Investment Insights

10 trends that will define the future of emerging market investing

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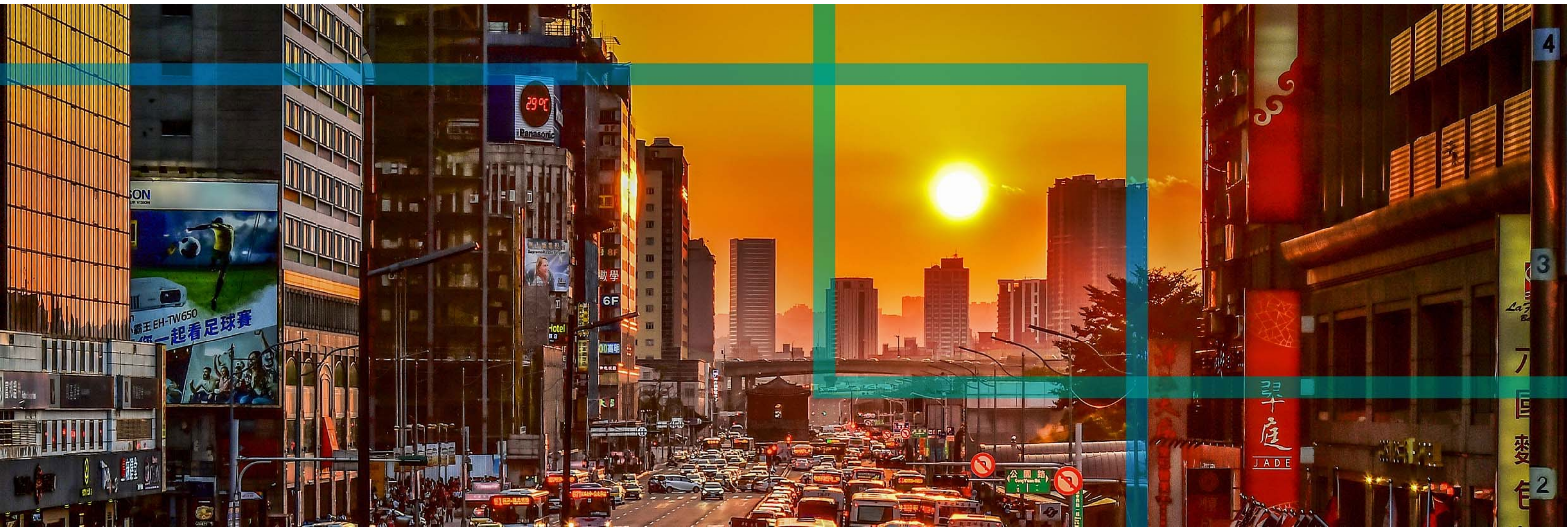

10 trends that will define the future of emerging market investing

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Key takeaways

- Major trends such as the revival in travel demand, the growth of digital platforms and the acceleration of mobile technology are spurring the prospects of emerging markets.
- Investment opportunities can be found in select companies that are driving innovation in emerging markets, as well as those catering to the underserved customer segments.
- Frontier markets, many of which did not experience a recession in 2020, offer an additional opportunity set for investors, particularly within fixed income.

Risks may be associated with investing in emerging markets, which are volatile and may suffer from liquidity problems.

Not the emerging markets of the 1990s

The emerging market universe today looks very different to that of the 1990s. Domestic inflationary pressures that were once these countries' weak point have generally been steadily reduced from an average of 78% in 1990 to 5% in 2020. Government debt has risen from around 45% of GDP in 1990 to 63% in 2020, but looks manageable compared to developed countries, which have seen government debt levels jump to over 120% of GDP in 2020. Meanwhile, emerging markets have seen their aggregate current account balance move from deficit to surplus. Compared with the 1990s when several emerging market economies experienced crises, foreign exchange reserves are now generally substantial, and currency pegs are less common, giving emerging market countries more flexibility in responding to crises.[1]

In addition to the adoption of more orthodox fiscal and monetary policies, many emerging markets have also become more dynamic, less cyclical, and more competitive in the knowledge economy. From a variety of tech components (TSMC chips), to electronics, digital payments, e-commerce, biopharma, gaming, social media and many more areas, emerging market companies are innovating and becoming increasingly competitive on a global scale.

