outperformed developed market equities.

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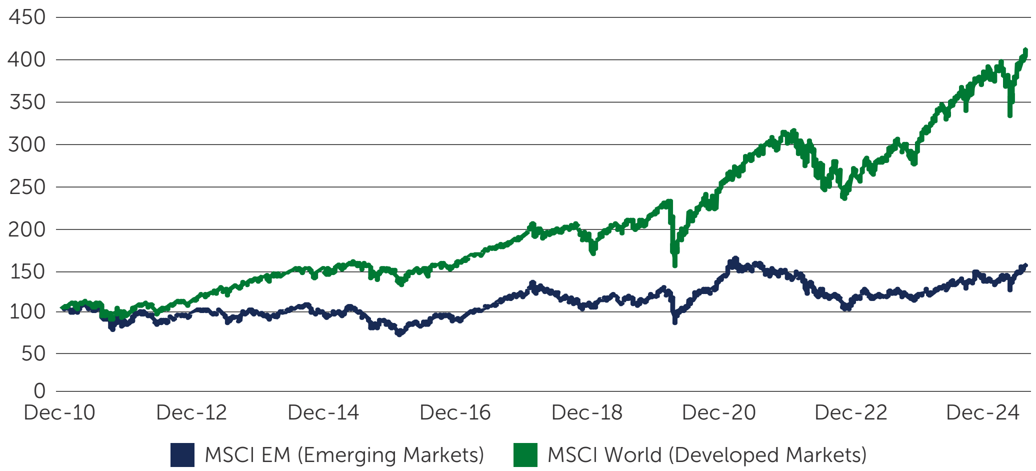
Figure 1: EM and DM Performance Over Time



Sources: MSCI; Refinitiv. As of June 30, 2025.

Emerging market (EM) equities as an asset class has not rewarded investors for more than a decade. The EM asset class has been in a broad sideways trending trading range and has significantly underperformed developed market (DM) equities over this period. Peak (starting) valuations, slowing economic growth, disappointing earnings delivery, a liquidity-sapping strong U.S. dollar and a lack of focus on corporate governance and shareholder returns have all weighed heavily on the asset class.

So far, 2025 is proving to be more promising. EM equities have delivered double-digit absolute returns year to date and have outperformed developed market equities. This performance is all the more impressive considering the backdrop of elevated trade tensions and rising tariffs for EM exports to the U.S.

We are encouraged by the recent behavior of emerging market equities and believe there are several factors underpinning a sustained period of absolute and relative performance.

1. Improving Earnings Outlook

In our opinion, cyclical and secular drivers within EM have the potential to support double-digit earnings growth over the coming years. From a cyclical standpoint, the policy cycle looks favorable as inflationary pressures are subdued in all regions, giving significant room for expansionary monetary policy. In addition, the fiscal position of EM countries from a budget deficit and/or debt-to-GDP ratio perspective allows for additional expansionary fiscal policy to help stimulate economies. Many countries have already started this process, including China, India, Korea, Mexico and Poland, while more are set to follow over the coming 12 months. These factors should help support stronger topline revenue growth for companies across EM.

In addition, companies' increased focus on profitability and capital efficiency is expected to enhance bottom-line earnings delivery. The slower economic growth environment in recent years has taught management teams the importance of disciplined cost management to help offset the impact of negative operating leverage on profit margins. Our regular interactions and active engagement with companies suggest this positive change in behavior is becoming the new norm. Politicians and regulators in several EM countries are also encouraging a focus on capital market efficiency and improved corporate governance. This suggests a growing understanding of the benefits that higher corporate profits, dividend payouts and local market equity valuations can have for government fiscal revenues and local pension funding.

