Global Insights

The Emerging Question: A Three-Part Series on Investing in Emerging Markets

In its March 31, 2022 “Annual Update of GIC Capital Market Assumptions,” the Global Investment Committee (GIC) pointed to better opportunities among international equities than US stocks over a strategic, or seven-year, horizon. Since then, a wave of selling consistent with capitulation has occurred, and the MSCI Emerging Markets Index is suffering its fourth worst bear market since 1995. In fact, only the Asian Financial Crisis, dot-com bubble and Great Financial Crisis saw more challenging drawdowns.

Since the upgrade of emerging markets and Asia ex Japan equities by Morgan Stanley & Co.’s chief Asia and emerging market equity strategist on Oct. 4, we have received an influx of inquiries regarding the scope of the recommendation. We think the setup for emerging markets is compelling and see a variety of tailwinds supporting the region.

This issue of Global Insights introduces a three-part series dedicated to exploring opportunities in emerging markets.
There is no universally accepted definition of an emerging market. In our July 2021 Global Insights, “Some EMs Are Not Like the Others,” we explored the limitations of making investment decisions for emerging markets as a whole. Naturally, we concede that there are some similarities within the grouping, such as underinvestment in infrastructure or underdeveloped capital markets.

Still, across regions, there have been relative winners and losers based on price returns (see Exhibit 1). Therefore, we urge investors to resist the temptation to view the group as monolithic. For example, the return dispersion for the regions that make up the MSCI Emerging Markets Index was 83.7% from 2010 to 2022. This factors in declines of 84.5% in emerging Europe and 0.8% in Asia ex Japan for the 12-year period following the index’s lengthy outperformance of the S&P 500 Index in the early 2000s (see Exhibit 13).

Exhibit 1: Emerging Markets Are Not Monolithic

At the country level, price return dispersion has been even greater—approaching 425% for the 24 emerging market economies in the MSCI Emerging Markets Index. This reflects a 91% decline in the MSCI Greece Index, driven by the European debt crisis, and a 329% gain in the MSCI Turkey Index, driven in part by extremely unorthodox monetary policy (see Exhibit 2).

The global pandemic presented a further challenge that disrupted a standard for thinking about emerging markets. In our April 2021 Global Insights, “COVID-19 Vaccines and an Uneven Recovery,” we reflected on the potential for an uneven recovery from the global pandemic; we believe that continues to be the case. The ongoing strictness of China’s COVID policies is emblematic of the pandemic’s unequal impact (see Exhibit 3).

Exhibit 2: Return Dispersion Among Individual Countries Has Been Wide

At the cycle low, the global economy has improved, thanks in part to a synchronized policy response that fueled rapid price increases. As a result of price gains running at levels not seen in decades, the synchronous recovery was quickly followed by asynchronous policy tightening. The sharp price increases have varied from country to country, driven in part by...
uneven economic recoveries from COVID. For example, annualized Asia Pacific consumer price gains, weighted by gross domestic product (GDP), made a cycle peak of 3.8% in September—well below 9.9% for global prices (see Exhibit 4).

Exhibit 4: Rising Inflation Is a Global Phenomenon

<table>
<thead>
<tr>
<th>Year</th>
<th>GDP-Weighted Inflation, Year Over Year</th>
</tr>
</thead>
<tbody>
<tr>
<td>2017</td>
<td>2%</td>
</tr>
<tr>
<td>2018</td>
<td>4%</td>
</tr>
<tr>
<td>2019</td>
<td>6%</td>
</tr>
<tr>
<td>2020</td>
<td>8%</td>
</tr>
<tr>
<td>2021</td>
<td>10%</td>
</tr>
<tr>
<td>2022</td>
<td>12%</td>
</tr>
</tbody>
</table>

Note: Asia Pacific is China, Hong Kong, India, Indonesia, Malaysia, Philippines, Singapore, South Korea, Taiwan, Thailand and Vietnam.
Source: Bloomberg, Morgan Stanley Wealth Management Global Investment Office as of Sept. 30, 2022

Ultimately, central banks ramped up their fight against higher prices amid fears that inflation could derail the post-COVID recovery. It seems, however, that emerging market countries got a head start on their developed market peers. For example, Brazil lifted its policy rate to 13.25% from an all-time low of 2% in just 17 months—pausing in August, just five months after the Federal Reserve’s first rate hike. Other emerging markets followed Brazil, albeit at a slightly more modest pace.