Meanwhile, emerging market debt has evolved from a mainly US dollar, Latin American sovereign, high-risk asset class to a much more diverse and higher quality universe, including both local currency and dollar corporate bonds from all over the world. "The increase in the breadth and depth of emerging market debt has given portfolio managers more degrees of freedom to position their portfolios in a way that benefits from their top-down views given that many of these sub-asset classes within emerging market debt have very different risk-return characteristics," says fixed income portfolio manager Luis Freitas de Oliveira.

Over 50% of the dollar index is currently rated 'investment grade' by the credit rating agencies. This is despite the addition of frontier markets issuing US dollar debt at index size and also recent downgrades to multiple credits. For almost 90% of its lifetime, 70% of the local currency index has been rated investment grade by the agencies and the index currently carries an average rating of BBB.[2]

In this paper we share 10 themes that we believe will drive opportunities in emerging markets in the next 10 years.

1. Emerging market middle classes are driving growth in air travel

Before the COVID-19 pandemic, around 150 million people in Asia travelled for the first time each year. Over the next 20 years, the region is expected to account for around 50% of incremental air traffic[3], fuelled by the rapidly rising middle class population.

If anything, the inability of leisure seekers in Asia to travel during the pandemic has only added to the desire to do so, and there are already signs of strong pent-up demand. The situation in China is a case in point as its domestic air travel had almost returned to pre-COVID levels in late 2020 after it brought the

1. Source: IMF World Economic Outlook, as at April 2021
2. As at 28 April 2021. The local currency bond index is JPMorgan GBI-EM Global Diversified and the dollar bond index is JPMorgan EMBI Global. Source: JPMorgan
3. Source: Boeing Commercial Market Outlook 2020-2039

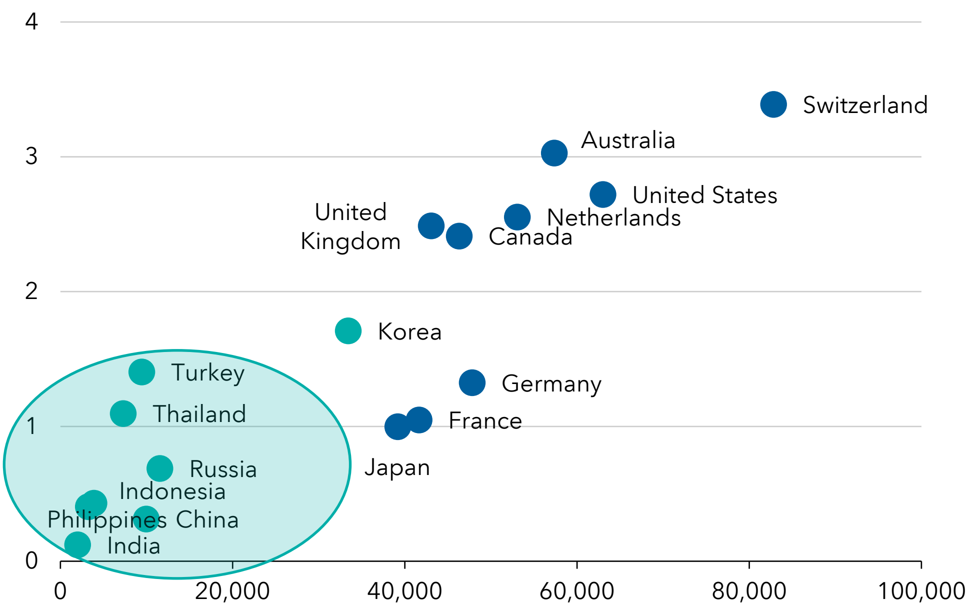
coronavirus outbreak largely under control. However, the recent rise in coronavirus cases brought back some travel restrictions.

Meanwhile, Kenya, the largest economy in East Africa, is looking to expand its charter flights services to boost the tourism sector. The country, which sees tourism as a key source of national income, has successfully welcomed visitors from Romania and Ukraine following support from its government.

