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# Emerging Markets 2.0:
## New Investment Mindset Required

Over the prior 40 years, or so, the Emerging Markets (EM) have witnessed multiple ups and downs. After starting as a "land of promise," the asset class lost steam sometime after the Great Financial Crisis. In this commentary, we trace that journey. We argue that EM remains an eminently investable and interesting asset class, but that the rules of the game have radically changed. We are now of the view that a new mindset is needed when investing in EM. We think the old days of investing in EM as a simplistic raw beta play are behind us. To successfully navigate the world of EM 2.0, investors must focus on differentiation, diversification, income, quality, disciplined risk management and rigorous research.

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## Executive summary

- Over the past 40 years, Emerging Markets (EM) have gone through a dizzying up and down. After being lauded as the new investment frontier,[1] the asset class lost steam sometime after the Great Financial Crisis.
- We believe the loss of market momentum very much reflected a marked downshift in EM's growth prospects. That, in turn, mirrored the plateauing of Chinese growth, de-globalization trends, rising EM indebtedness, and, like the advanced world, a sharp escalation in political polarization and volatility.
- The change in EM's landscape does not mean the asset class is not attractive. EM still offers significant opportunities and value propositions. What it does mean is that EM 2.0 requires an entirely different investment mindset.
- Investing in EM 2.0 necessitates laser focus on differentiation, diversification, income as a source of potential return and a preference for quality. To successfully navigate the asset class, the investment process must rely on deep and rigorous investment research, employ the various asset allocation levers available to them, and, crucially, have sophisticated risk measurement and management tools.


## EM as the "Land of Promise," and the Disappointing Aftermath

By the late 1980s, the then-labelled less-developed countries had gone through a wrenching "lost decade" where economies stagnated, inflation soared, politics destabilized, and dozens of countries experienced sovereign crises and defaults. Sometime around the early 1990s, a remarkable emergence took place. Underneath the transformation was a set of seminal historical events: 1) the fall of the Berlin Wall and the incorporation of many countries into a new (and more market oriented) world order; 2) the coming of age of post-Deng Xiaoping's China, creating a powerful locomotive for global growth; 3) trade agreements that ushered in a golden age of globalization; and 4) technological revolutions that brought the world much closer together. The Emerging Markets (as the group of countries eventually became known) themselves were part and parcel of this global transformation when a new set of reform-minded leaders took over and implemented wide-ranging macro-and micro-economic reforms, which, in turn, allowed the economies to truly benefit from these favorable global tailwinds.

The transformation delivered the hoped-for economic results. According to IMF data, EM's growth more than doubled between the 1980s and the 2000s. Within the same period, inflation collapsed, exports rose at almost

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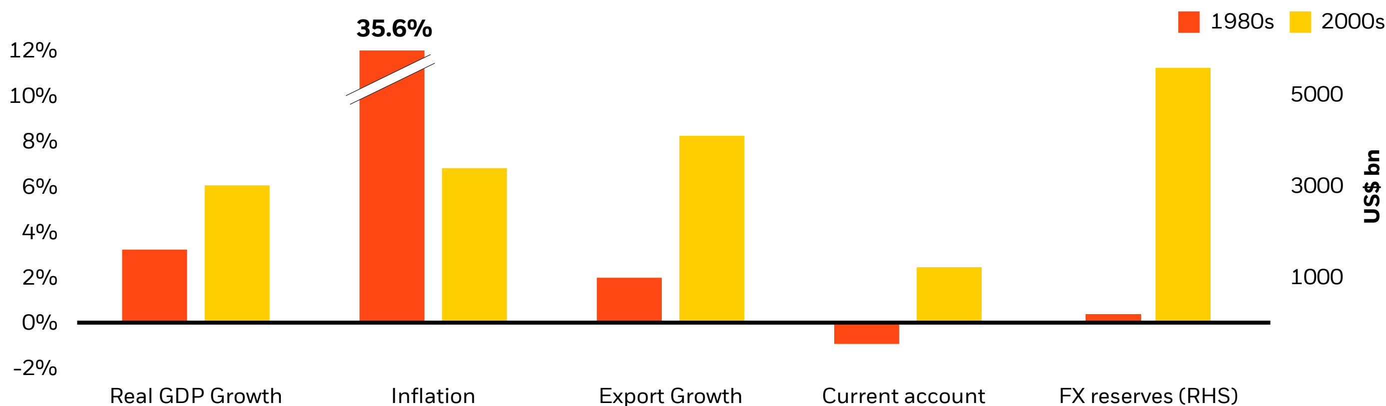
**Figure 1. Emerging Markets in the 1980s vs 2000s**




Sources: World Bank, International Monetary Fund and BlackRock calculations; data as of April 30, 2022

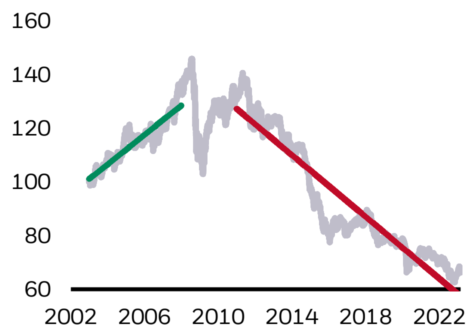
double-digit rates and, as a result, external accounts (including foreign exchange reserves) dramatically improved (see Figure 1). This stellar economic performance was no surprise. After all, EMs are labor-abundant, but capital-poor economies.

Capital markets quickly noticed the favorable political and policy transformations adopted at this time and investors increasingly saw EM as the "new promised land." This led to a dramatic increase in interest in the asset class and subsequent sharp rise in capital inflows that funded private sector exports of internationally competitive goods and services. In Figure 2, we illustrate the performance of different EM assets during the 2000s when all segments of the asset class (equities, hard currency, FX and local rates) sharply rallied.