Rate hikes in emerging market nations have slowed, and as a result, their central bankers have found themselves out of sync with developed market peers. Based on MSCI categorization and our own evaluations, and defining a “hike” as every 25-basis-points worth of policy rate increase, we found that over the past two years, emerging, frontier and developed market economies have hiked 477, 233 and 102 times, respectively and in aggregate. What’s more, over the past six months, the same countries hiked 230, 128 and 92 times, respectively (see Exhibit 5). Said another way, for the emerging market economies that we measured, 48% of the tightening enacted by their central banks over the past two years occurred in the past six months. That compares to 90% for developed markets.

Exhibit 5: The Emerging Market Central Bank Tightening Cycle Is Slowing Versus Developed Markets

Still, monetary policy is just one of many levers available to influence outcomes. Fiscal policy is also an important consideration. In the aftermath of stimulative spending, governments face the tricky task of bringing debt down to more sustainable levels. In fact, according to the International Monetary Fund (IMF), government debt in emerging markets is up by almost 10% since 2019 and reached an estimated 64% of total GDP at the end of 2021.

Unquestionably, debt burdens will vary across economies, but we think it is likely that policymakers will tighten their fiscal stances. In fact, we see evidence that the fiscal impulse that supported emerging markets during the global pandemic could flip from a strong tailwind to a modest headwind as government spending is lowered. According to IMF and World Bank data, the percentage of “emerging market and developing economies” with tightening fiscal stances is likely to grow to nearly 85% by 2023, from just under 70% at the start of 2021 (see Exhibit 6).
Exhibit 6: Some Emerging Economies Could Be Vulnerable to Tighter Fiscal Stances

The key point is that many emerging market economies are on different flight paths, and the recent selloff could present an opportunity for investors. Successful investing involves buying cheap stocks with above average growth rates. To be sure, emerging market stocks are trading cheaply relative to developed markets and their own history.

For example, the MSCI Emerging Markets Index’s 12-month forward price/book (P/B) ratio is now at its 23rd percentile level since 2005, while its 12-month forward price/earnings (P/E) and price/sales (P/S) ratios are at their 15th and 2nd percentile levels, respectively. Emerging market equities also appear attractive versus developed market equities, especially when factoring in currency valuations. In the chart below, we plotted the cyclically adjusted price-to-earnings (CAPE) ratio of major emerging market and developed market MSCI equity indexes, as well as the average for developed and emerging market countries. The developed market economies are highlighted in blue, while the emerging market economies are highlighted in green. A lower CAPE ratio suggests a more attractively valued equity index relative to long-term inflation-adjusted earnings. We then estimated each currency’s valuation according to its relative standing versus the US dollar over the past 20 years. Lower Z-scores indicate lower valuations. For the US, we based the currency Z-score on the US Dollar Index.

We found that developed markets had higher CAPE ratios and currency Z-scores, on average, than emerging markets (see Exhibit 7). Notably, the US is an outlier in terms of equity and currency valuation.

Finally, not only are investors being offered cheap valuations for emerging market equities, but they are also being rewarded more for taking on equity risk. In the chart below, we plot the equity risk premium (ERP)—the compensation above the risk-free rate that an equity investor requires to own stocks. We see that investors in the MSCI Emerging Markets Index are receiving more compensation, given its higher ERP versus the MSCI EAFE Index and the S&P 500 Index (see Exhibit 8).

Exhibit 7: Emerging Markets Are Attractively Valued From Both an Equity and Currency Standpoint.

Note: Z-score is a statistical measurement of a score’s relationship to the mean in a group of scores. A Z-score of 0 means the score is the same as the mean. Source: Bloomberg, Morgan Stanley Wealth Management Global Investment Office as of Oct. 26, 2022

Exhibit 8: Emerging Market Valuations Are Attractive

Note: Blended Emerging Markets is an equal-weight mix of India, China, Brazil and South Korea. Source: Bloomberg, Morgan Stanley Wealth Management Global Investment Office as of Sept. 30, 2022

Additionally, investors are being compensated more for taking on credit risk in emerging markets, especially among high yield corporate bonds. Local currency emerging market debt currently offers attractive income and valuations and has largely priced in tighter monetary policy and still-elevated...
inflation. The current spread between emerging market high yield bonds and investment grade bonds is at the 95th percentile since 2000, while the spread between emerging market high yield bonds and US high yield bonds is at the 99th percentile since 2000 (see Exhibit 9).