A revival in travel demand in Asia and other parts of the world could have a powerful ripple effect, creating the need for a range of goods and services and helping drive jobs growth across a variety of industries. Among these are aircraft manufacturers, jet engine makers, hotels, casinos and restaurants.

Air travel is a secular growth industry, supported by Asia's emerging middle class

Annual number of flights per capita

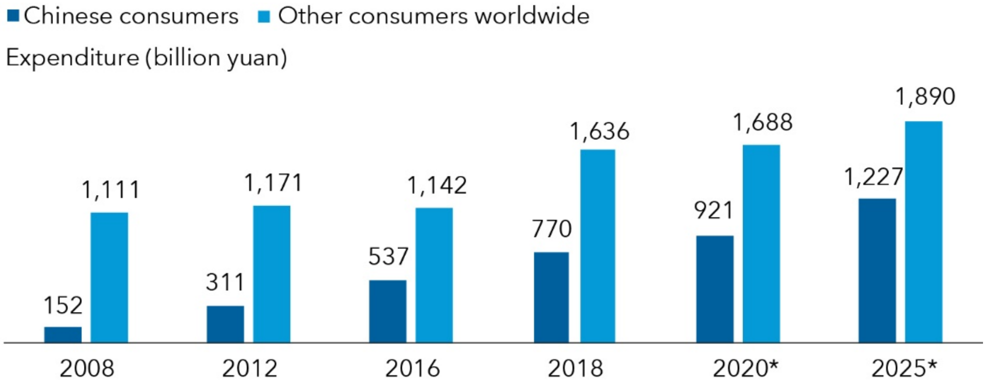


Data as at 2018. GDP: gross domestic product
Sources: CIA World Fact Book (Annual number of flights per capita) and World Bank (GDP per capita)

2. Emerging markets underpin long-term growth in luxury goods

Given the discretionary nature of consumer spending, sales of luxury goods are viewed as cyclical. The evolution of a wealthy class in China and other Asian economies over the past three decades has provided the industry an underpinning of sustained and structural growth. In addition to dominating the market, Chinese customers have become highly knowledgeable about luxury products in this relatively brief time, through frequent purchases and consumption of social media.

Chinese consumers increasingly dominate spending on personal luxury goods



*Expenditures for 2020 and 2025 are forecasts, shown for illustrative purposes only.
Source: Statista, Inc.

Equity analyst Lauren Carter expects demand to escalate in the coming years as the ranks of the consumer class expand and newcomers are attracted by the social cachet and aspirational value of luxury items. She expects China to remain a powerful source of growth in the years ahead. Indeed, Chinese consumers have shown a greater affinity for high-end goods than their counterparts around the world.

3. Emerging markets are driving the transformation to digital payments

The pandemic has expedited the long-term structural trend from cash to electronic payments. In China, electronic payments have been widely adopted due to the proliferation of e-commerce, mostly supportive regulation (until recently) and a large target market. Other regions are rapidly catching up given the adoption of the internet, e-commerce and smartphones; younger, more tech-savvy demographics; ease of use (versus cash) and greater access to financing; and changing regulations allowing unbundling from banks. In addition, COVID-19 has resulted in new users of the technology across generations, who are unlikely to fully revert to old habits.

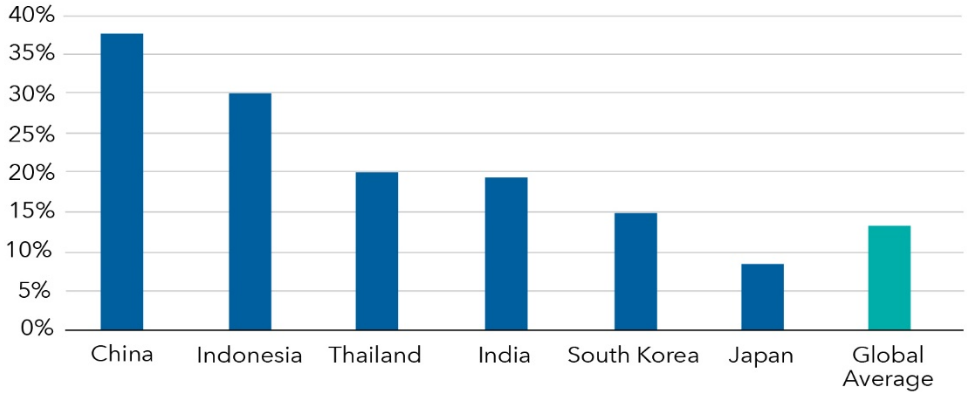
In Latin America, Brazil, despite being the largest economy in the region, has low credit card penetration mainly due to very high credit card fees[4]. This is a result of an oligopoly of big banks dominating the banking sector.

