The Wrong Reason to Invest in Emerging Markets

Investors have a false impression that economic growth equals big stock gains.

By 2050, the world’s population is projected to reach 9.5 billion, up from 7.2 billion today. Nearly all of that growth will come from emerging markets, where living standards are rapidly improving. Although these markets have experienced large capital inflows, they still have a long way to go to match developed countries’ levels of capital, productivity, and wages. Consequently, emerging markets will likely continue to grow faster than developed markets for the foreseeable future. While this growth may lift hundreds of millions out of poverty and spur investment and innovation, evidence suggests investors may be left behind.

In a seminal research paper, Ritter (2005) documented a negative relationship between economic growth and stock market returns. Ritter’s findings are no fluke. Using real gross domestic product data from the World Bank and the gross return version of each market’s MSCI country index, Morningstar found a weak negative correlation between GDP growth and stock market returns across 41 countries from 1988 to 2013.

This relationship is plotted in Exhibit 1, where each country represents a separate point. Excluding China — the outlier at the bottom right of the chart — results in a slightly positive, though still very weak correlation between GDP growth and stock market performance.

While the correlation between these two variables may change a little over time, the findings are fairly robust over long time horizons. It’s clear that higher economic growth does not necessarily translate into superior stock market returns.

Reasonable Assumptions?
This result should not be surprising given the strong assumptions that would be required to link GDP growth to stock market returns.

In order for this relationship to hold, publicly traded stocks’ valuations and earnings as a share of GDP would need to remain stable over time. This means that private and public companies would need to grow at the same rate, and there could be no new enterprises or initial public offerings. Second, there could be no dilution from new share issuance. Finally, all companies would need to generate substantially all of their revenue and profits from the domestic economy.

Linking Economic Growth and Profitability
In a closed economy, it would be reasonable to expect that corporate profits in aggregate would grow at a similar rate as the economy in the long run. Although the share of corporate profits relative to GDP fluctuates over time, it tends to revert to the mean. Profits cannot persistently grow faster than the economy because they would crowd out all other economic activity and attract new competitors. Similarly, total corporate profits should not grow slower than the economy in the long run, as firms exit unprofitable businesses, allowing those remaining to preserve margins.

But any country that U.S. investors can access is not closed. The largest firms listed in most countries tend to be multinational ones that generate a large portion of revenue and income outside their host country. For example, in 2013 the constituents of the S&P 500 generated about 46% of their sales outside the U.S., according to data from S&P. This exposure means that profits can grow at a different rate than the domestic economy, even in the long run.

Exhibit 1

Weak Link In 41 emerging markets between 1988 and 2013, there was a weak correlation between economic growth and stock returns.

Source: Morningstar. Data for seven of these countries — China, Colombia, India, Israel, Peru, Poland, and South Africa — was not available until 1993, while data on Russia started in 1995.
Even if aggregate corporate profits grow in sync with GDP, dilution can prevent shareholders from enjoying the benefits of growth. Creative destruction is essential to economic growth. In aggregate, all companies that are publicly listed today will grow slower than the economy because new entrants drive much of that growth. Between the time these new companies are launched and publicly listed, their growth dilutes most investors’ ownership interest in the economy. Flagrant dilution of corporate earnings through employee stock grants and secondary offerings is also a very real risk. Additionally, earnings growth can only create value if it allows firms to generate returns that exceed their cost of capital. High reinvestment rates may enhance both corporate and domestic economic growth but destroy shareholders’ wealth through inefficient capital allocation.

Is Growth Already Priced In?
Growth expectations influence stock market valuations. Valuations are rich when investors expect strong growth. However, as developing economies mature, their growth rates slow and valuations may decline. Consequently, even when countries realize their expected growth rates, their stock markets may not keep pace.

The impact of lofty growth expectations on valuations can create a treadmill effect, whereby fast-growing economies must realize high growth in order to generate a competitive rate of return. For example, in the mid-1980s the so-called Asian tigers had experienced two decades of rapid growth and investors had high expectations for future growth. In contrast, several countries in Latin America were facing severe inflation, a debt crisis, and low expectations for future growth. As a result, according to Henry and Kannan (2008), in 1986 Latin American stock markets were trading at 3.5 times earnings, while the Asian markets were trading at 18.3 times earnings.

Over the next two decades, Latin American stock markets posted more than twice the annualized returns of the Asian markets, despite experiencing lower GDP growth over that horizon. Henry and Kannan persuasively argue that this was because Latin American countries implemented economic reforms that allowed them to exceed investors’ low expectations. Conversely, Asian markets performed in line with investors’ high expectations, which were already priced in.

What’s an Investor to Do?
To benefit from economic growth, investors must identify markets that have the potential to exceed expectations. Russia may fit the bill.

At the end of 2014, the Russian equity market, as proxied by Market Vectors Russia ETF RSX, was trading at a paltry 6.5 times forward earnings, making it the cheapest of any major emerging market. Corruption and a taxing regulatory environment have stunted the country’s growth and depressed valuations. Falling oil and gas prices and geopolitical risk haven’t helped either. However, if (and this is a big if) Russia adopts structural reforms that investors aren’t expecting (and they’re not expecting much), it could offer investors rich rewards—albeit with high risk.

Even if fast-growing emerging markets do not offer superior risk-adjusted stock market returns, they can provide good diversification benefits. Over the past 20 years, the MSCI Emerging Markets Index and S&P 500 were only 0.73 correlated.

Vanguard FTSE Emerging Markets ETF VWO offers broad exposure to companies listed in emerging markets but is dominated by large-cap multinational names. A small-cap fund, such as WisdomTree Emerging Markets Small Cap Dividend DGS, offers cleaner exposure to emerging markets because small-cap firms tend to generate a greater portion of their profits from the domestic economy than their large-cap counterparts.

Alex Bryan is an analyst specializing in passive strategies with Morningstar’s manager research group.

References