**Figure 2. Historical Performance of Emerging Markets Assets**

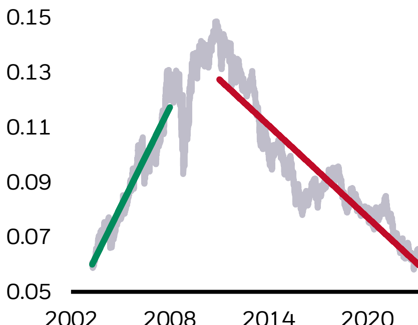
**EM Currencies***

EM FX Total Return



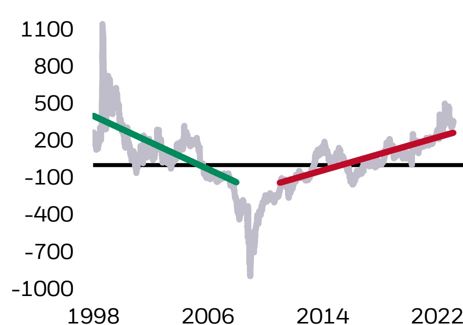

**EM Equities***

MSCI EM/MSCI ACWI



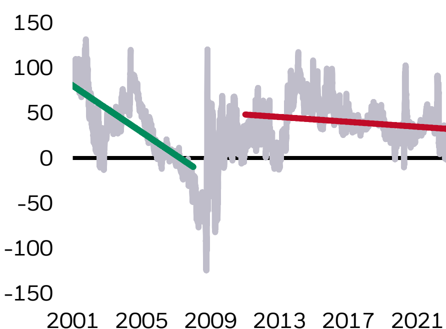

**EM High Yield (HY) Spread****

EM HY spread - US HY Spread



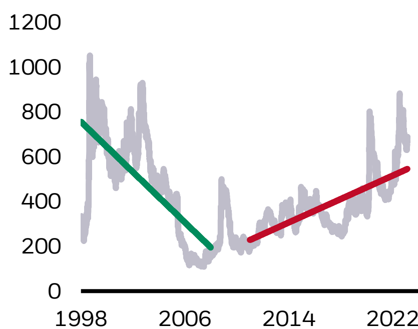

**EM Investment Grade (IG) Bond Spread****

EM IG Spread - US IG Spread



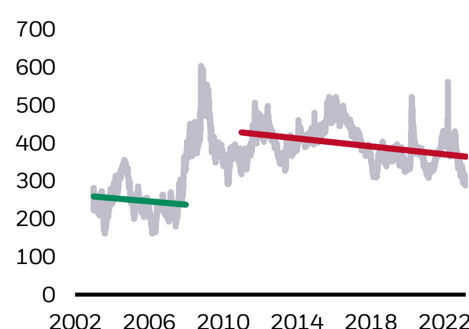

**EM HY vs IG Spread****

EM HY - EM IG Spread




**EM Local Currency Bonds Yield******

GBI-EM Yield - US Treasury Yield




* Total Return index relative to US index equivalent. ** Spread differential vs US spread or EM IG spread measured in bps **** Yield to maturity of GBI-EM index minus 10yr US Treasury Yield to maturity in bps. Notes: Green line indicates trend from 2004 (or earliest available) until 2008, Red line indicates trend from 2010 to latest data.
Source: Bloomberg, MSCI, JPMorgan, BlackRock, Data as of December 2022, for illustrative purposes only. Index performance returns do not reflect any management fees, transaction costs or expenses. Indices are unmanaged and one cannot invest directly in an index. **Past Performance is not indicative of future results**

Unfortunately, EM's golden age proved relatively short lived. Just as fast as EM rallied in the 2000s, the 2010s saw a gradual but steady removal of this premium (see the red lines in Figure 2). Our contention is that this de-pricing reflected a new fundamental EM reality. The remainder of this paper tries to explain the factors behind the reversal. It concludes with a section where we argue that the "EM 2.0," as we like to call it, still offers significant opportunities for potential durable returns, but that investing in it requires a different investment approach.

## What Changed for EM Economies in the Wake of the Global Financial Crisis?

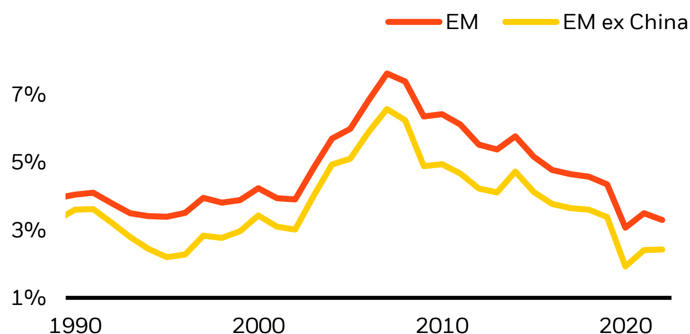
In our view, EM's disappointing performance is primarily explained by the sharp growth downshift experienced after the Great Financial Crisis. In turn, that slowdown reflected multiple and interrelated factors including a less powerful China pull; the difficulty EM experienced in replacing external growth sources with internal ones; the broad deglobalization trend; rising indebtedness; and the worsening political backdrop. Below, we delve into those dynamics in more detail.

### Growth slowdown

The key factor that changed in 2010 was that EM's growth boom ran out of steam. At its peak, EM was growing at an almost 8% pace, but by the time the Covid pandemic hit in 2020 the pace had fallen to just over 3% (see Figure 3). Where growth is concerned, compounding matters: at an 8% annual growth rate, an economy doubles roughly every 8 years but at a 3% rate of growth, the doubling occurs every 23 years. Moreover, and as we show in Table 1, the deceleration was not concentrated in just one or two areas but cut across all EM regions.

