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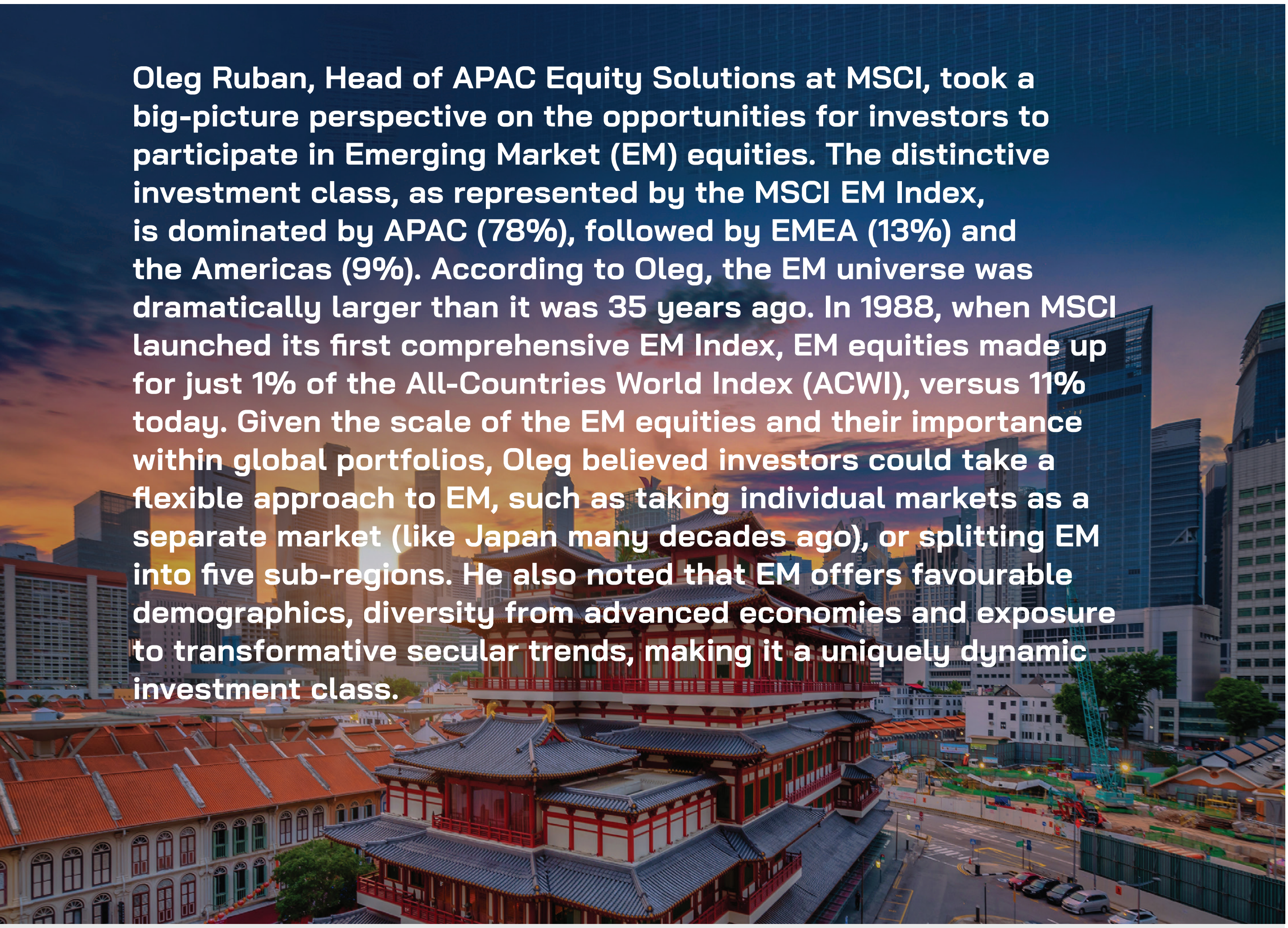
Dynamic Exposures: MSCI APAC Research Guru Discusses EM Opportunities and Risks



Oleg Ruban, Head of APAC Equity Solutions at MSCI, took a big-picture perspective on the opportunities for investors to participate in Emerging Market (EM) equities. The distinctive investment class, as represented by the MSCI EM Index, is dominated by APAC (78%), followed by EMEA (13%) and the Americas (9%). According to Oleg, the EM universe was dramatically larger than it was 35 years ago. In 1988, when MSCI launched its first comprehensive EM Index, EM equities made up for just 1% of the All-Countries World Index (ACWI), versus 11% today. Given the scale of the EM equities and their importance within global portfolios, Oleg believed investors could take a flexible approach to EM, such as taking individual markets as a separate market (like Japan many decades ago), or splitting EM into five sub-regions. He also noted that EM offers favourable demographics, diversity from advanced economies and exposure to transformative secular trends, making it a uniquely dynamic investment class.

