The Tide May Be Turning Toward Emerging Markets

The sectors dominating emerging markets have been changing. This, combined with a decade of underperformance, may mean emerging markets are set for a rotation in their favor.

MARCH 5, 2021

Rajiv Gandhi Sea Link, Mumbai, India

Key Takeaways

- For emerging markets generally, the energy and materials sectors rose in importance during the decade ended December 31, 2010 but fell in importance during the most recent decade.
- The information-technology, communication-services and consumer-discretionary sectors have seen their roles in emerging markets expand dramatically over the past 10 years, and these trends should continue—along with the growing importance of health care.
- During the most recent decade, emerging-market stocks dramatically underperformed U.S. stocks—and small caps underperformed large caps. However, if we go back further to the 10 years ended December 31, 2010, we see outperformance by emerging-market stocks and small caps.
- Over the next decade, we believe there should be better prospects to generate attractive returns in emerging-market stocks and small caps.
- There may be a return to a strengthening cycle for emerging-market currencies, which could create an additional tailwind for investors.
- As world-wide economies begin to get back on track in 2021, there may be a new economic paradigm.
- Certain emerging markets appear to have enormous headroom to increase their GDP per capita.
- Statistics comparing equity market size to GDP indicate where we may find some especially attractive investments.

One of our favorite observations about investing comes from Seth Klarman: "I think investors always learn the lessons of the recent past. And that is the lesson." In other words, because conditions can change and stock prices can move in cycles, the *recent* past may not be a good roadmap for the future. Today, we believe this is especially true for emerging markets.

EMERGING MARKETS HAVE BEEN CHANGING

For a better understanding of how emerging markets have been changing, refer to ***Figure 1*** on page 2—which shows the sector weightings of the MSCI Emerging Markets Index in 2000, 2010 and 2020. As you can see, energy and materials rose in importance during the decade ended December 31, 2010 but fell in importance during the most recent decade. Conversely, information technology (IT), communication services and consumer discretionary have seen their roles in emerging markets expand dramatically during the most recent decade. These are the sectors that

Figure 1: Sector Weightings of the MSCI Emerging Markets Index

	December 31, 2000	December 31, 2010	December 31, 2020
Communication Services	17.9%	7.4%	11.6%
Consumer Discretionary	6.3%	6.9%	18.3%
Consumer Staples	8.9%	6.7%	5.9%
Energy	5.9%	14.3%	5.0%
Financials	19.0%	25.1%	18.0%
Health Care	2.0%	1.0%	4.7%
Industrials	6.8%	7.4%	4.3%
Information Technology	15.4%	12.9%	20.5%
Materials	12.3%	14.9%	7.6%
Real Estate	—	—	2.1%
Utilities	5.5%	3.4%	2.0%
Total	100%	100%	100%

Source: FactSet and MSCI. Past performance is not indicative of future results. You cannot invest directly in an index.

include, for example, semiconductors, e-commerce, cloud computing and software as a service (SaaS).

One sector that hasn't shown as much significance in the Index is health care. But we think this will change dramatically during the coming decade due to the growing utilization of health-care services by people in developing nations and the use of technology to make health care more accessible to these people. For example, China's Ping An Healthcare & Technology is an online and mobile provider of medical services through the internet-based platform "Ping An Good Doctor." The platform is used for remote consultations, hospital appointments, health management, wellness services and health-care resource referrals. Ping An's goal is to improve efficiencies in the allocation of primary-care and hospital resources through the use of innovative technologies including artificial intelligence.

Shanghai, China

Another example is Wuxi Biologics, which is headquartered in China but operates globally. The company develops antibody drugs and biological medicines and provides value-added services to other pharmaceutical firms. Wuxi has an expanding pipeline of business including involvement in vaccine production for Covid-19.