More interesting than EM's absolute growth slowdown is that, after 2010, *relative* performance also disappointed. A key insight of the "EM promise" is that the structural transformations of the 1990s allowed EM to grow at a clip sharply faster than that of their rich brethren. Sadly, EM started to lose the race after 2011, with growth differentials (vis-à-vis the Developed Markets) shrinking from four percentage points in 2010 to around one percent toward the end of the decade (see Figure 4).[2] With the DM growing at roughly the same pace as EM, it is no surprise investors shied away from paying a premium for EM assets.

**Figure 3. EM Trend Growth (1990-2022)**



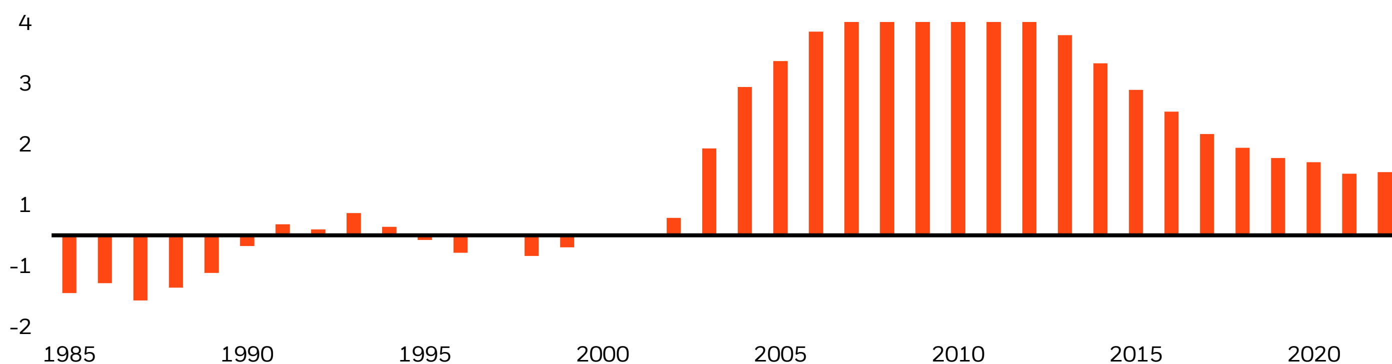

Note: Calculated as the 5 yr CAGR. Source: IMF, BLK calculations. Data as of January 2023

**Table 1. EM Trend GDP growth (%)**

| | 2003-2007 | 2015-2019 |
|---|---|---|
| EM | 6.2 | 4.7 |
| EM ex China | 5.3 | 3.7 |
| LatAm | 7.9 | 6.8 |
| EMEA | 6.1 | 2.9 |
| EM Asia | 6.2 | 4.7 |

Note: Calculated as the 5 yrs CAGR. Source: IMF, BLK calculations. Data as of January 2023

**Figure 4. EM (ex-China) / Developed Markets (DM) Annual Growth Differential (%)**




Sources: International Monetary Fund, BlackRock calculations, data as of December 30, 2022. Note: 2022 Forecasts are made by IMF.



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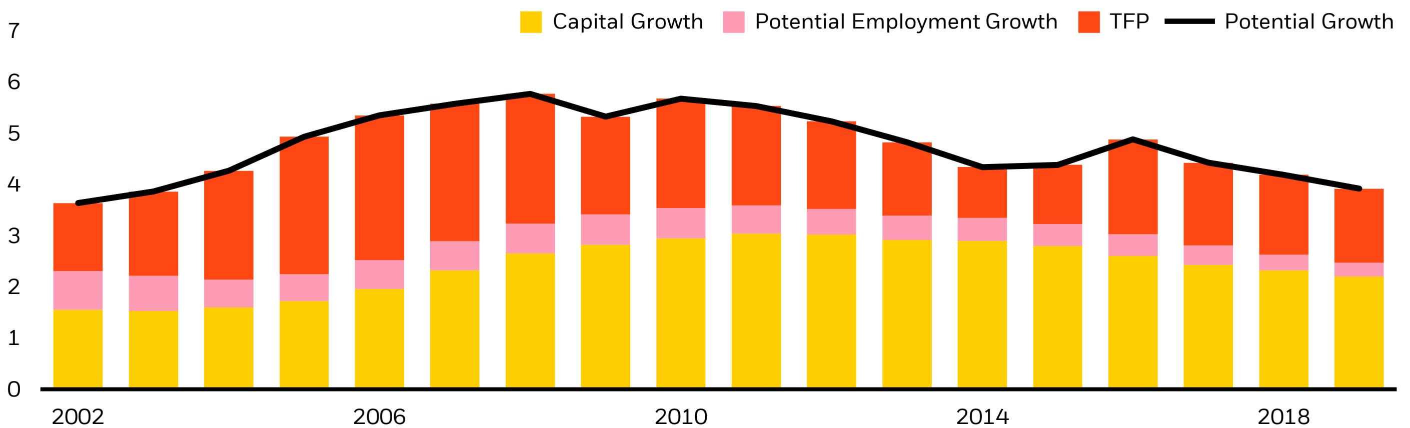
## Decomposing the Growth Downshift

What was behind the weakening in EM's growth? To answer that question, we employ a basic "growth accounting" framework. We decompose EM's economic growth performance into three buckets: 1) growth that came from the accumulation of capital (i.e., investment); 2) growth that came from labor's participation in the economic cycle and 3) growth that came from how those two resources (i.e., capital and labor) were employed—what economists refer to as "Total Factor Productivity."