**Exhibit 9: Emerging Market Credit Offers Meaningfully Higher Yield Differentials**

![Graph showing yield differentials between various categories of bonds.](image)


Despite attractive valuations, there are risks to our positive outlook for emerging markets. First, a global recession could potentially suppress demand for risk assets. Should the global slowdown be deeper and longer than expected, cyclically oriented economies could struggle. Second, should US dollar strength persist and inflation remain sticky, emerging market economies may be forced to tighten monetary policy further, which could weigh on growth. Notably, the negative correlation between the dollar and some emerging market economies is well documented. Finally, lower global prices could become entrenched amid demand destruction. Not only would this affect exporters’ revenues and profit margins, but also their countries’ respective current account balances.

**Investment Implications**

Emerging markets are not a monolith, and we see opportunities in the broadly defined category. Unprecedented monetary and fiscal policies have led to an era of higher inflation and asynchronous tightening. Although emerging market assets should broadly benefit from current trends, there are opportunities to be more selective. We will explore this further, on a regional basis (i.e., Latin America, Asia and Europe), later in the series.
Exhibit 10: International Equities Are Projected to Outperform US Large Cap, According to the GIC’s Capital Market Assumptions


Exhibit 12: Could Higher Prices for Key Exports Offset Lower Volumes and Reduce Current Accounts?

Source: Bloomberg, Morgan Stanley Wealth Management Global Investment Office as of Oct. 27, 2022

Exhibit 11: Emerging Market Bond Funds Face Net Weekly Outflows


Exhibit 13: The MSCI Emerging Markets Index Has Underperformed the S&P 500 Since 2010


Please refer to important information, disclosures and qualifications at the end of this material.
Emerging market currencies have fallen approximately 8% versus the US dollar this year, on average (see Exhibit 14). Given the support of stronger public sector balance sheets, tighter monetary policies and elevated commodity prices, the declines have been smaller than during previous periods of dollar strength. Near-term uncertainty regarding the currencies is being driven by concerns about global GDP growth, which was down 0.9% in the second quarter, the upcoming refinancing at higher interest rates of more than $1 trillion in emerging market debt and geopolitical issues. Longer-term, deglobalization may provide a tailwind for emerging market economies, as developed economies increasingly look to “near-shoring” to better secure supply chains and strategically important commodities. —Brad Fulton

Disclosure Section

Index Definitions

STRINGENCY INDEX is a composite measure based on nine response indicators including school closures, workplace closures and travel bans.

For other index, indicator and survey definitions referenced in this report please visit the following: https://www.morganstanley.com/wealthinvestmentsolutions/wmir-definitions

Glossary

Important note regarding economic sanctions

This report may involve the discussion of country/ies which are generally the subject of selective sanctions programs administered or enforced by the U.S. Department of the Treasury’s Office of Foreign Assets Control (“OFAC”), the European Union and/or by other countries or multinational bodies. The content of this presentation is for informational purposes and does not represent Morgan Stanley’s view as to whether or not any of the Persons, instruments or investments discussed are or may become subject to sanctions. Any references in this presentation to entities or instruments that may be covered by such sanctions should not be read as recommending or advising on any investment activities involving such entities or instruments. You are solely responsible for ensuring that your investment activities in relation to any sanctioned country/ies are carried out in compliance with applicable sanctions.

Risk Considerations

Investing in foreign markets entails greater risks than those normally associated with domestic markets, such as political, currency, economic and market risks. Investing in currency involves additional special risks such as credit, interest rate fluctuations, derivative investment risk, and domestic and foreign inflation rates, which can be volatile and may be less liquid than other securities and more sensitive to the effect of varied economic conditions. In addition, international investing entails greater risk, as well as greater potential rewards compared to U.S. investing. These risks include political and economic uncertainties of foreign countries as well as the risk of currency fluctuations. These risks are magnified in countries with emerging markets and frontier markets, since these countries may have relatively unstable governments and less established markets and economies. Yields are subject to change with economic conditions. Yield is only one factor that should be considered when making an investment decision.