PERFORMANCE OVER THE DECADES

Now that we've discussed the sector drivers of emerging markets over the past two decades, let's look at emerging-market stock performance versus U.S. stock performance broken down by market capitalization. ***Figure 2*** on page 3 includes the MSCI Emerging Markets Index of large caps, the MSCI Emerging Markets Small Cap Index, the Russell 1000® Index of U.S. large caps and the Russell 2000® Index of U.S. small caps. All of the numbers presented are cumulative (not annualized) total returns calculated in U.S. dollars.

What we see is that over a longer period of time, the 20 years ended December 31, 2020, emerging-market stocks outperformed U.S. stocks. What we also see is that over 20 years—both in emerging markets and in the United States—small caps outperformed large caps. This makes sense to us because emerging-market companies and small-cap companies generally have more headroom for growth, despite their generally higher risk profiles.

Next we look at a shorter time period, the 10 years ended December 31, 2020. This period tells a very different

Figure 2: Cumulative Total Returns Calculated in U.S. Dollars

	10 Years Ended December 31, 2010	10 Years Ended December 31, 2020	20 Years Ended December 31, 2020
MSCI Emerging Markets Index USD (Large Caps)	337.02%	42.82%	524.13%
MSCI Emerging Markets Small Cap Index USD	445.79%	25.42%	584.54%
Russell 1000 Index USD (U.S. Large Caps)	19.86%	271.02%	344.71%
Russell 2000 Index USD (U.S. Small Caps)	84.77%	189.20%	434.35%

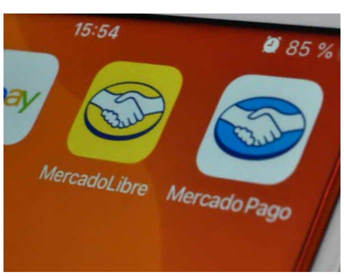
Source: Morningstar Direct. Past performance is not indicative of future results. You cannot invest directly in an index.

story. Emerging-market stocks dramatically underperformed U.S. stocks, and small caps underperformed large caps. However, if we go back further—to the decade ended December 31, 2010—we see outperformance by emerging-market stocks and small caps. Moreover, we believe these areas may be favored by investors once again.

LONG-TERM EXPECTATIONS AND CYCLICAL IMPROVEMENTS

Having described the growing importance of tech- and consumer-oriented companies—along with the broad performance of stocks over the past two decades—we have some thoughts about what may lie ahead.

Over very long periods of time, we believe there will be better opportunities to generate attractive returns in emerging-market stocks and in small caps. The main reason is that greater headroom for growth in these areas generally means a seemingly higher valuation may be less of an impediment to long-term investment success.



Particularly among emerging-market companies and small-cap companies, we believe investment success comes more from properly assessing business models, management teams and competitive landscapes than from assessing valuations. For our part, business models, management teams and competitive landscapes—among other fundamental factors—are where we concentrate the bulk of our research efforts.

As an example, consider MercadoLibre—a Latin American e-commerce and fintech pioneer. Back in 2010, the company had a market capitalization of about US$2 billion. Since then, the market cap of MercadoLibre has skyrocketed to approximately US$79 billion. Another example is India's HDFC Bank, which grew from about US$15 billion in 2010 to approximately US$117 billion today.

Still, we understand that cyclical factors also impact market prices. For instance, the most recent decade has been out of sync with what we'd expect over the longer term. In other words, we believe emerging-market stocks and small caps will see cyclical improvements in performance relative to U.S. stocks and large caps. The reasons for such improvements include comparatively attractive prices and the aforementioned headroom for growth and technological advances—which may create a revolution that would be particularly beneficial for emerging-market and small-cap companies.