The exercise's results are interesting (as displayed in Figure 5). Strikingly, the drop in growth was not explained by investment, which remained stable during this period (see Figure 6a). Also, while labor participation, as a contributor to growth, declined marginally in most regions (see Figure 6b), that was a relatively minor explanatory factor for growth's overall downshift. Instead, and by far, the most important factor explaining the EM growth slowdown was the meaningful drop in the productivity factor (see Figure 6c).

For us, the key question that arises is: what explains the disappointing productivity performance? We try to unpack these factors in the next few paragraphs.

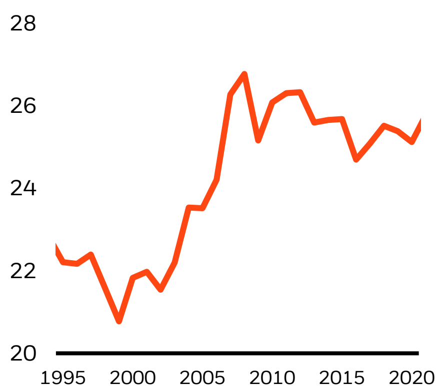
### Figure 5. EM (ex-China) Potential GDP Growth Decomposition (%)




Source: BLK calculations with data from OECD, UN population statistics, IMF. Methodology: Growth decomposition based on methodology outlined in Chapter 3 IMF World Economic Outlook 2015. Due to data availability countries included in the estimation are Brazil, Mexico, India, Russia and Turkey.

### Figure 6a. Capital

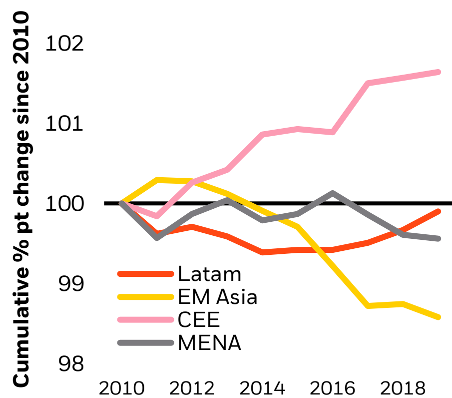
EMX Investment (% of GDP)




Source: International Monetary Fund, BlackRock calculations, data as of December 30, 2022. Excludes Covid-19 Period

### Figure 6b. Labor

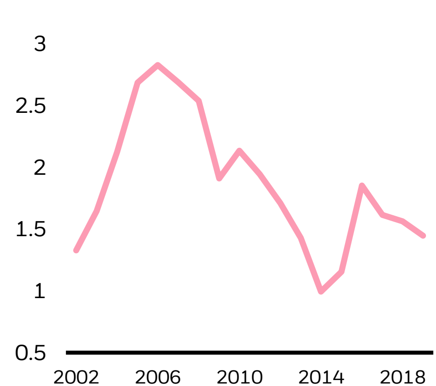
Change in Labor Participation Rate




Source: JP Morgan Research. Data as of September 2020.

### Figure 6c. Productivity

EM (ex-China) TFP Growth (%)




Source: BlackRock calculations with data from OECD, UN population statistics, IMF. Methodology: Growth decomposition based on methodology outlined in Chapter 3 IMF World Economic Outlook 2015. Due to data availability countries included in the estimation are Brazil, Mexico, India, Russia and Turkey. Excludes Covid-19 Period

## The Role of China in the EM Transformation

No discussion of the EM transformation is complete without touching on the Chinese economy. After all, as the giant economy embarked on its dramatic industrialization boom in the 1990s and 2000s, it demanded ever larger amounts of commodities and intermediate products, which the rest of EM specialized in producing. Figure 7 illustrates how dependent the rest of EM became on the North Asian giant. For example, in the 2000s one percentage point of incremental Chinese growth translated into a 0.3 percentage point of extra growth in the rest of EM. But, by 2019, this marginal contribution had almost doubled to 0.5. At its most basic level, the EM story of the 1990s and 2000s was that of a set of countries transforming themselves into becoming more and more integrated into China's own economic transformation.

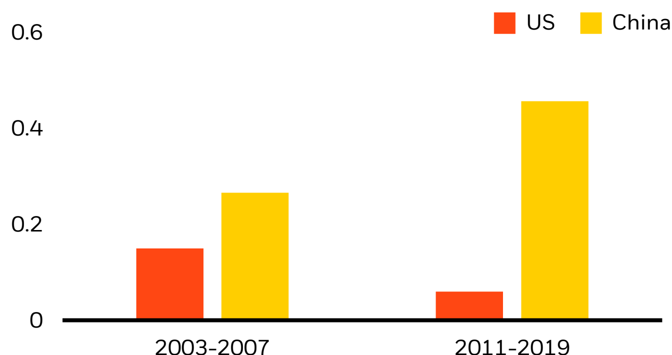
Unfortunately, precisely as the rest of EM grew more leveraged to China's growth, Chinese growth itself was starting to decelerate from double digit levels in 2010, to 8% in 2015 and to 5% more recently (see Figure 8).[3] Not surprisingly, as China's economy lost steam, so then did the rest of EM.

## Deglobalization

Another key to the growth spurt of the 2000s was EM's increasingly deeper integration into the global economy. Decades of inward-looking economic policies were replaced by a paradigm in which EM exported more and received more foreign capital. As global trade expanded, EM's share of that trade also grew, leading to better economic performance in EM itself (see Figure 9).