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Historically, some investors were intensely focused on China, whose weight within EM grew rapidly until 2020.

He noted that China has been undergoing a transition in the past two decades. Industries such as financials, traditional energy, utilities, materials, and industrial real estate used to dominate China's economy. However, technology, healthcare, communications and digital services, as well as the consumer sectors are emerging as powerful economic drivers in recent years.

Reassessing China

Investors are increasingly reevaluating their allocations to China due to its size in the EM universe. Meanwhile, geopolitical tensions have raised questions about the investment opportunities related to China.

Some investors have started contemplating separating China from the rest of their EM allocations because of its size and the perception that its near-term risks may be different from other EM countries. That is akin to the approach taken with Japan decades ago, when the Japanese market was considered a unique market within the Asia equity space.

Nuances within EM

"If you look at the drivers of equity prices, you will see that dividends, margin expansion and sales growth have had a positive contribution to equity returns in EM ex China," said Oleg. "This contrasts with the drivers of performance in offshore Chinese stocks, or H-shares," he added.

He emphasized the richness of innovation spread across Asia, noting that a significant number of innovative enterprises originate from various emerging markets in the region such as India and Indonesia.

Splitting EM into different baskets?

"If allocating to emerging markets as a whole no longer seems viable, what kind of approach can we take?" he asked. "One possibility is to look at individual country allocations, but perhaps that makes sense mostly for the largest countries in the EM universe. Why? Because a lot of investors do not fancy analysing 24 individual EM countries when they are constructing their model portfolios or thinking about their asset allocation strategy."

An alternative approach is to look at regional or geographical blocks within emerging markets, which can be more efficient and manageable. By dividing emerging markets into five regional blocks, investors can capture many benefits while simplifying decision-making, as it reduces the number of decisions from 24 to just five. "This regional approach can be a viable and useful way to structure emerging market portfolios in the current environment," he suggested.

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"China Plus One" and its impact

With a growing number of companies diversifying their supply chains away from China, a concept known as 'China Plus One', or nearshoring, friendshoring, and reshoring emerged. Equity allocation will also need to take the phenomenon into consideration.

First, there will be countries benefitting from the supply chain diversification strategies of many firms. Think Vietnam, India, Mexico, Thailand and Malaysia. Second, there are ramifications from the disruption in global supply chains, which is typically inflationary. The situation could lead to higher demand for automation, including robotics and factory automation, which is employed at times to help mitigate inflationary pressures.

Third, there has been a noticeable increase in demand for commercial warehouses and industrial real estate in both Central and Eastern Europe and certain ASEAN countries, which could be linked to the rise of the "China Plus One" phenomenon.

"When considering the impact of supply chain diversification away from China, it is essential to explore sectors that might be affected," he noted. "One approach is to examine sectors impacted by geopolitical action. Another approach involves looking at sectors in China with significant economic exposure to foreign countries."

Oleg explained that in the context of "China Plus One", emerging markets can be segmented into different camps based on how internationally exposed they are economically. For example, Egypt primarily has a domestic economy. Taiwan is highly international. India falls somewhere in the middle.

"While this segmentation doesn't provide a complete picture," said Oleg, "it is still an interesting perspective to identify potential beneficiaries of the global supply chain restructuring."

India becomes a rising star

Within emerging markets, India has become a rising star, according to Oleg. "India has experienced

significant growth in various benchmarks, including the EM Index, the EM Exchange Index, and the All-Country World Index," he noted. "This growth has led to an enlarged opportunity set, marked by higher market capitalisation and a greater number of securities within India's investable universe."

From a fundamental perspective, he said this is supported by India's impressive growth trajectory. While some emerging markets are projected to experience slowing growth in the coming years, India's growth forecast for 2023, 2024, and 2025 remain stable. Historical growth rates for India have grown sustainably over time, and forecasts from institutions like the IMF and the World Bank suggest that this trend is expected to continue.

Changing times, changing approaches

Oleg concluded that given the fascinating and significantly changing landscapes, a more flexible approach to allocating to emerging markets is essential. This approach must consider the impact of supply chain diversification and capacity restructuring from China,. India, as a standalone country, stands out due to its recent performance, strong fundamentals , and relatively low correlations with major global markets.

"Taking a very adaptable approach to EM portfolio construction is vital in the evolving investment landscape," he said. ■