September 2024

The “Rise of the Rest” 2.0

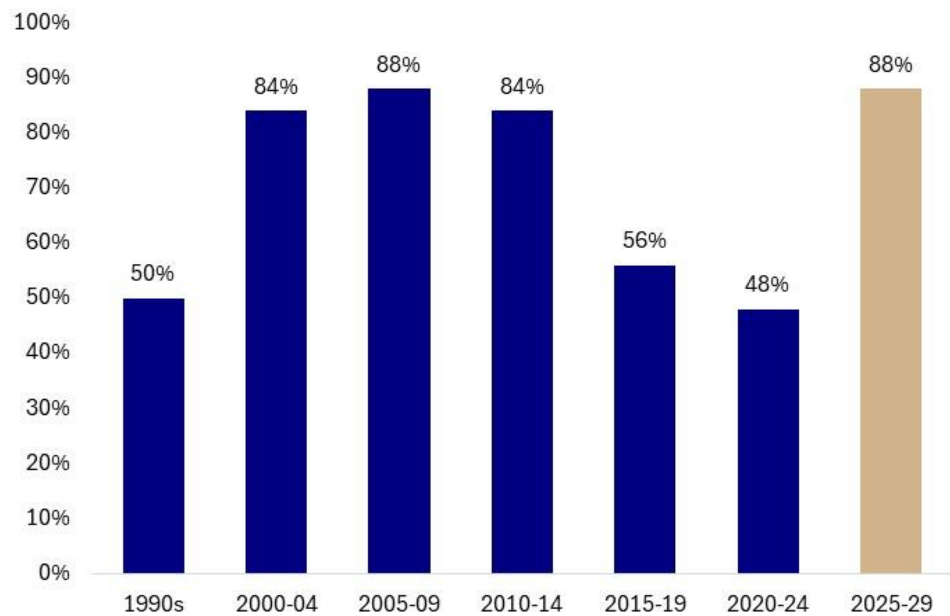
Back in the 2000s, as emerging economies accelerated, capital flowed into their stock markets. By the end of the decade hype for “the rise of the rest” had reached a risky peak—as our founder warned at the time. Indeed the 2010s turned out to be a lousy decade for emerging stock market returns, demonstrating once again the cyclical nature of economic life. But now, we believe the cycle is turning again.

After staging its own surprising comeback in the last decade, the United States is starting to grow more slowly relative to most emerging economies. Today it is the emerging economies undergoing a revival. Only this time, in contrast to the early 2000s, they are rising outside of China, not led by China. We believe we are positioned to capitalize on this trend, once stock market investors recognize the new rise of the rest.

Back to the 2000s

As the United States pumped trillions of dollars into its economy to counter the shock of the pandemic, emerging economies could not keep up. Normally the typical emerging economy grows relatively fast thanks to the simple boost of base effects, but in the last five years the share of emerging economies posting faster per capita GDP growth than the US fell to less than half. Now, as growth in investment, consumption and (select) exports picks up, so have EM prospects. Based on IMF forecasts, the share of emerging economies growing faster than the US is on pace to spike from 44 percent in the last five years to 88 percent in the next five—slightly outdoing the emerging world acceleration between the late 90s and early 2000s (Chart 1 below).

Chart 1. Share of EMs With Faster Per Capita GDP than US (Versus Projections for 2025-2029)



Source: IMF, UN, Haver Analytics, Breakout Capital Calculations.

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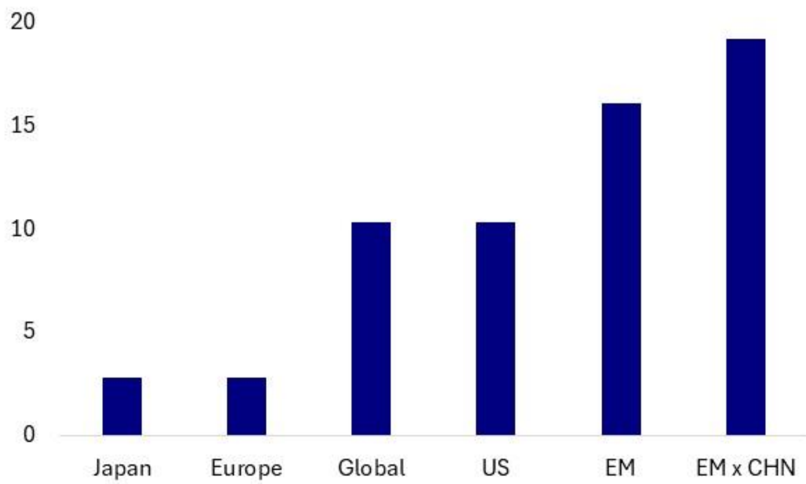
Strong Economy, Strong Earnings