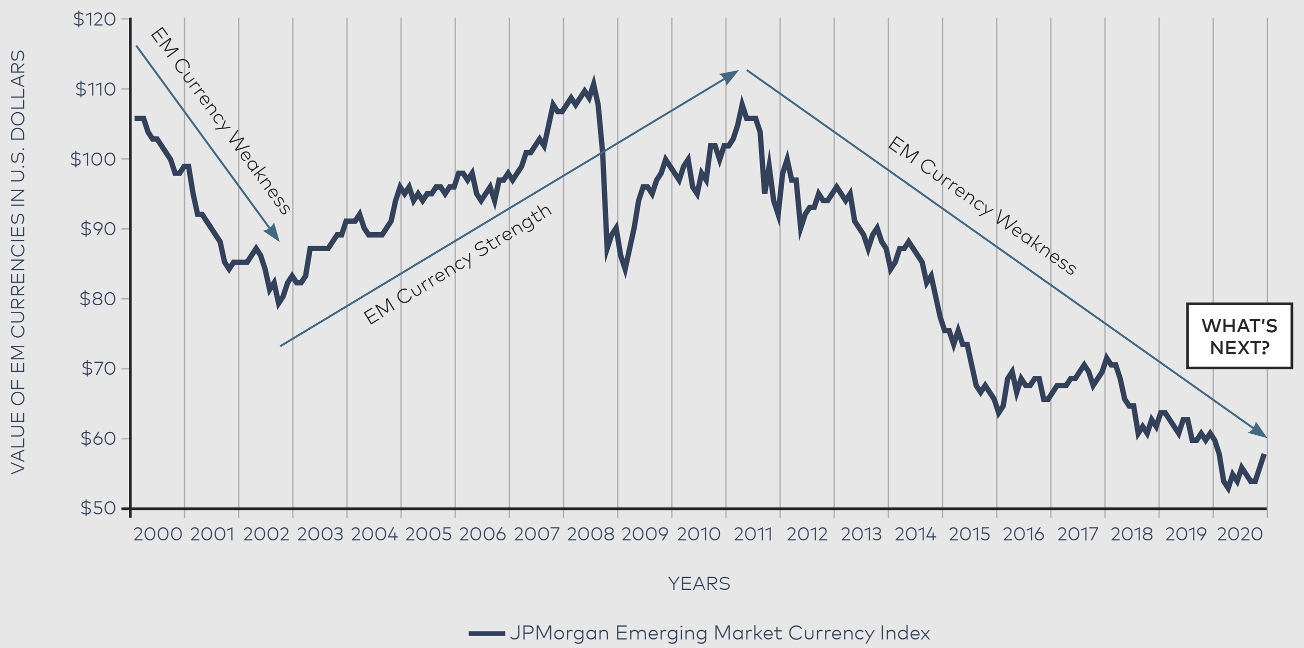
CURRENCY TRENDS

Another cyclical factor is the value of the U.S. dollar compared to other currencies. Broadly speaking, during the decade ended December 31, 2020, emerging-market currencies fell relative to the dollar—which created headwinds for emerging-market governments and companies due to effects on borrowing costs, commodity prices and overall economic tightness. To illustrate the historical strength in the dollar and weakness in emerging-market currencies for

Figure 3: Emerging-Market (EM) Currencies

WEAKENING AND STRENGTHENING CYCLES VERSUS THE U.S. DOLLAR

MONTHLY DATA FROM JANUARY 31, 2000 THROUGH DECEMBER 31, 2020



Source: Bloomberg. Chart includes all the month-end data available for the JPMorgan Emerging Market Currency Index through December 31, 2020.

the past decade, we show in ***Figure 3*** above that the JPMorgan Emerging Market Currency Index is down more than -45% from a high in 2011 and is now close to its lowest level since then.

Particularly for U.S.-based investors, weaker emerging-market currencies hurt emerging-market stock prices due to currency-conversion effects. But prior to the recent weakening cycle, emerging-market currencies were in a strengthening cycle. As you may have surmised, the currency strengthening cycle coincided with the decade of outstanding emerging-market stock returns. And the weakening cycle coincided with the decade of lackluster returns.

At some time in the years ahead, we believe there may be a return to a strengthening cycle for emerging-market currencies. And while our investment approach by no means depends on such a cycle, we think strong currencies could give an added boost to emerging-market stocks. The primary reasons for our longer-term view on the strength of emerging-market currencies relative to the dollar are the likelihood

of cyclical slowing in U.S. economic growth, continued dovish U.S. monetary policies and improved fiscal conditions in emerging markets.

