Global Emerging Markets

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Time to rethink EM in the new multipolar world.

By Nick van Rensburg

The world is shifting from a unipolar world to a multipolar world. While this statement seems more obvious by the day, asset allocation has been slow to reflect the new reality.

Brexit, Trump, Covid, the CCP clampdown on Chinese Technology stocks and the Russian invasion of Ukraine have taught us that those who ignore geopolitics do so at their peril. Being geopolitically aware has become a necessary risk management tool through which we identify a range of risks, and then track signposts that would confirm, or disprove, our risk assessment. This is an overlay to our bottom-up stock picking process.

As a result of the geopolitical overlay in our process, we rapidly cut Russian exposure after Russia hit an invasion signpost, leading into Putin's speech and the invasion of Ukraine. Ignoring geopolitics would have been expensive.

We believe geopolitical risks in general, remain especially under-priced within allocators' dominant equity exposure, US equities.

While the US produces around 26% of global GDP, US equity market capitalisation represents 62% of global equity market capitalisation[1]. This lopsided weighting seems reflective of the unipolar world of yesterday.

US companies benefitted in a unipolar world through mostly unfettered global access, cost savings delivered by offshoring and the related use of low offshore tax jurisdictions, along with falling domestic taxes and interest rates, financial engineering, the consistent bid of Baby Boomer savings during their peak earnings years, and the growth in foreign ownership of US equities from USD 2 trillion in 2009, to USD 12.2 trillion by 2022.[2]

Add to that the AI boom, and US outperformance has been understandably persistent.

As we look ahead to the next decade, we believe we are likely nearing the end of an era of US outperformance. This is understandably a contrarian view and needs some explanation.

Bullish US positioning suggests that investors today look for what else can go right for US equities, and what else can go wrong with EM equities. Studies have shown recency bias to be the most expensive bias, and when it comes to love for US equities, we are under no illusion that the recency bias is strong, and for good reason.

So, let's assess the possibility that the status quo does not hold, by asking the opposite questions to reduce recency bias:

What can go wrong with US equities over the coming decade?

Valuation: Rest of World equities are now 2 standard deviations cheaper than US equities, according to JPMorgan Asset Management.[3]

Secular growers: The most common refrain to a bearish argument on US equities, is that US equity leadership consists of secular growers like Apple, Microsoft, Alphabet, Amazon, Meta, Nvidia and Tesla. The chart below from Jurien Timmer, strategist at Fidelity, suggests that concentrated leadership may not last. In fact, while the 10-year trend has favoured the leaders, the 60-year trend has not.

Could today's secular growers be victims of geopolitics, higher taxes, or regulation? At what point does their power scare politicians enough to clamp down, like China did? They also compete more fiercely amongst each other in a battle of the transformers, and its' inevitable that not all will be winners.

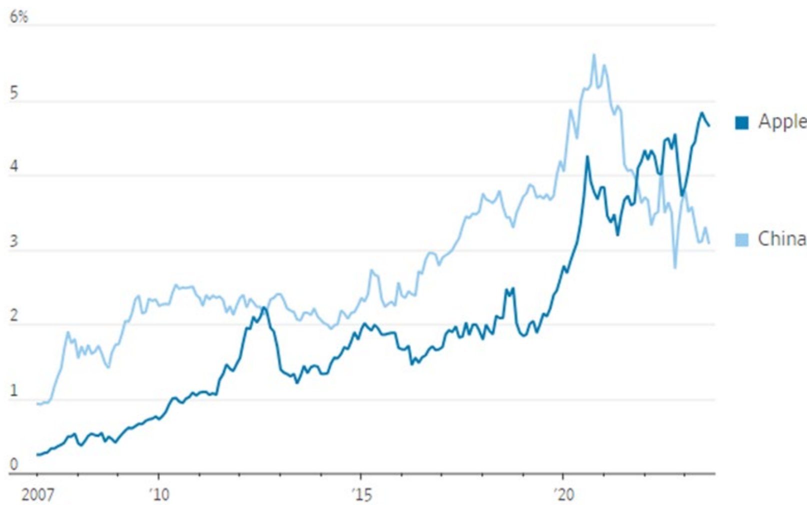
Selective view of risk: China risk, and specifically the risk of Taiwan friction, is to some extent reflected in low Chinese and EM equity valuations.