As GDP growth picks up, so have forward earnings. In Q2 this year, earnings grew 19% in EM excluding China, nearly double the pace in the United States and the rest of the world (Chart 2). Beating consensus expectations by 8 points, compared to 5 points in the US, EMs had never outperformed the United States so dramatically, not since records began in 2009. And there are good reasons to believe this gap will grow: over the last 15 years, the United States has delivered higher earnings growth by almost 8 points thanks almost entirely to big tech; now tech sector earnings are expected to decelerate sharply, eroding the US lead.

Chart 2. Blended Earnings Growth, Q2 2024, YOY Change in Percent



Source: Deutsche Bank

Where Globalization Still Lives

Despite the reality of deglobalization—international trade is not expanding as fast as it did in the last heyday of emerging markets—it is important to recognize where globalization still lives. Export volumes are growing, just more modestly, and almost entirely out of emerging markets. In the last five years export volumes have been stagnant out of developed markets, but up 20 percent out of emerging markets. And the gains are broad based, lifting larger markets from China to Poland, Vietnam, Indonesia and Brazil, among others (Chart 3).

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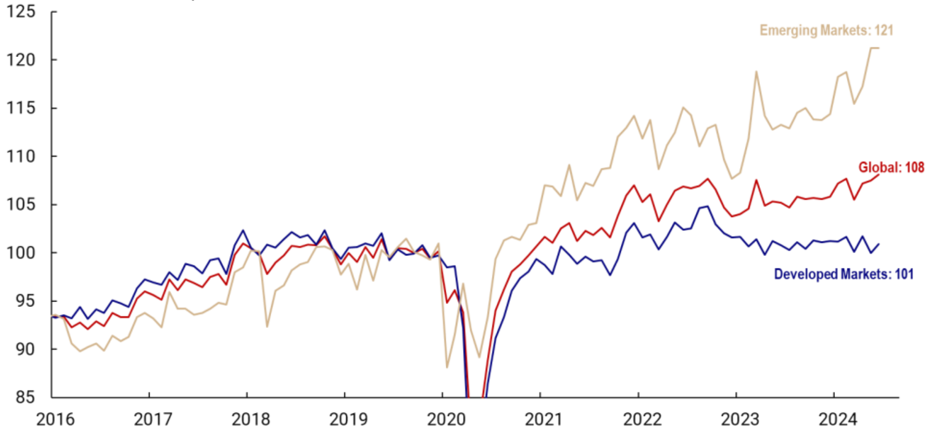
Chart 3. Global Export Volumes; Index – 2019; Q4 = 100