But consumers and businesses now have something to cheer about thanks to the disruptive ideas and solutions provided by fintech companies. For example, payments provider PagSeguro offers point-of-sale terminals to small merchants, most of whom were previously unable to accept electronic payments. Payment advances, a key source of revenues for merchants, are also available as traditional credit card transactions can take 30 days to settle. Consumers, on the other hand, benefit from PagSeguro's range of digital banking services, which can be accessed conveniently on their mobile phones.

4. As at 30 November 2020. Credit card annual percentage rates are nearly 300% in Brazil despite the central bank's lending rate being significantly lower. Source: Brazil central bank

The use of digital payments is rising across EM

Usage of digital wallets for both in-store and online payments



Data as at 30 June 2020. Source: Euromonitor International, Digital Consumer Survey 2020

4. Mobile technology trends are accelerating as internet usage rises

Emerging market companies within e-commerce, gaming and social media have developed and localised their technology, while accelerating their growth in ways that differ from their peers in developed markets.

Gaming is rapidly moving into mainstream entertainment as a wide variety of games become available on mobile devices. China-based Tencent, for example, has grown to become a dominant player in the global gaming market. One of its high-profile investments is US-based Riot Games, the developer of the popular multiplayer game League of Legends. The company acted swiftly in announcing new restrictions limiting game duration and in-game purchases for minors amid expectations of regulatory moves to curb internet addiction among students.

Tencent has also found success in its WeChat Mini Program, a closed internet environment where users can access all businesses that operate within the WeChat app without the need to download native apps. The ecosystem now houses more than a million apps.

In other parts of emerging markets, there are individual companies that have displayed resilience despite the challenging economic environment. For example, Argentine e-commerce operator MercadoLibre generates most of its business from Argentina and Brazil – two countries that are experiencing huge financial constraints. Although the company was hit by a loss in the first quarter of 2021 due to higher taxes, it was able to grow its top line significantly due to the high demand for its e-commerce and fintech services. This shows that individual companies can grow even amid macroeconomic and political uncertainty. The Mercado Libre app was among the 10 most downloaded shopping apps worldwide in 2020[5].

5. Innovation is a dominant force that will transform the health care industry in emerging markets

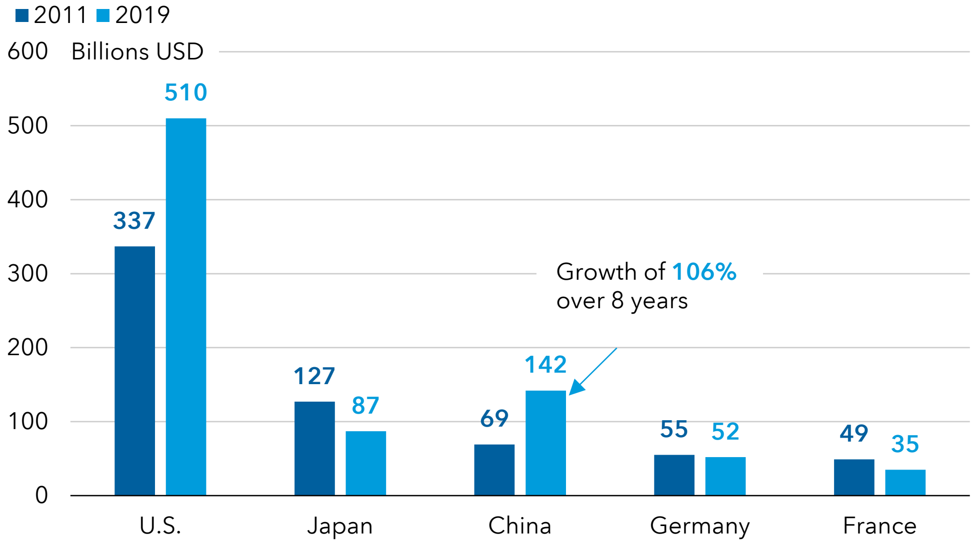
Over the next decade, China's strategic policy initiatives in biomedicine could have broad ramifications for investments in the global pharmaceutical sector and in China itself. Based on our current growth projections, China is steadily closing the gap between it and the US market. This growth comes as China is already the largest global supplier of active pharmaceutical ingredients, a point that raised