2. Underappreciated Emerging Market Attributes

A sustained period of underperformance often leads investors to focus on the negatives and overlook the positives associated with that asset class. This is very much the case with EM equities today, where many existing attributes seem less appreciated by investors compared to the attention they often receive in DM equities. The benefits of EM equities include:

- **Innovation**
- **Consumption Potential**
- **Natural Resources**

Each of these can play an important role in driving earnings growth for the asset class over the medium term.

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Innovation is evident in many areas across EM, but the technology space stands out, specifically in regions where AI enablers reside. EM has the most advanced semiconductor foundry in the world, which produce leading-edge AI server processors for Nvidia. The assemblers of these AI servers are also EM companies, and two of the three largest memory producers essential to AI servers are Korean. The recent performance statistics from large language models in China developed by companies such as DeepSeek and Alibaba highlight how EM is helping to push the boundary in advancing AI.

Innovation can be found in other areas across EM as well, including electric vehicles. China represents 50% of the global electric vehicle market, and Chinese companies have become global leaders in space over the past five years. EM companies have become dominant in key components for electric vehicles such as batteries, operating systems, touch-screen technology and ADAS (Advanced Driving Assistance Systems).

Consumption potential is another key attribute widely found across EM. India is forecasted to experience rapid expansion in the upper-middle and high-income categories over the next two decades, which should continue to create investment opportunities in organized retail, ecommerce, and the services/experience industries. Additionally, the economic convergence of Eastern European economies has created a new generation of aspirational and wealthy consumers in countries like Poland. Favorable demographics in Latin America, South Africa, the Middle East and ASEAN will also support rising penetration not only in various consumer staple and discretionary segments, but also in key areas such as financial services. Even an aging China holds much promise from a consumption perspective, as the economy is expected to shift from fixed investment led growth toward domestic consumption over the next decade and beyond.

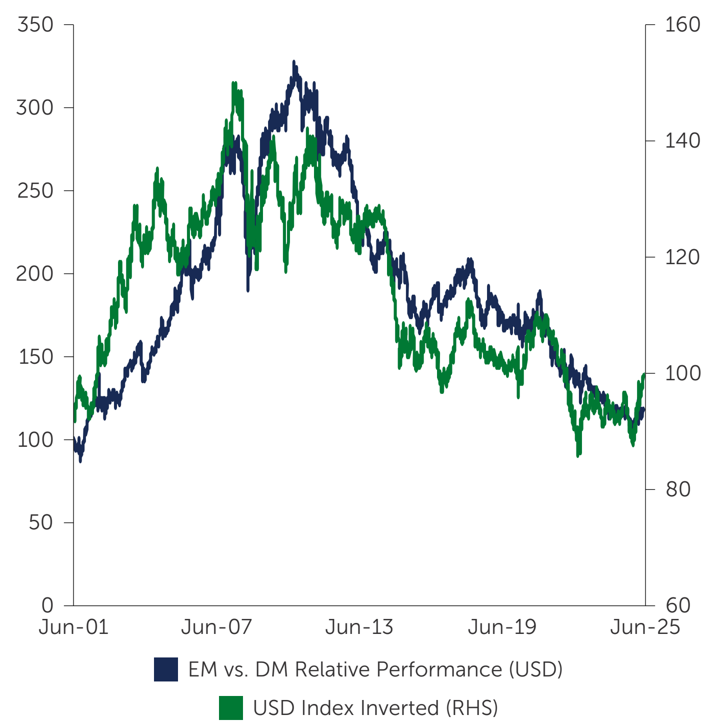
EM is rich in many **national resources**, including copper and lithium, which are required to support energy transition and AI infrastructure build-out. There will be an estimated 70% increase in annual demand for copper by 2050, challenging supply to keep up with demand. Latin America is well positioned to benefit, with world-class commodity deposits making it the leading region for copper sourcing.

Soft commodities represent another area where emerging markets—particularly Brazil—are well-positioned. Over the past 25 years, Brazil has tripled its grain and soybean production, driven in large part by its world-class agricultural sector. A key advantage is Brazil's ability to harvest twice annually, thanks to its tropical climate and fertile soil. In contrast, regions like Europe and North America typically produce only one major harvest per year.