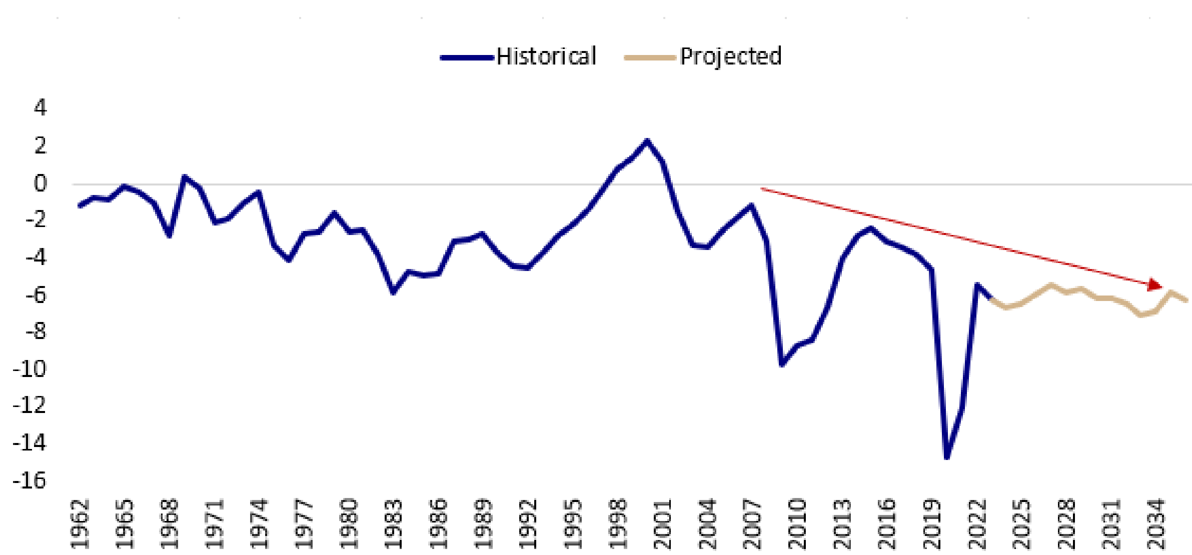


Source: Citi

The Not So Mighty Dollar

We believe America is an overstimulated superpower, with fiscal deficits widening at a rate that will set records, compared to both the US past (Chart 4) and the rest of the world. As a result, public debt is already sky high and expected to rise further in the United States, even as other governments scale back. At some point, the rest of the world has to think twice about continuing to fund US borrowing habits, and that moment is nigh. With Fed rate cuts on the horizon, the dollar has started to decline. Since these periods of decline have typically lasted around 6 to 7 years, this one could easily last the rest of the decade. That's good news for EM currencies, which typically benefit when capital starts reallocating to nations with higher rates.

Chart 4: US Fiscal Deficit to GDP (Percent)

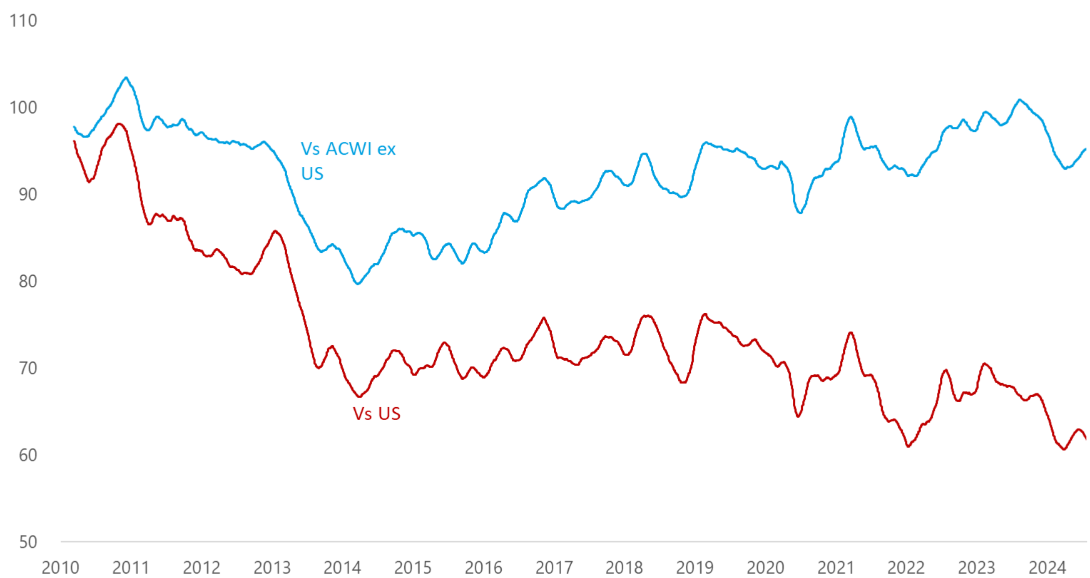


Source: Haver Analytics, Congressional Budget Office

An Overlooked Bargain

Despite the improving outlook for EM growth and earnings, stock market investors have not taken notice, yet. EM valuations remain low compared to the rest of the world, and especially compared to the United States (Chart 5). And that makes potential rewards in EM compelling over the coming years.

Chart 5. 12M Forward Price to Earnings, EM Relative to US and Global Indices in Percent



Source: Bloomberg, Breakout Capital Calculations

The Return of the EM Asset Class

All these factors—including growth, earnings, currency, valuations—put emerging markets in position to revive as a popular asset class, after 15 years of underperformance. However, as has always been the case, it is risky to think about emerging markets as one group, rather than individual nations. Some will capitalize on trends in global trade, and the weakening dollar, some not as much. Some will get an added boost from new domestic leaders and economic reforms, others will not. And the whole purpose of our research systems is to separate the likely leaders from laggards, so we can position our portfolio to capitalize on the new era.

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For more information, please contact:

Cheryl Galante, Head of Investor Relations
Main 212 497 5100 | Direct 646 216 8400
cgalante@breakout-capital.com