5. Data as at 7 January 2021. Source: Apptopia

concerns during the pandemic given rising geopolitical tensions and policies promoting domestic protectionism. "The US and China have been forerunners in the adoption of a lot of new technologies, so an interesting way to approach some exciting mid-cap opportunities is to look at the trends in these markets and overlay them onto the emerging markets of Latin America and Southeast Asia," investment analyst Johnny Chan notes.

At the same time, China is beginning to export new and innovative drugs. Last year, BeiGene was the first company to secure US regulatory approvals for a drug largely based on clinical data generated in China. So even in this tense geopolitical climate, prospects remain encouraging for both multinationals and local Chinese firms as China makes a strong push to move up the value chain in health care. UK-based AstraZeneca might be one of those beneficiaries; it currently counts 20% of its global revenue from China through partnerships it has cultivated with four local firms[6].

China's pharmaceutical market has rapidly grown to become the world's second largest



Data as at September 2020. Sources: IQVIA, GLOBOCAN, World Bank

Elsewhere, telehealth could become a permanent fixture in the way we deliver health care going forward. Funding has been going into companies that use either an app, as a front door to a medical system, or remote patient monitoring for things like blood glucose, blood pressure and weight.

The idea is that, instead of a visit to see a doctor, the patient's first stop would be an app. Such is the case in Mexico, where doctors can monitor the blood sugar levels of their patients remotely using an app developed by Clinicas del Azucar, a health care provider of low-cost diabetes care.[7] This self-monitoring approach allows patients to remain in the comfort of their home, greatly benefitting those living in remote and rural areas.

6. As at February 2021. Source: AstraZeneca
7. "After coronavirus, telemedicine is here to stay", an article published by the World Bank on 7 July 2020.

6. The US-China rivalry may define geopolitics

In what may feel like a lifetime ago, trade disputes between the US and China were the biggest economic storylines in the pre-COVID era, but the frosty relationship between the two superpowers could remain one of the top investment themes over the next decade.

According to portfolio manager Chris Thomsen: "It's not just geopolitics. It will also have a direct impact on businesses as they are forced to take sides and perhaps adjust the way they operate on both sides of the fence". While he prefers to avoid companies that may get caught in the crossfire, he still believes great investment opportunities abound. "Purely domestic Chinese internet companies aren't going to be hurt by a trade war. I also look across industries at innovative start-ups led by amazing entrepreneurs."

Indeed, the internet space has been one of the most attractive investment areas. Although companies such as Tencent initially copied their peers, they have since evolved into incredibly sophisticated multifaceted platforms. Today, the company could be viewed as one of the first-generation of Chinese internet companies.

There is also a new wave of innovative second- and third-generation companies run by dynamic entrepreneurs. These companies, such as multi-service platform Meituan, have scaled up incredibly fast due to the size and technological sophistication of China's market.

Capturing these opportunities requires in-depth research, which can help us identify companies and industries that are aligned with the Chinese government's policy priorities as well as those that have attractive long-term fundamentals.

7. Indian equities: an expanding opportunity set

India's entrepreneurial culture and vast pool of technology talent has given rise to a host of domestic competitors, some with significant private equity funding.

"In our many conversations with companies, we sense a buoyancy in corporate and entrepreneurial sentiment that has been missing for the past few years," says portfolio manager Brad Freer. "The central government budget for the 2022 fiscal year, with its focus on infrastructure spending and growth, has further buoyed sentiment."