As an aside, we believe exchange rates aren't as important when investing in China, Taiwan and Korea because these countries generally have been able to keep their currencies within reasonable ranges relative to the dollar.

A NEW ECONOMIC PARADIGM

Beyond the long-term changes and market cycles that we had recognized even before the coronavirus pandemic, we think the pandemic may have accelerated the development of a new economic paradigm. More specifically, as world-wide economies begin to get back on track in 2021, we think it's important to keep in mind that "getting back on track" may not be the same as "getting back to normal" because "normal" may have changed. In other words, the pandemic—coupled with technology—may have permanently altered the way people live and work. As a result, a seemingly well-positioned company in 2019 may now be obsolete.

Based on the recent performance of the Wasatch strategies and funds, which you can access at ***wasatchglobal.com***, we think our bottom-up research process meant we were nicely prepared for this unexpected new paradigm that has favored IT, consumer-oriented and health-care companies. The continuation of this paradigm will also influence our investment decisions going forward because it may create unforeseen opportunities, as well as accelerate other opportunities we had already expected.

GDP PER CAPITA: U.S. VERSUS CHINA AND INDIA

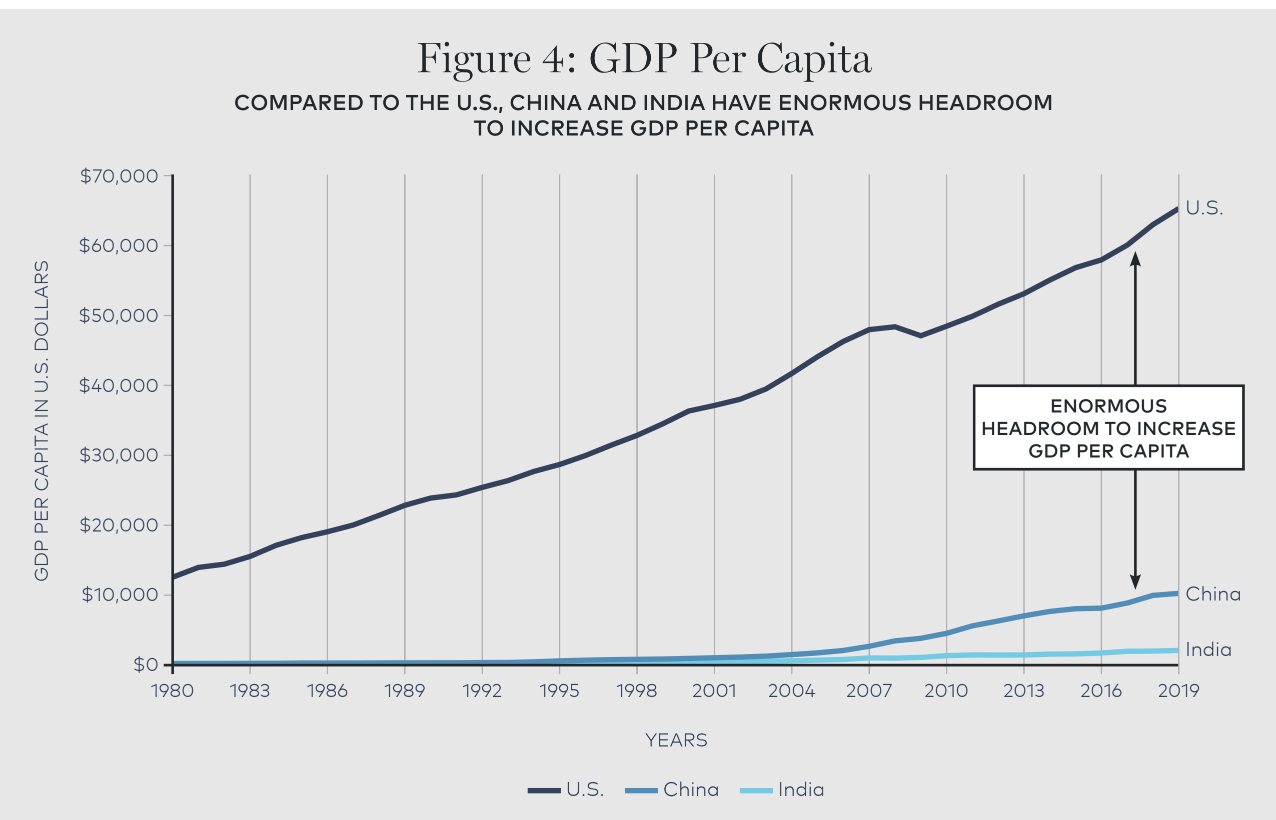
Another way to consider the investment opportunity set in emerging markets is to look at gross domestic product (GDP) per capita. As you can see in ***Figure 4*** below, for example, GDP per capita is about US$65,000 in the United States, US$10,000 in China and US$2,000 in India.