Equity securities may fluctuate in response to news on companies, industries, market conditions and general economic environment.

Bonds are subject to interest rate risk. When interest rates rise, bond prices fall; generally the longer a bond’s maturity, the more sensitive it is to this risk. Bonds may also be subject to call risk, which is the risk that the issuer will redeem the debt at its option, fully or partially, before the scheduled maturity date. The market value of debt instruments may fluctuate, and proceeds from sales prior to maturity may be more or less than the amount originally invested or the maturity value due to changes in market conditions or changes in the credit quality of the issuer. Bonds are subject to the credit risk of the issuer. This is the risk that the issuer might be unable to make interest and/or principal payments on a timely basis. Bonds are also subject to reinvestment risk, which is the risk that principal and/or interest payments from a given investment may be reinvested at a lower interest rate.

Bonds rated below investment grade may have speculative characteristics and present significant risks beyond those of other securities, including greater credit risk and price volatility in the secondary market. Investors should be careful to consider these risks alongside their individual circumstances, objectives and risk tolerance before investing in high-yield bonds. High yield bonds should comprise only a limited portion of a balanced portfolio.

Yields are subject to change with economic conditions. Yield is only one factor that should be considered when making an investment decision.

Asset allocation and diversification do not assure a profit or protect against loss in declining financial markets.

Investing in commodities entails significant risks. Commodity prices may be affected by a variety of factors at any time, including but not limited to, (i) changes in supply and demand relationships, (ii) governmental programs and policies, (iii) national and international political and economic events, war and terrorist events, (iv) changes in interest and exchange rates, (v) trading activities in commodities and related contracts, (vi) pestilence, technological change and weather, and (vii) the price volatility of a commodity. In addition, the commodities markets are subject to temporary distortions or other disruptions due to various factors, including lack of liquidity, participation of speculators and government intervention.

The returns on a portfolio consisting primarily of environmental, social, and governance-aware investments (ESG) may be lower or higher than a portfolio that is more diversified or where decisions are based solely on investment considerations. Because ESG criteria exclude some investments, investors may not be able to take advantage of the same opportunities or market trends as investors that do not use such criteria. The companies identified and investment examples are for illustrative purposes only and should not be deemed a recommendation to purchase, hold or sell any securities or investment products. They are intended to demonstrate the approaches taken by managers who focus on ESG criteria in their investment strategy. There can be no guarantee that a client’s account will be managed as described herein.

Rebalancing does not protect against a loss in declining financial markets. There may be a potential tax implication with a rebalancing strategy. Investors should consult with their tax advisor before implementing such a strategy. The indices are unmanaged. An investor cannot invest directly in an index. They are shown for illustrative purposes only and do not represent the performance of any specific investment. The indices selected by Morgan Stanley Wealth Management to measure performance are representative of broad asset classes. Morgan Stanley Wealth Management retains the right to change representative indices at any time.
Disclosures

Morgan Stanley Wealth Management is the trade name of Morgan Stanley Smith Barney LLC, a registered broker-dealer in the United States. This material has been prepared for informational purposes only and is not an offer to buy or sell or a solicitation of any offer to buy or sell any security or other financial instrument or to participate in any trading strategy. Past performance is not necessarily a guide to future performance. The author(s) (if any authors are noted) principally responsible for the preparation of this material receive compensation based upon various factors, including quality and accuracy of their work, firm revenues (including trading and capital markets revenues), client feedback and competitive factors. Morgan Stanley Wealth Management is involved in many businesses that may relate to companies, securities or instruments mentioned in this material.

This material has been prepared for informational purposes only and is not an offer to buy or sell or a solicitation of any offer to buy or sell any security/instrument, or to participate in any trading strategy. Any such offer would be made only after a prospective investor had completed its own independent investigation of the securities, instruments or transactions, and received all information it required to make its own investment decision, including, where applicable, a review of any offering circular or memorandum describing such security or instrument. That information would contain material information not contained herein and to which prospective participants are referred. This material is based on public information as of the specified date, and may be stale thereafter. We have no obligation to tell you when information herein may change. We make no representation or warranty with respect to the accuracy or completeness of this material. Morgan Stanley Wealth Management has no obligation to provide updated information on the securities/instruments mentioned herein.