Now, as companies extend their scale, many are lining up in the initial public offering queue. If successful, these deals could help support the digital ecosystem and diversify India's equity markets. New public companies are part of the further diversification of India's equity market away from state-owned enterprises to private-sector banks, technology companies and consumer stocks.

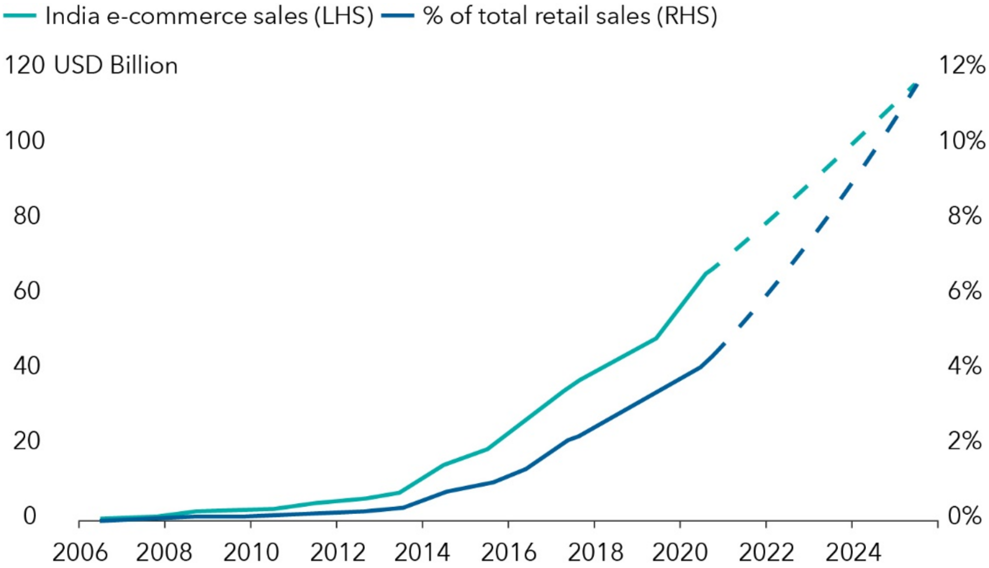
Some key sectors will be critical to watch. These include:

- **E-commerce:** India's digital transformation is moving at a brisk pace, pitting domestic technology companies against multinationals looking for a piece of the country's large and youthful consumer market.
- **Banks:** India's banks have strong growth potential owing to relatively low market penetration and the rapid growth of mobile banking.
- **Residential real estate:** In recent years, new laws have both formalised and legitimised the industry, leaving a few large, organised, regional homebuilders as survivors. Besides the homebuilders themselves,

opportunities could arise for companies that provide cement, paint, tiles or household appliances.

Room to run

E-commerce takes a growing share of Indian retail sales



Actual figures as of 2020; forecast through 2025 shown for illustrative purposes only.
Source: Euromonitor International

In the health care sector, India has continued to upgrade its infrastructure following the devastating second wave of coronavirus infections, which now appears to be mostly under control. According to our estimates, by the fourth quarter this year, more than half of the population over 15 years of age would have received at least one dose of COVID-19 vaccine if the current pace of vaccination is maintained.

The United Nations had warned that the country's growth outlook for this year is "highly fragile". But that did not stop the intergovernmental organisation from raising India's economic growth forecast for 2021 to 7.5% (from an earlier estimate of 7.3%) and projecting the nation to become the fastest-growing major economy in 2022 with a growth rate of 10.1%.[8]

At a market capitalisation of about US$872 billion, based on the MSCI India IMI as at 31 December 2020, India's equity market is still relatively small compared with the size of the economy and its potential growth. That could mean an expanding opportunity set in India over the coming years.

8. Banks, insurers and financial exchanges: The rising trio of the financial sector sets the stage for long-term economic progression in emerging markets

Financial sector headlines are often dominated by banks and insurers. Insurance companies, for instance, have reported significant growth in business segments serving China's growing middle class and high-net worth individuals. One of the beneficiaries is AIA Group. "To build a sustainable business model, the company (AIA) trains young agents to sell higher quality products. Their focus on rewards

8. Data as at 11 May 2021. Source: United Nations

and recognition attracts more high-calibre candidates, while improving the brand in the eyes of customers," says investment analyst Patricio Ciarfaglia.

