JOHCM Funds

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Emerging Markets Spotlight

One of the major features of the economic landscape has been inflation in major developing markets rising to its highest levels since the 1980s. A rapid increase in demand after a reduction in capacity has led to significant price pressure from many commodities and some goods and services, which is now feeding through to wage demands. There are suggestions that inflationary expectations are starting to adjust to higher levels, which might embed inflation in the system. Some commentators have raised the risk of a return to the economic situation and market environment of the 1970s.

Emerging market equity as an asset class didn't exist in the 1970s, so it is not realistic to look at how emerging markets did in that decade. However, looking at some of the main drivers of market returns in the 1970s, is possible to make a few suggestions about how emerging markets might do.

The 1970s were overall a very bad decade for financial assets. US equities returned an annualized -1% in real USD terms in the decade, with major European equity markets performing even more poorly. As EM equities are both higher beta than developed market equities, and also represent the sharp end of international equity investing (for US investors), it might be presumed that a return to the 1970s would be a highly negative environment for EM equities (in real USD terms). We believe that this is too crude an analysis, and that there are reasons to think that EM equity might be among the best asset classes in such an outcome.

The 1970s were particularly characterized by an oil price shock that transmitted into broad commodity price inflation, a pattern that we also see in 2022. Real oil prices rose by about 20% annualized, meaning that energy was the only sector in the US equity market to deliver a real positive return in the decade. Other commodities did well, including gold and silver, with the CRB commodity index returning a real USD annualized return of 3% and some agricultural products also performing well.

One of the often-overlooked features of EM equity as an asset class is its exposure to commodities, both at a sectoral level (as at 31 May 2022, energy and materials were respectively 5% and 9% of the MSCI EM Index), and also at a country level (as at 31 May 2022, Latin America, Indonesia, South Africa and the GCC were in aggregate 22% of the MSCI EM Index). During the long commodity sell-off from 2013 to 2020, investors' focus on EM was mostly limited to EM Asia and to technology and internet companies, but the strong recovery in commodity prices has led to an apparent change in leadership in the asset class. In the first five months of 2022, MSCI EM returned -11.8% in USD terms, but all the Latin America markets, Indonesia, South Africa and all the GCC markets delivered positive returns; we have been overweight Brazil, Mexico, South Africa and the UAE as the benefits of high commodity prices feed through to economic growth and company profits.

It is not a given that we will see a return to the embedded inflation of the 1970s; this current surge may indeed prove 'transitory'. We feel there is substantial reason for optimism about the prospects for emerging markets if commodity price-driven inflation does prove enduring, not because of the technology and internet stocks that have dominated portfolios and investors' minds for the last decade, but because of the deep and broad opportunities in commodity producing companies and countries.

Source for all data JOHCM/Bloomberg (unless otherwise stated)