Of course, there are large portions of the economy that aren't captured by GDP statistics in China and India. But there's still enormous headroom for China, India and other emerging markets to increase their GDP per capita relative to the U.S. and relative to other developed nations. Moreover, this growth potential is even greater when population size is considered. China and India, for instance, each have over four times the population of the United States.

LOWER EQUITY MARKET SIZE COMPARED TO GDP MAY FAVOR EMERGING MARKETS

Although we think GDP per capita is especially interesting for emerging markets, next we consider total GDP—which is the overall value of all the finished goods and services produced within a country's borders during a specific time period, usually a year. In ***Figure 5*** on page 6, a light blue bar represents the total annual GDP for each country. As you can see, some emerging markets have sizable GDP tallies even compared to developed countries.

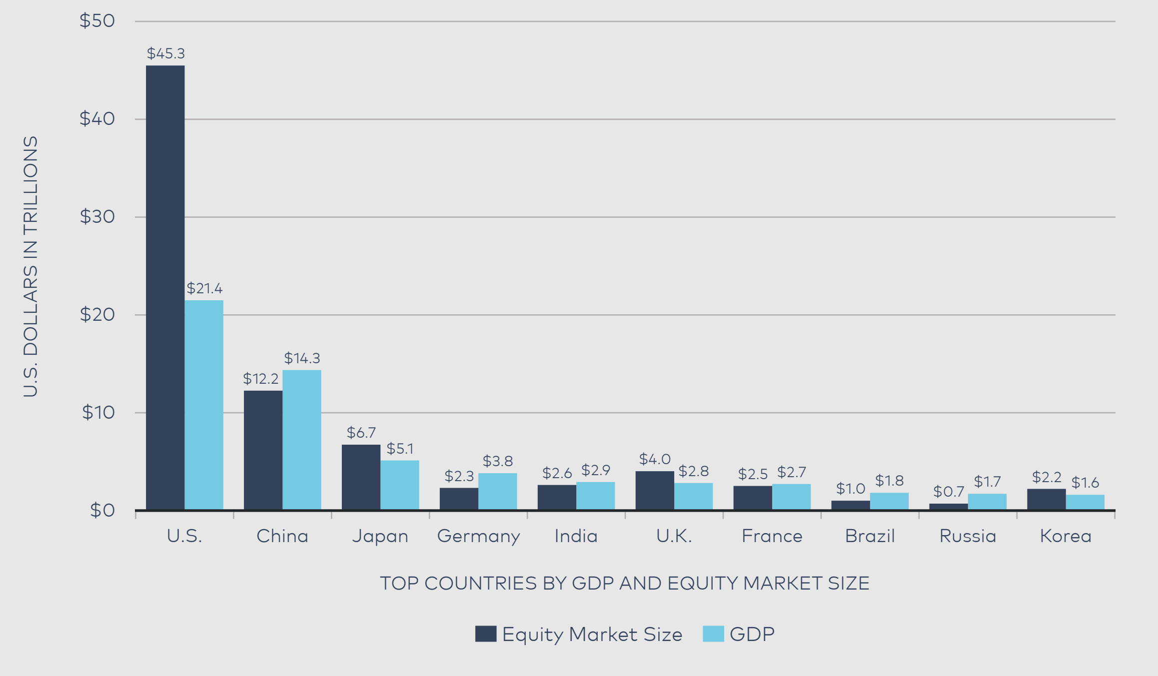
Also for each country in ***Figure 5***, a dark blue bar represents the total equity market size—which is the combined value of all publicly traded stocks. For the U.S., the equity market size is about double the annual GDP. Historically, such a situation often meant that stocks were richly valued. For the other countries shown, the equity market size is much closer to annual GDP. In particular, we note that for