3. USD Tailwind

There is an inverse relationship between the U.S. dollar and MSCI EM equities **(Figure 2)**. A stronger U.S. dollar is typically associated with tightening liquidity, particularly in EM, where domestic money market interest rates often rise to compensate investors for holding depreciating local currencies. The increased local discount rate can in turn place downward pressure on equity valuations. A strong U.S. dollar also increases the cost of imports, which can be harmful for inflation and influence official monetary policy, ultimately affecting the broader economic outlook. Higher import costs may also compress corporate profit margins, especially for companies with limited ability to pass these costs on to consumers.

Figure 2: EM and USD

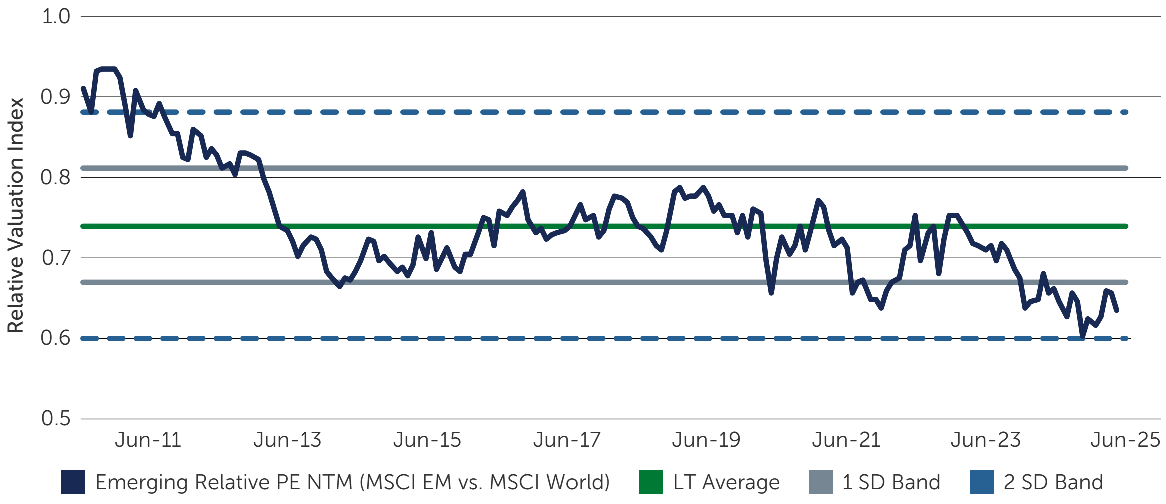


Sources: MSCI; Refinitiv. As of June 30, 2025.

As bottom-up EM investors, we prefer to avoid making macro forecasts such as predicting the future direction of the U.S. dollar. However, after many years of appreciation, there is growing belief that the U.S. dollar is due for an extended period of consolidation or reversal. Should this occur, it would likely prove to be another powerful tailwind for EM equities.

4. Valuation

Figure 3: EM Relative NTM PE



Sources: MSCI; Refinitiv. As of June 30, 2025.

Emerging market equity valuations peaked in 2011, and over the past 14 years have consistently de-rated relative to their developed market peers. Additionally, the valuation of the asset class is currently deeply discounted compared to its own long-term average.

Just as the elevated valuation of 2011 suggested investor expectations were unrealistically high, we believe the depressed valuation of EM today implies expectations are overly negative. Emerging market equities are arguably entering a new era of opportunity, supported by improving earnings, structural innovation, and attractive valuations. While past challenges have tempered investor enthusiasm, today's EM landscape is defined by resilient fundamentals, dynamic consumption trends, and a potential tailwind from a stabilizing U.S. dollar. For investors seeking long-term growth, EM equities offer compelling value and diversification potential as the asset class continues to evolve.

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