The securities/instruments discussed in this material may not be appropriate for all investors. The appropriateness of a particular investment or strategy will depend on an investor’s individual circumstances and objectives. Morgan Stanley Wealth Management recommends that investors independently evaluate specific investments and strategies, and encourages investors to seek the advice of a financial advisor. The value of and income from investments may vary because of changes in interest rates, foreign exchange rates, default rates, prepayment rates, securities/instruments prices, market indexes, operational or financial conditions of companies and other issuers or other factors. Estimates of future performance are based on assumptions that may not be realized. Actual events may differ from those assumed and changes to any assumptions may have a material impact on any projections or estimates. Other events not taken into account may occur and may significantly affect the projections or estimates. Certain assumptions may have been made for modeling purposes only to simplify the presentation and/or calculation of any projections or estimates, and Morgan Stanley Wealth Management does not represent that any such assumptions will reflect actual future events. Accordingly, there can be no assurance that estimated returns or projections will be realized or that actual returns or performance results will not materially differ from those estimated herein.

This material should not be viewed as advice or recommendations with respect to asset allocation or any particular investment. This information is not intended to, and should not, form a primary basis for any investment decisions that you may make. Morgan Stanley Wealth Management is not acting as a fiduciary under either the Employee Retirement Income Security Act of 1974, as amended or under section 4975 of the Internal Revenue Code of 1986 as amended in providing this material except as otherwise provided in writing by Morgan Stanley and/or as described at www.morganstanley.com/disclosures/dol.

Morgan Stanley Smith Barney LLC, its affiliates and Morgan Stanley Financial Advisors do not provide legal or tax advice. Each client should always consult his/her personal tax and/or legal advisor for information concerning his/her individual situation and to learn about any potential tax or other implications that may result from acting on a particular recommendation.

This material is disseminated in Australia to "retail clients" within the meaning of the Australian Corporations Act by Morgan Stanley Wealth Management Australia Pty Ltd (A.B.N. 19 009 145 555, AFSL No. 240813). Morgan Stanley Wealth Management is not incorporated under the People's Republic of China ("PRC") law and the material in relation to this report is conducted outside the PRC. This report will be distributed only upon request of a specific recipient. This report does not constitute an offer to sell or the solicitation of an offer to buy any securities in the PRC. PRC investors must have the relevant qualifications to invest in such securities and must be responsible for obtaining all relevant approvals, licenses, verifications and or registrations from PRC’s relevant governmental authorities.

If your financial adviser is based in Australia, Switzerland or the United Kingdom, then please be aware that this report is being distributed by the Morgan Stanley entity where your financial adviser is located, as follows: Australia: Morgan Stanley Wealth Management Australia Pty Ltd (ABN 19 009 145 555, AFSL No. 240813); Switzerland: Morgan Stanley (Switzerland) AG regulated by the Swiss Financial Market Supervisory Authority; or United Kingdom: Morgan Stanley Private Wealth Management Ltd, authorized and regulated by the Financial Conduct Authority, approves for the purposes of section 21 of the Financial Services and Markets Act 2000 this material for distribution in the United Kingdom. Morgan Stanley Wealth Management is not acting as a municipal advisor to any municipal entity or obligated person within the meaning of Section 15B of the Securities Exchange Act (the "Municipal Advisor Rule") and the opinions or views contained herein are not intended to be, and do not constitute, advice within the meaning of the Municipal Advisor Rule.

This material is disseminated in the United States of America by Morgan Stanley Wealth Management.

Third-party data providers make no warranties or representations of any kind relating to the accuracy, completeness, or timeliness of the data they provide and shall not have liability for any damages of any kind relating to such data.

This material, or any portion thereof, may not be reprinted, sold or redistributed without the written consent of Morgan Stanley Smith Barney LLC.

© 2022 Morgan Stanley Smith Barney LLC. Member SIPC.