Financial exchanges are another area that have emerged as steady growers and dividend payers. In Asia, exchanges are at the centre of public financial markets that are expanding, providing a tailwind of secular growth. Russia has also experienced similar growth in recent times as retail investors flock to stock trading platforms in search of higher returns.

On the banking front, larger private banks in India have been growing profits and gaining market share. They are well-positioned to scoop up some of the country's weaker lenders. For instance, HDFC Bank and Kotak Mahindra Bank are leveraging technology, amid the digitalisation of India's economy, to make faster lending decisions and reach customers in rural areas through mobile apps.

Like India, Indonesia is also one of the most populous countries in the world. The relatively young nation has seen remarkable growth in its middle class, which has gone from 7% to 20% of its population over the past 15 years[9]. In many emerging economies, however, it is often women, the poorest and those living in rural areas that have the least access to internet and financial services.

But the opportunity to tap into the underserved market segments has not gone unnoticed. Indonesia-based Bank BTPN Syariah is specifically focused on empowering low-income women living in rural communities. Not only does the lender provide women with the financing to begin their entrepreneurial ventures, it also partners with universities to offer financial education and mentorship to help ensure the success of their businesses.

9. Rapid urbanisation in China and rising incomes will increasingly mean rising demand for housing

The percentage of US citizens living in cities is expected to increase to 90% by 2050, from 74% in the 1980s. The percentage of the Chinese population living in Chinese cities in 2050 could also approach high the 90s, up from the very low base of just 20% in the 1980s. Every year, the equivalent of 1% of China's population moves to the cities. That is 14 million people, and it is equivalent to two cities the size of London.[10]

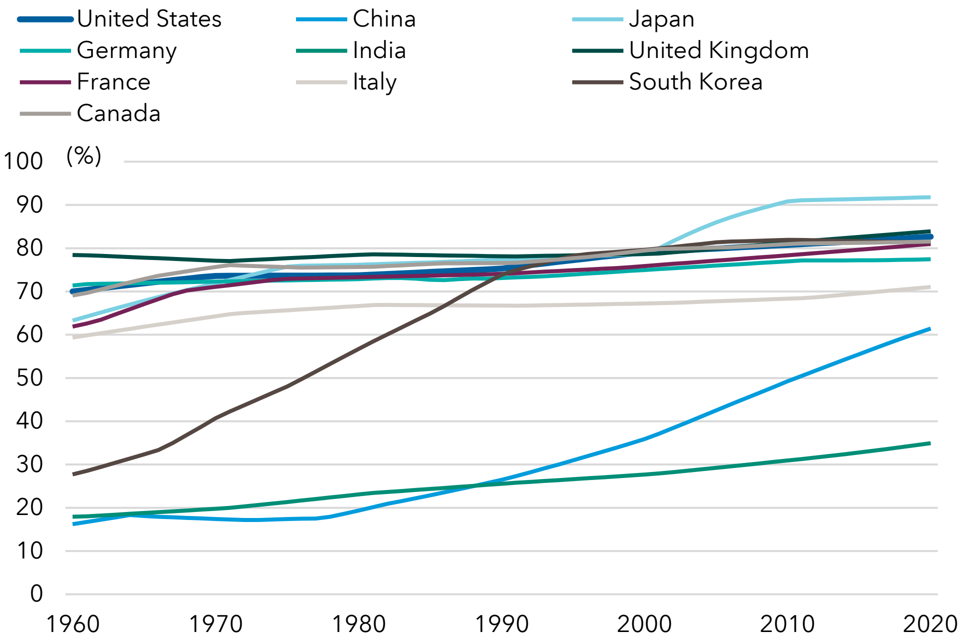
This is an unprecedented rate of urbanisation and it creates opportunities for companies that are able to secure attractive land sites for development at a reasonable cost.

Let's not forget – existing homeowners also tend to upgrade their homes as their incomes rise. Emerging markets, such as Qatar, United Arab Emirates and China, have among the highest gross domestic savings rates in the world. High savings rates, coupled with low interest rates, have been the key drivers propelling the global property market, including China's, despite the ongoing uncertainty.

