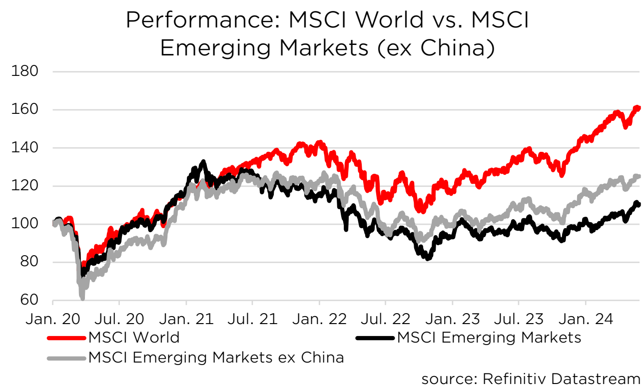
31 May 2024

Equity markets: emerging markets or industrialized countries?

Financial blogs often tout a portfolio consisting of the MSCI World and the MSCI Emerging Markets Index as the gold standard. The highlight: with such an investment strategy, investors benefit from an extremely broadly diversified portfolio: they participate in the performance of 2,840 stocks from a total of 23 industrialized countries and 24 emerging markets. However, the approach currently has a catch: while the MSCI World Index has risen sharply in value since the coronavirus pandemic, the MSCI Emerging Markets Index has fallen short of expectations. So should emerging market equities disappear from the portfolio and is the MSCI World Index perhaps enough?

Stumbling block China

Since January 2020, the MSCI World Index has increased in value by around 61 percent. The positive performance is due in particular to the strength of the US equity market, as the US equity market accounts for around 70 percent of the MSCI World Index. By contrast, the investor regions of Japan (six percent), the UK (four percent) and France and Canada (three percent each) have only a minor influence. From a risk perspective, this concentration of countries harbors a major cluster risk (see Economic Situation and Strategy from 16.05.2024: "Stock market indices: How big is the cluster risk?"). The MSCI Emerging Markets Index is much more broadly diversified. The largest investment region in the emerging markets index is China with a share of 27 percent, followed by India (18 percent), Taiwan (17 percent) and South Korea (12 percent). However, the performance of the MSCI Emerging Markets Index since January 2020 has been considerably lower at just 11 percent. The relative weakness is due in particular to the weak performance of the Chinese stock market.

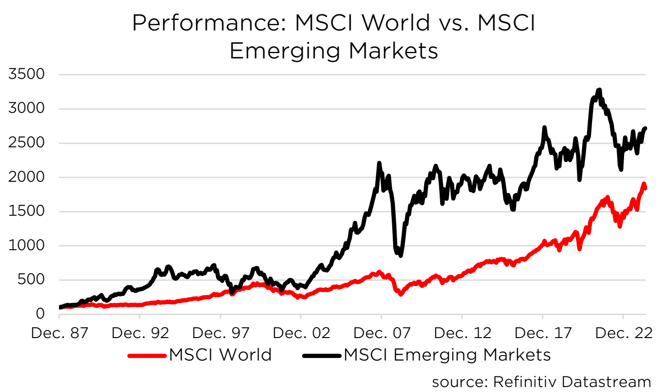


Why is that? For a long time, China was the engine of the global economy with unprecedented growth rates. Since 2000, the Chinese economy has grown by an average of more than eight percent per year, spurred on by its accession to the World Trade Organization (WTO) in 2001, among other things. However, China's export-driven growth model has since run into considerable difficulties and has faced structural challenges in recent years as well as economic ones (including demographic change and the crisis on the real estate market). Regulatory intervention by the government has also scared off foreign investors in particular. Unforeseeable measures by the Chinese Politburo, for example, forced listed companies to change their business model and operate as non-profit organizations in the future.

The performance of emerging market equities looks better if China is excluded as an investment region. For example, the performance of the MSCI Emerging Markets ex China Index has amounted to 25 percent since January 2020. The reason why it is not even better is that China's aforementioned difficulties are spreading to neighboring countries due to close trade links and Asian economies dominate the MSCI Emerging Markets Index at the same time. Other emerging markets, for example from South America, only have a small weighting in the index. However, stocks from South America have recently been among the relative winners, as they have benefited from the rise in commodity prices. According to the Food and Agriculture Organization of the United Nations, Brazil (third place after the USA and the EU) and Argentina (tenth place) are among the world's most important agricultural exporters. As a result, they have benefited from the price increases for soy, corn and sugar. However, industrial raw materials such as iron ore and bauxite from Brazil, copper from Chile and Peru and lithium from Argentina, which are essential for the development of future technologies, are also massively mined and exported. The interim conclusion is that the MSCI Emerging Markets Index has been a drag on the portfolio over the last four years.

The long-term perspective

However, anyone investing in stocks should take a longer investment horizon as a basis: at least five years, but preferably ten years or longer. It is therefore advisable to take a longer-term view of the two global indices. In fact, the picture is particularly surprising for younger equity investors. For example, the MSCI Emerging Markets Index has outperformed the MSCI World Index (8.3 percent p.a.) since 1987 with an annualized return of 9.5 percent and justifies its place in a globally oriented equity portfolio, even if the outperformance is accompanied by a higher risk.



However, a look at the development of the active return of the MSCI World Index compared to the MSCI Emerging Markets Index shows that the emerging markets index has performed relatively worse since 2011.

What should investors do?