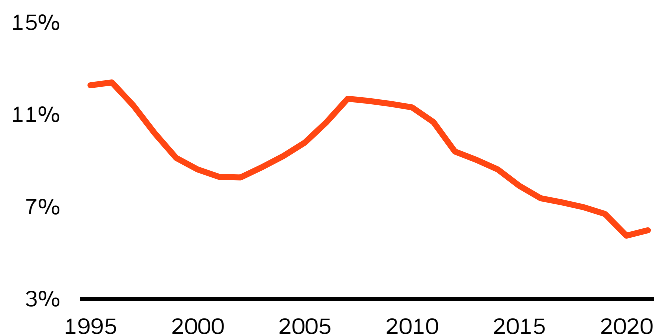
Here too, however, the globalization dynamic started reversing. As Figure 9 illustrates, global trade lost steam sometime around 2010 as did other forms of international integration including capital flows and labor migration.4 Just as the world coming together helped EM grow, the reversal of this trend, de-globalization, became a clear and present headwind.

### Figure 7: EM ex China Growth Beta



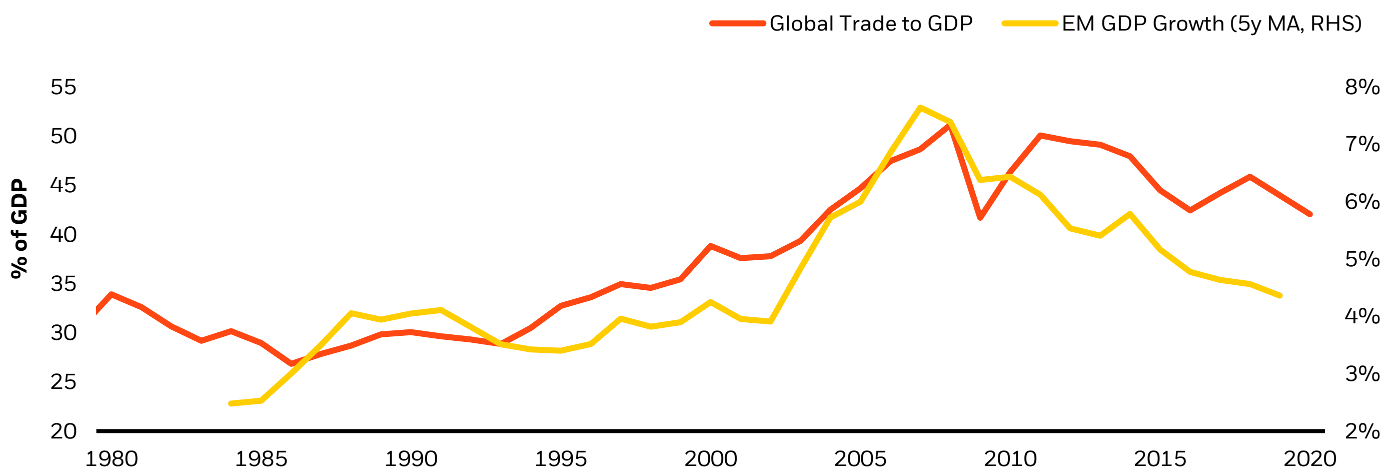

Note: EM ex China growth beta based on QoQ saar GDP growth
Source: BlackRock calculations. Haver Analytics, JP Morgan DataQuery. Data as of January 2023.

### Figure 8. China: GDP growth (% 5yr ma)




Source: BlackRock calculations. Haver Analytics. Data as of December 2022.

### Figure 9: Relationship Between Global Trade and EM Growth in a Deglobalizing World

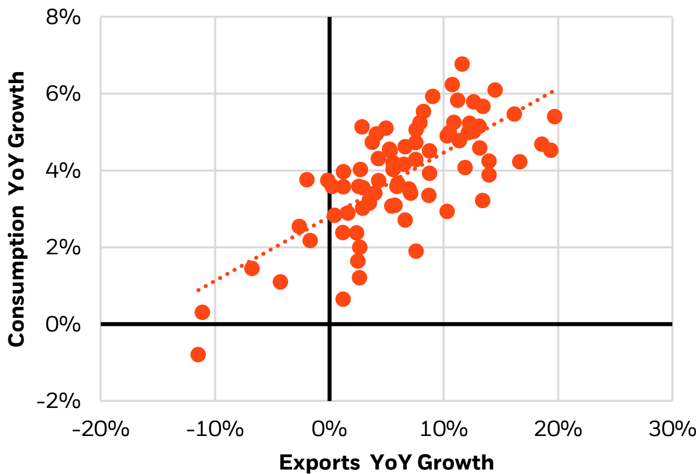



Sources: World Bank, International Monetary Fund and BlackRock calculations; data as of April 30, 2022

## Absence of an EM Domestic Growth Engine

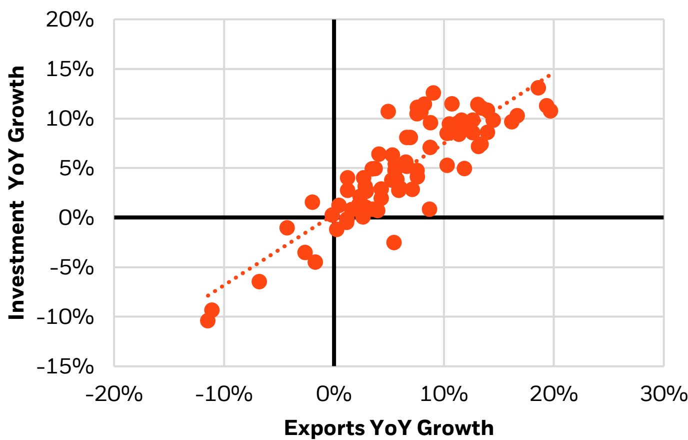
As external growth "pulls" (including Chinese slowdown and de-globalization) were losing steam, EM was unable to generate enough domestic growth to fill that gap. As Figures 10a and 10b indicate, EM's growth was (and remains) highly correlated to its export activity. Put differently, EM growth has largely been an externally led story. EM has, thus far, not been able to generate enough domestic organic sources of economic growth to counteract a slowdown in international linkages.