9. As at January 2020. Source: The World Bank
10. As at 30 June 2020. Forecasts shown for illustrative purposes only. Source: Oxford Economics

China sees a sharp increase in urbanisation compared to other leading economies

Urbanisation rate of the 10 largest economies by gross domestic product



Urbanisation rate is calculated using the number of urban population as a percentage of total population, with data updated as at 30 July 2021. Gross domestic product is as at the end of 2020, except Japan, which is based on end-2019 data. Source: World Bank

10. Frontier markets will continue to be an area of focus given the growth and diversification potential for long-term investors

Frontier markets offer an additional opportunity set for investors, particularly within fixed income, but for many investors, they remain relatively unexplored. Many traditional emerging market countries are now much more developed than they used to be, with more stable institutions and infrastructure. As such, it will be difficult for these countries to grow at the same rate as they did in previous decades. Meanwhile, financial markets have deepened, communication from authorities has improved and risk premiums have declined, reducing expected returns from investing in emerging markets. Not only are frontier markets experiencing "catch up growth" from being less developed, but many of them are also benefitting from a demographic dividend, which means that the labour force is temporarily growing more rapidly than the population that is dependent on it, freeing up resources for investment in economic development and welfare.

There are a number of countries in Sub Saharan Africa with high structural growth rates that have the potential to grow into more mainstream emerging markets soon. Many of these countries didn't experience a recession in 2020 and could enjoy continued compounding of growth. This includes the more traditional frontier economies such as Benin and Ethiopia, which have low per capita GDP and other measures of human development, heavy dependence on agriculture, shallow financial markets and low debt levels. It may also include those economies that tend to be more diversified and have higher levels of per capita income and higher debt levels such as Senegal, Côte d'Ivoire, Kenya and Ghana.

Among non-traditional emerging markets, Dominican Republic is one of the fastest growing economies in the world. Despite having no equity market, the nation is the largest and one of the more diversified economies in the Caribbean, with gold production, construction, agriculture, manufacturing, commerce and tourism. "Over the past decade the country substantially reduced poverty rates while supporting the expansion of the middle class. Tourism is a structurally growing sector, with rapidly rising visitor numbers and per-visitor spending," says fixed income investment analyst Thomas Kontchou. Although the COVID-19 pandemic has pushed the Dominican Republic into its first recession in nearly 25 years, growth is expected to return this year, according to Kontchou.

Within equities, many may consider the frontier markets index[11] to consist of a large number of small countries. In fact, it is very concentrated by country, with the MSCI Kuwait, Vietnam and Morocco comprising approximately half the index[12]. However, frontier markets are generally under-owned and under-researched, which could create opportunities to generate alpha.

An alternative approach to capture opportunities arising from frontier markets is by investing beyond the traditional boundaries of geographical domicile, focusing instead on successful companies that are taking advantage of key secular trends in developing countries. Food delivery, for example, is a very underpenetrated market in these regions but this business tends to thrive in countries with high population density and a wide income gap, which makes many frontier markets ideal hotspots for growth. One company that has been able to tap into this demand is Germany-based Delivery Hero, which has been building a strong business footprint across various Middle Eastern countries.

All in all, multiple secular growth trends underpin the promising outlook for emerging markets. As the focus of growth shifts towards emerging markets, we believe that an on-the-ground presence in these regions and in-depth fundamental research are key to identifying important trends, and finding companies with robust networks and supply chains, while being sensitive to unique intricacies and constraints in these regions. This should ultimately help generate strong long-term investment results.

***Valeria Vine** is an investment specialist at Capital Group. She has 12 years of industry experience and has been with Capital Group for five years. Prior to joining Capital, Valeria worked as a management consultant at Ernst & Young. Before that, she was a senior consultant at FactSet. She holds a master's degree in banking and international finance from Cass Business School and a bachelor's degree in economics from University of Nottingham. She also holds the Chartered Financial Analyst® designation. Valeria is based in London.*

11. MSCI Frontier Markets 100 Index
12. As at 31 April 2021. Source: MSCI

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