Source: The World Bank. Year-by-year GDP per capita data are from December 31, 1980 through December 31, 2019.

Figure 5: Equity Market Size and GDP

COMPARED TO THE U.S., OTHER COUNTRIES LOOK UNDERVALUED ON AN EQUITY MARKET SIZE TO GDP BASIS



Sources: The World Bank and World Federation of Exchanges databases. Equity market size data are as of December 31, 2020 and GDP data are as of December 31, 2019.

China and India—two of our favorite sources of investment opportunities—the equity market size is actually below annual GDP.

Please keep in mind the conditions presented in ***Figure 5*** don't mean that every stock in the U.S. is overvalued or that every stock in China and India is undervalued. But we believe the conditions do indicate where we may find some especially attractive investments if we perform proper due diligence into company fundamentals and competitive environments.

THE WASATCH OUTLOOK

The coronavirus pandemic and geopolitical tensions, which caused dramatic shortages of protective gear and pharmaceutical ingredients, also highlighted that countries and companies need to diversify their supply chains and exert more control over production. Low cost can no longer be the primary consideration. For example, Apple is planning to expand iPhone production in India. In addition, Samsung already has its largest smartphone manufacturing facility located in India and will start making TVs there too.

We think new and enhanced supply chains will provide attractive investment opportunities over the coming years. In particular, thousands of companies will enter—or increase their involvement in—the technologically advanced supply chains running through emerging markets. And with so many companies, some will succeed spectacularly while many others will struggle. Therefore, we think active stock picking will be especially important.

In this regard, we continually add resources to our emerging markets research team. Our latest addition is Neal Dihora, CFA, who comes to Wasatch as a Portfolio Manager from the highly regarded Nicholas Company. Neal was born in Bhavnagar, India and speaks Gujarati.

Wasatch's experience in analyzing innovative, technology-driven companies should be well-suited to navigating the rapidly shifting terrain of emerging markets. Moreover, while some of our strategies and funds focus on small caps, our "select" strategies and funds allow us to invest in mid- and large-cap companies that we believe can continue to grow substantially.

To summarize, within emerging markets, we want to own many of the types of tech-related companies that have brought enormous efficiencies and modern conveniences to developed nations for many years—including during the coronavirus pandemic. Additionally, if we're

São Paulo, Brazil

correct that the investment cycle and the currency cycle have shifted in favor of many emerging markets, we may experience an even stronger tailwind.

In this paper, we've also described a new economic paradigm, the trends in GDP per capita and the levels of equity market size compared to GDP. Although we think it's impossible to predict exactly how these conditions will evolve, we believe we have our research efforts concentrated in the right places and we're ready to make company-specific investment decisions when opportunities arise. This is very important because relatively few individual stocks tend to outperform a corresponding benchmark index.

WASATCH HEAD OF EMERGING MARKET INVESTING

Ajay Krishnan, CFA

Portfolio Manager and Head of Emerging Markets Investing

26 Years of Experience / 26 Years at Wasatch

Mr. Krishnan joined Wasatch Global Investors in 1994 and serves on the Board of Directors. He is also a Portfolio Manager, the head of emerging markets investing and a member of the global research team.

Mr. Krishnan earned a Master of Business Administration from Utah State University, where he also worked as a graduate assistant. He completed his undergraduate degree at Bombay University, earning a Bachelor of Science in Physics with a minor in Mathematics.