### Figure 10a: EM (ex-China) Exports vs Consumption Growth




Source: BlackRock calculations. Haver Analytics. Data from 1999 to 2019

### Figure 10b: EM (ex-China) Exports vs Investment Growth

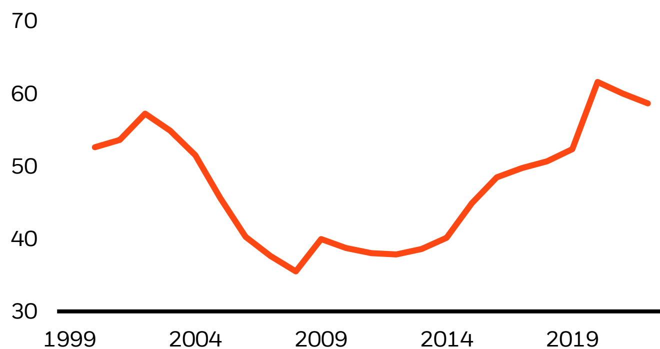



Source: BlackRock calculations. Haver Analytics. Data from 1999 to 2019

## Return of the Debt Overhang

A notable feature of the past decade is the rising spending by EM's governments.[5] Part of this reflected governments reacting to the 2008 global financial crisis and, eventually to the COVID pandemic of 2020-21. However, it also reflected governments trying to forestall the broader economic slowdown described above by using the fiscal lever. Not surprisingly, the result was a widening in EM fiscal deficits that rose from near balanced levels in 2010 to an average deficit of 4% of GDP in 2019. With global interest rates low and liquidity ample, these deficits were relatively easy to finance via debt, but of course, the result was a sharp rise in government debt (from 36% of GDP in 2008 to just below 60% currently—a level that the economics literature suggests is unsustainably high for developing economies (see Figure 11). However, as global interest rates normalize, debt servicing will (and, in some cases, has) become a material drain on national resources. There is ample empirical and theoretical evidence that maps higher debt servicing to lower (and less sustainable) levels of future growth.[6]

### Figure 11. EM (ex-China) Government Debt to GDP (%)




Source: International Monetary Fund, BlackRock calculations, data as of December 30, 2022

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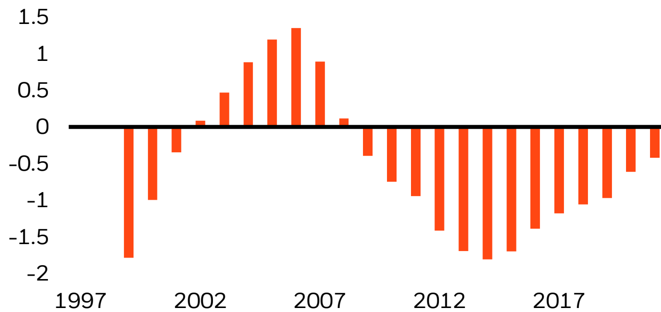
## EM External Accounts still Healthy, but there are some Flies in the Ointment

One area in which EM countries remain on solid footing is in their external accounts. Unlike the 1970s when external borrowing was massive and eventually led to the sovereign debt crises of the 1980s, EM's external accounts today are healthy. Current account deficits are modest and, if anything, have improved after the 2013 Taper Tantrum (see Figure 12). Moreover, EM today boasts an impressive arsenal of FX reserves that has rose from around US$1.1 trillion in 2015 to around US$7.1 trillion in 2021.[7] External resilience reflects an increased reliance on flexible exchange rates, and crucially, on a deepening of domestic capital markets that allowed replacing external borrowing with internal debt.

That said, there is a fly in this story's ointment. Historically, capital flows into EM have been correlated with the growth differential between EM and DM (see Figure 13). As EM growth lost its relative luster, capital has become harder to come by. With global rates normalizing and DM central banks withdrawing liquidity, we think external flows into EM are likely to face strong headwinds.

### Figure 12: EM (ex-China) Government Debt to GDP (%)




EM current account to GDP for EM excluding China and Golf Cooperation Council (GCC). Source: International Monetary Fund, BlackRock calculations, data as of December 30, 2022

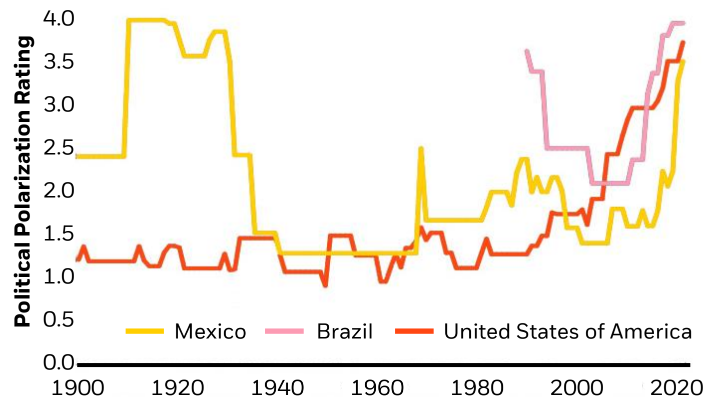
### Figure 13: Capital Flows and Growth Differential