Rarely discussed are inherent China risk within US companies.

Apple has a 4.7% weight in the MSCI All Country World Index, which is greater than the whole of MSCI China at 3.2%.

Apple's sales split is 80% product and 20% services. Over 90% of its products are still being manufactured in China, which means that over 70% of total sales are being "manufactured" in China. (Source FT).

While China fear is represented within EM valuations, China fear is completely absent from Apple's valuation. Yet, the China risk within Apple alone, is greater than the entire MSCI China market cap. Nvidia and Tesla are also heavily exposed to China and Taiwan.



Source: Wall Street Journal: Yes, there is a bull case for investing in China, Sept 5, 2023

<u>Multipolar future versus unipolar history</u>: We suggest that the privileged position that US corporates built up in the unipolar era, will dissipate somewhat in a new multipolar world.

The two largest beneficiaries of globalisation, the US and China, are likely to have smaller addressable markets in the multipolar world of tomorrow, than during the unipolar world of years gone by. US companies lost access to Russia in 2022, and China has become increasingly off limits. These two countries account for around 20% of global GDP.

While US companies are global, and seem to offer inherent diversification, they remain US companies. This ties them to perceptions of the US' geopolitical stance; the same way Chinese companies are tied to China's geopolitical political stance.

US political division is at multi-decade highs and perception of wokeness, or political leaning, is likely to alienate a portion of existing customers, as seen with Bud Lite recently. The leading Republican candidate has 4 criminal indictments against him.

Buybacks, and interest rates: Domestically, US corporates face higher interest rates, and high valuations, resulting in less earnings enhancing buybacks.

Tax & fiscal discipline: Very high boom-time US budget deficits make it unlikely that US corporates will continue to contribute only 9% of total US government tax revenue.[4]

The US budget deficit recently surprised to the upside and could amount to more than 8% of GDP, despite the US economy continuing its boom. What happens in a recession?

AI: The AI boom could continue to benefit US companies, and if it drives significant productivity growth, without job losses, my cautious US thesis might be wrong over the next 1-2 years.

As for the large platforms, the cloud service providers should benefit while incurring greater capex expense. Consumers tend to use one search engine, making it likely that one of the platforms will dominate provision of consumer access to the most advanced AI. The history of technological disruption suggests it's highly unlikely that all the Magnificent 7 will be in pole position in 3-5 years' time.

AI might eventually be a zero-sum game for corporate America, as it's a general-purpose technology offered by open platforms. We do however believe companies can have an edge via speed of deployment or by owning unique private data sets.

Potential equity supply: Boomers and the Silent Generation together represent around 26% of the US population, and own 62% of all US wealth, but 66% of US household equities, mutual fund, and pension holdings.[5]

By value, we estimate that Baby Boomers and the Silent Generation own approximately $30 trillion in equities, with the overwhelming majority likely consisting of US equities. Average US life expectancy for men is 73 and for women 79, according to the CDC, which compares with Boomers' median age at 68 and the Silent Generation who are 77+.

Both generations will also be transferring significant wealth to Millennials and Generation X, who are likely to sell some assets as they are in the peak spending phase of their lives.

Passive risk: US mutual fund assets are now 52% passive, and 48% active, according to BoFA, and the US has the highest passive share in the world.

What happens if passive flow reversed, like when the largest, wealthiest cohort in history retires? We anticipate that market structure will become increasingly unstable.

What can go right for EM?

A multipolar world: The globalisation of old is turning into friendshoring, nearshoring and reshoring.

It seems likely that non-aligned EM corporates are better positioned than either US or Chinese corporates.