Chinese equities have recovered in recent weeks, giving the emerging markets index a tailwind. This was partly due to improved economic data from China, which fueled hopes of an economic turnaround. However, it is certainly premature to proclaim an economic turnaround in China, and at the same time the ongoing structural challenges in the Middle Kingdom should not be ignored. What makes the Chinese equity market and the MSCI Emerging Markets Index attractive for some investors, however, are the favorable valuations.

A direct investment in the Chinese capital market is still out of the question for us due to the political risks. The highly controlled and ideological style of government of the Chinese politburo has led to an immense loss of confidence for us, which does not justify an entry despite considerable valuation discounts. At the same time, in the event of a geopolitical escalation between China and Taiwan, there is a threat of severe protectionist reactions against the communist-ruled country. Those who would nevertheless like to benefit indirectly from an economic recovery in China can instead focus on neighboring countries and allocate to an emerging market index ex China, for example. With a view to long-term asset accumulation, we never tire of preaching that broad diversification is essential. However, as our analysis underlines, it can make tactical sense to (temporarily) underweight certain investment regions or even remove them from the portfolio.

Simon Landt

Market data

Stock marktes	As of 31.05.2024 08:22	Change versus 24.05.2024 -1 week	30.04.2024 -1 month	29.02.2024 -3 months	30.05.2023 -1 year	29.12.2023 YTD
Dow Jones	38111	-2,5%	0,8%	-2,3%	15,3%	1,1%
S&P 500	5244	-1,1%	4,1%	2,9%	24,7%	9,9%
Nasdaq	16737	-1,1%	6,9%	4,0%	28,6%	11,5%
DAX	18497	-1,1%	3,1%	4,6%	16,3%	10,4%
MDAX	26805	-1,2%	2,1%	3,8%	0,0%	-1,2%
TecDAX	3351	-2,5%	2,3%	-1,1%	4,1%	0,4%
EuroStoxx 50	4982	-1,1%	1,2%	2,1%	16,1%	10,2%
Stoxx 50	4464	-0,7%	1,6%	4,4%	12,4%	9,1%
SMI (Swiss Market Index)	11870	-0,5%	5,4%	3,8%	5,2%	6,6%
Nikkei 225	38488	-0,4%	0,2%	-1,7%	22,9%	15,0%
Brasilien BOVESPA	122707	-1,3%	-2,6%	-4,9%	12,6%	-8,6%
Russland RTS	1151	-3,7%	-2,0%	2,1%	9,9%	6,2%
Indien BSE 30	74064	-1,8%	-0,6%	2,2%	17,6%	2,5%
China CSI 300	3590	-0,3%	-0,4%	2,1%	-6,4%	4,6%
MSCI Welt	3420	-1,2%	3,5%	2,5%	21,0%	7,9%
MSCI Emerging Markets	1058	-2,3%	1,2%	3,6%	9,0%	3,4%
Bond markets						
Bund-Future	129,18	-90	-90	-347	-601	-804
Bobl-Future	115,88	-33	-55	-34	-177	-340
Schatz-Future	104,96	0	-16	-20	-52	-159
3 Monats Euribor	3,79	-12	-9	-9	32	-9
3M Euribor Future, Dec 2024	3,38	-3	6	36	41	108
3 Monats $ Libor	5,61	0	2	1	11	2
Fed Funds Future, Dec 2024	5,06	-2	-4	45	158	123
10 year US Treasuries	4,55	8	-13	29	86	69
10 year Bunds	2,66	9	10	27	30	66
10 year JGB	1,07	7	23	36	64	45
10 year Swiss Government	0,94	11	19	12	-2	24
US Treas 10Y Performance	578,72	-0,6%	1,4%	-1,4%	-3,2%	-3,7%
Bund 10Y Performance	543,24	-0,5%	-0,4%	-1,4%	0,2%	-3,9%
REX Performance Index	438,02	-0,3%	-0,3%	-0,2%	0,7%	-2,2%
IBOXX AA, €	3,57	6	6	14	-4	50
IBOXX BBB, €	4,12	5	3	7	-44	36
ML US High Yield	8,17	8	-15	15	-63	38
Commodities						
MG Base Metal Index	457,04	-0,8%	2,5%	20,0%	20,7%	16,9%
Crude oil Brent	81,80	0,1%	-7,0%	-2,4%	11,2%	5,3%
Gold	2343,45	0,2%	2,0%	14,6%	19,7%	13,5%
Silver	31,36	3,5%	18,7%	38,6%	35,1%	29,3%
Aluminium	2656,84	1,5%	2,8%	21,5%	18,0%	13,3%
Copper	10007,14	-1,9%	1,2%	19,1%	23,5%	18,2%
Iron ore	117,62	0,0%	6,0%	-5,8%	11,8%	-13,7%
Freight rates Baltic Dry Index	1801	0,2%	6,9%	-14,7%	60,4%	-14,0%
Currencies						
EUR/ USD	1,0815	-0,2%	0,9%	-0,1%	0,7%	-2,1%
EUR/ GBP	0,8503	-0,1%	-0,4%	-0,6%	-1,6%	-1,9%
EUR/ JPY	169,64	-0,4%	0,8%	4,4%	13,1%	8,5%
EUR/ CHF	0,9791	-1,3%	0,0%	2,7%	1,0%	5,7%
USD/ CNY	7,2428	-0,1%	-0,1%	0,7%	2,3%	2,0%
USD/ JPY	156,83	-0,1%	-0,6%	4,6%	12,2%	11,2%
USD/ GBP	0,79	0,2%	-1,5%	-0,5%	-2,4%	0,3%

Source: Refinitiv Datastream

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