Source: JP Morgan Research. Data as of April 2022

## Deteriorating Politics is no Coincidence

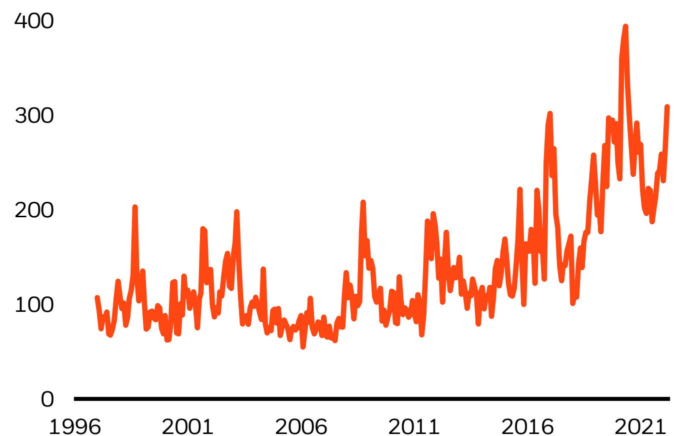
The last angle to explore is the distinct deterioration in governance and politics in EM. It is our view that the rise in populism and polarization in EM is no coincidence. These factors follow the slowing of growth and the frustrated aspirations of, especially, EM's middle class. To be fair, this is not solely an EM phenomenon, but is one that can be seen across DM too where policy responses to repeated crises since 2008 may have perpetuated political polarization (see Figure 14). Nonetheless, deteriorating *politics* (and the increased policy uncertainty shown in Figure 15) can be mapped to worsening *policies* which, in turn, have acted as a headwind to growth.

### Figure 14: Political Polarization Ratings




Source: Carnegie Endowment for International Peace. Coppedge et all. Data as of 2020

### Figure 15: EM Economic Policy Uncertainty (Index)

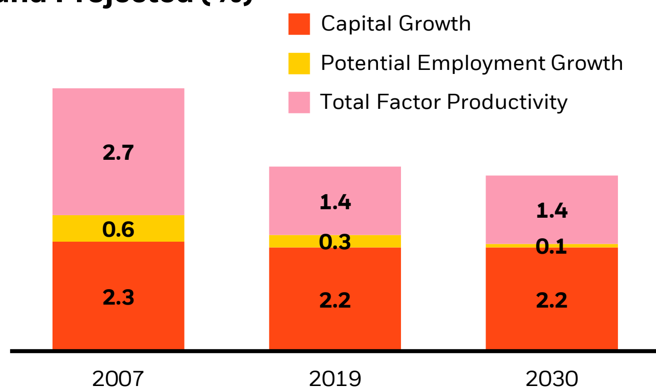



Source: : Haver, BlackRock. Data as of June 2022. Trimmed mean of individual country economic policy uncertainty indices.

### Forward looking perspectives on EM growth

So far, this commentary's focus has been on the past. The question, of course, is whether we can extrapolate these same dynamics into the future? The growth accounting framework we used above may shed some light on this question. In that regard, we think we can make a few forward-looking observations. First, we believe it is tough to see an acceleration in capital accumulation in EM, given continued deglobalization pressures, rising levels of debt (that will make funding these investments harder to come by) and structurally higher global rates. Second, labor growth in EM is already turning downward with the demographic dividend enjoyed by most EM countries running out of steam.[8] Finally, while we acknowledge that it is difficult to forecast productivity, given the political landscape we're now seeing in EM, we find it difficult to imagine an acceleration of structural reforms that could lead to greater efficiency. Figure 16 summarizes our attempt at putting some numbers to these broad forward-looking views. Our judgement is that over the next decade we are more likely to see a gradual (though slight) worsening in EM's growth potential than to see a favorable reversal.

**Figure 16. EM (ex China) Trend Growth—Past and Projected (%)**




Source: BLK calculations with data from OECD, UN population statistics, IMF. Methodology: Growth decomposition based on methodology outlined in Chapter 3 IMF World Economic Outlook 2015. Due to data availability countries included in the estimation are Brazil, Mexico, India, Russia and Turkey. Projections are illustrative in nature and do not express a forecast.

## What Are the Investment Implications of EM 2.0?

This paper has traced the changed economic and fundamental backdrop facing EM, noting that markets have already become aware of these changes and have steadily repriced the asset class (as we showed in Figure 2 at the outset). The question then becomes, do those changes require a different approach to investing in the asset class? Our view is that the answer is a resounding "yes." Below we spell out some of the implications of this new EM investing paradigm:

- **Not all EM is the same**. We do not think EM assets should be seen as a generic bet on a broad "EM promise." As a result, we do not think EM should be invested in as a "raw beta" play. Selectivity and differentiation are key elements for the new EM investment mindset. In fact, our analysis shows that dispersion in EM asset price changes has already risen.[9] We believe this trend will persist.
- **Asset allocation within EM is a too-important lever not to use.** EM is far from a uniform asset class and investors may allocate across regions, quality spectrums, and sub asset classes (including local markets, hard currency sovereigns, hard currency corporates, equities, private assets and distressed). Recently, correlations across those vectors have fallen.[10] Consequently, it is our view that dynamic asset allocation across EM asset classes is an important return lever for those seeking exposure to EM.
- **In EM debt, carry is powerful**.[11] Historically, investors tended to see EM as a "re-pricing" play. That approach made sense when the "EM promise" was in its ascendency and the asset class was steadily re-pricing stronger. As we discussed above, though, we believe those days are behind us. Instead, what we think is most compelling in our portfolios is to focus on monetizing the EM discount, which we define as the excess yield EM may offer over its DM comparators.[12]
- **High quality EM assets should be a core part of an EM portfolio**. In periods in which favorable macro backdrops dominate, it is reasonable for investors to prefer the riskiest EM names (for example, securities rated as sub investment grade). As we've argued throughout this paper though, we think the macro backdrop for EM has dramatically changed. While there definitely is a place for risky (and idiosyncratic) names in one's portfolio, we believe positions should not be concentrated in the lowest parts of the risk spectrum. EM is a wide-ranging asset class with ample high-quality names that may offer yield pickups to their DM comparators.
- **The benefits of diversification, especially in EM portfolios.** Concentrated positioning is reasonable when the "tide is rising" and rallying trends are powerful. However, our contention in this note is that EM's backdrop has structurally changed and risk in EM is now two-sided. In the meantime, as discussed above, intra-asset class correlations have fallen. As a result, we believe it would be more prudent to spread EM risk across a much wider net.