The beneficiaries in a multipolar world are the likes of India, Mexico, Vietnam, Thailand, Malaysia, Indonesia, and even Africa with 54 UN General Assembly votes. The EU & G7 have announced significant infrastructure investment into Africa, equating to over 10% of annual African GDP, to be spread out over the next 7 years.

For smaller economies, the new factories and related infrastructure investments provide a relatively larger bump to GDP.

Cyclical exposure: The trends towards reshoring and green energy are driving new global capex cycles. The future is capital heavier, rather than capital lite. These trends favour cyclical businesses, more common in EM and Europe. The eventual post war rebuilding of Ukraine is estimated to cost $750 billion, according to President Zelensky.

Fiscal discipline: Another striking point is how EM has dealt with the recent lockdowns and inflation surge. EM countries generally hiked sooner and higher and did not expand budget deficits to the same extent as the US is still doing today. A surprising change.

Positioning: MSCI China is worth less than Apple which manufactures over 70% of its sales in China. The combined value of Apple, Microsoft, Amazon and Nvidia is more that the total value of EM.

Chinese technology companies don't have the AI premium of US counterparts, and India has a fast-developing technology sector. We suspect that Indian technology companies will lead the way in India.

AI: AI makes intelligence free. EM has less at-risk white-collar jobs, and greater skills shortages. AI could conceivably be a boost to EM productivity, as it would be elsewhere. The great promise of AI is the expansion of healthcare and education at low cost, both which are in greater shortage in EM. Uptake is likely to be slower than in the US. That said, India, Brazil, Columbia, and the Philippines have been top 10 users of ChatGPT, according to Similarweb.

China: Markets are filled with China pessimism, and the Chinese economy will no doubt grow more slowly in future. Against the negativity, valuations are historically low, and the government is pushing equities as a domestic savings vehicle to take over from real estate.

In true multipolar fashion, China trade with ASEAN has surpassed that with the US.

In August, the China Securities Regulatory Commission suggested listed companies do share buybacks. With falling interest rates and low valuations, buybacks will be a welcome improvement and rich hunting ground for bottom-up stock pickers.

Political ideology remains the risk to be aware of, along with real estate contagion risk, which seems under control at the moment.

There is an opportunity for Xi Jinping to drive a diplomatic process in the Ukraine war, as no-one else has the ear of Putin. Chinese equities suffer a Russian Taint due to its unlimited friendship, which may lift somewhat if diplomatic progress is made. A potential signpost is Putin's planned visit to Beijing in October.

Conclusion

The US has been the top investment destination during the post GFC unipolar world, which allowed its share of global equity market capitalisation share to grow to 62%. Many of the favourable trends that drove the outperformance could reverse over the coming decade.

US companies might see their domestic market shrink due to political division, and their global market due to a new multipolar world order. Fiscally, the US Congress behaves more like that of an emerging market, which could introduce term premium into the discount rate of US equities. US corporate tax rates are more likely to rise, than fall, while buybacks are less attractive due to high valuations and higher interest rates. Secular winners might be disrupted by technological change, regulation, or geopolitics. Significant equity supply is possible from Baby Boomers and the Silent Generation, and lastly, with a passive share greater than 50%, market structure is likely to become increasingly unstable.

Emerging markets on the other hand represents 30% of global nominal GDP and 11% of global equity market capitalisation. A new multipolar world is more likely to benefit Emerging Market countries over the coming decade. Risk is better understood in EM, as its all anyone ever focuses on, and as a result valuations are significantly lower than in the US. EM has more cyclical exposure which should benefit from global capex cycles related to friendshoring, nearshoring and the green energy revolution. EM fiscal discipline has on average been better than US fiscal discipline during the current cycle.

Countries like India, Mexico, Vietnam, Thailand, Indonesia, Malaysia, Saudi Arabia should see significant fixed direct investment.

The US is priced for continued success, while its risks are under-appreciated in the shift to a multipolar world. EM risk receives greater focus while especially EM ex China has greater potential in a multipolar world.

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