Mr. Krishnan is a CFA charterholder and a member of the Salt Lake City Society of Financial Analysts.

Ajay is a native of Mumbai, India and speaks Hindi and Malayalam. He enjoys traveling and cycling.

RISKS AND DISCLOSURES

Mutual-fund investing involves risks, and the loss of principal is possible. Investing in small cap funds will be more volatile and loss of principal could be greater than investing in large cap or more diversified funds. Investing in foreign securities, especially in emerging markets, entails special risks, such as unstable currencies, highly volatile securities markets and political and social instability, which are described in more detail in the prospectus.

An investor should consider investment objectives, risks, charges and expenses carefully before investing. To obtain a prospectus, containing this and other information, visit wasatchglobal.com or call 800.551.1700. Please read the prospectus carefully before investing.

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Portfolio holdings are subject to change at any time. References to specific securities should not be construed as recommendations by the Funds or their Advisor. Current and future holdings are subject to risk.

References to individual companies should not be construed as recommendations to buy or sell shares in those companies.

As of December 31, 2020, the Wasatch Emerging Markets Select Fund had 5.0% of its net assets invested in HDFC Bank Ltd., 5.7% of its net assets invested in MercadoLibre, Inc., 0.8% of its net assets invested in Ping An Healthcare & Technology Co. Ltd. and 3.6% of its net assets invested in Wuxi Biologics Cayman, Inc.

As of December 31, 2020, the Wasatch Frontier Emerging Small Countries Fund had 7.3% of its net assets invested in MercadoLibre, Inc.

As of December 31, 2020, the Wasatch Global Opportunities Fund had 3.5% of its net assets invested in MercadoLibre, Inc.

As of December 31, 2020, the Wasatch Global Value Fund had 3.2% of its net assets invested in Samsung Electronics Co. Ltd.

As of December 31, 2020, the Wasatch Greater China Fund had 1.7% of its net assets invested in Ping An Healthcare & Technology Co. Ltd. and 4.6% of its net assets invested in Wuxi Biologics Cayman, Inc.

As of December 31, 2020, the Wasatch Emerging India Fund had 7.6% of its net assets invested in HDFC Bank Ltd.

As of December 31, 2020, none of the Wasatch strategies or funds held Apple, Inc.

Wasatch Advisors, Inc., doing business as Wasatch Global Investors, is the investment advisor to Wasatch Funds.

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DEFINITIONS

*The "**cloud**" is the internet. **Cloud-computing** is a model for delivering information-technology services in which resources are retrieved from the internet through web-based tools and applications, rather than from a direct connection to a server.*

Gross domestic product (GDP) *is a basic measure of a country's economic performance and is the market value of all final goods and services made within the borders of a country in a year.*

GDP per capita *is a measure of the total output of a country that takes the GDP and divides it by the number of people in the country.*

The **JPMorgan Emerging Market Currency Index** *measures the strength of the most traded developing country currencies against the U.S. dollar. You cannot invest in this or any index.*

The **MSCI Emerging Markets Index** *is a free float-adjusted market capitalization index designed to measure the equity market performance of emerging markets. You cannot invest directly in this or any index.*

The **MSCI Emerging Markets Small Cap Index** *is a free float-adjusted market capitalization index designed to measure the equity market performance of small capitalization securities in emerging markets. You cannot invest directly in this or any index.*

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The **Russell 1000 Index** *is an unmanaged total return index of the largest 1,000 companies in the Russell 3000 Index. The Russell 1000 typically comprises about 92% of the total market capitalization of all listed stocks in the U.S. equity market. It is considered a bellwether index for the performance of large company stocks. You cannot invest directly in this or any index.*

The **Russell 2000 Index** *is an unmanaged total return index of the smallest 2,000 companies in the Russell 3000 Index, as ranked by total market capitalization. The Russell 2000 is widely used in the industry to measure the performance of small company stocks. You cannot invest directly in this or any index.*

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Valuation *is the process of determining the current worth of an asset or company.*

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