(Note: Diversification and asset allocation may not fully protect you from market risk.)

- **Rigorous research is necessary for EM 2.0**. EM is no longer a simplistic unidimensional thematic asset class. Indeed, the new EM paradigm we discussed throughout this paper requires numerous asset allocation and bottoms-up security selection decisions. Our view is that a well-staffed and deep research bench with access to data, systems and analytics is a necessary tool for effectively managing EM portfolios.
- **Comprehensive risk infrastructure is a prerequisite**. We believe EM debt is an attractive and potentially high yielding asset class, but with that yield, there is often volatility and occasionally large drawdowns. More so in a world in which EM is no longer benefitting from the kinds of tailwinds it experienced a decade ago. A disciplined approach to EM risk (both in terms of measuring and managing that risk) is an important tool when investing in EM.
- **ESG Analytics are a very powerful tool**. In early 2022, geopolitical developments resulted in severe and disruptive restrictions on investing in Russian assets. Unfortunately, we cannot rule out similar episodes in years to come, so ESG analytics (especially those focused on the "Governance" part of the framework) can be useful in preemptively identifying risks that go beyond traditional financial metrics.
- **Solution based EM investing**. Not all investors are equal in their EM needs. Given how heterogenous EM is, different investors may target different quality, regional, ESG specifications, and/or sub-asset class exposures. We believe a solutions-based investment approach (including customization) could be an important tool for EM investors.

## Conclusion

It is our contention that EM, as an asset class, has radically changed over the past two decades, and as a result, requires a novel investing approach. We think the days where one invested in EM as a "raw beta" play are gone. We believe differentiation, diversification, disciplined risk frameworks, rigorous research and solution-based investments are the hallmarks of successfully navigating the world of EM 2.0.

## Endnotes

1. In their 2003 paper called "Dreaming with the BRICS", Goldman Sachs coined the term "BRICS" to refer to Brazil, Russia, India, China and South Africa and predicted that by 2043 the group would become a much larger force in the world economy surpassing the largest six western economies. In 2005, they also coined the "Next 11" to refer to Bangladesh, Egypt, Indonesia, Iran, Korea, Mexico, Nigeria, Pakistan, Philippines, Turkey and Vietnam, as countries that would become the next BRICS and rival the G7 economies over time.
2. Here, we show the growth only for EM excluding China mainly to abstract from China's own dynamics (which we touch on below). The narrative won't change much if we incorporate China's growth into the aggregate.
3. Reasons for China's own slowdown are beyond the scope of this paper. They have to do with the Chinese economy exhausting gains from export- and investment-led growth and the downward pressure from increased leverage and deteriorating demographics. For an exhaustive discussion on the topic, see: https://carnegieendowment.org/chinafinancialmarkets/87007.
4. There are multiple examples one can give for the evolution of globalization outside pure trade in goods and services. For example, foreign flows to EM ex-China rose steadily in the early 2000s from 1.7% of GDP to 8.3% of GDP in 2007, but that metric fell back to around 3.7% of GDP between 2011 and 2019 (Data from IIF and IMF, data as of June 2022). Labor mobility also lost team: data from the UN shows that international migration growth that had accelerated from 1.4% annually to 2.9% in 2010, had fallen back to 2.5% annually since 2010.
5. To state the obvious, this wasn't just an EM phenomenon. Rich countries also reacted to the 2008 financial crisis and the COVID pandemic by sharply increasing spending.
6. See, for example, IMF Working Paper: Public Debt and Growth, Kumar and Woo, 2010.
7. Source: IMF, BLK calculations. Data as of Jan 2023
8. For the five countries used in our potential growth estimation, our estimations using UN population data projections show that working age population growth will decline from 1% in the late 2010s to 0.6% in the late 2020s. For all EM in aggregate, working age population growth will decline from 1.2% in the late 2010s to around 0.9% in the late 2020s. Forecasts are made by the UN. Forecasts may not come to pass. Data as of January 2023.
9. We measured dispersion as the square root of the averaged squared deviations from the markets' mean return. We ran the analysis across countries, regions, and ratings. Within each, we looked at FX, sovereign, corporate and local bonds. While there is no clear and linear trend across all these vectors, there is a spike in EM dispersion after 2015 and then after 2019. The results of the analysis are available upon request.
10. We ran EM cross asset correlations. For example, we looked at the correlation between EM hard currency and EM local bonds; between FX and hard currency sovereign bonds; etc. While the correlations changed over time, we observed a broad trend towards reduced co-movements especially after 2017. Results available upon request.
11. Using JPM EMBI Index data we calculated that 72% of total return of hard currency debt in EM from 2003-2010 came from carry. That ratio rose to a whopping 94% in 2011-2019. For local currency debt, using the GBI-EM index data we find that 71% of the total return came from carry pre 2010 and 94% after 2010.
12. For example, investment grade hard currency debt comprises 58% of the EM sovereign index (JPMorgan's EMBIG) and 65% of the corporate index (JPMorgan's CEMBI Broad index). In absolute terms, there are US$636bn of investment grade sovereign hard currency debt (at market value) and $690bn in investment grade corporate hard currency debt (at market value). Source: JPM Index data as of January 2023.

Risk management cannot fully eliminate the risk of investment loss.

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