A MOMENT IN MARKETS – THE LONG-AWAITED RETURN OF THE EMERGING MARKETS RISK PREMIUM?

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03 Feb 2021

The notion of an emerging markets (EM) risk premium exists to compensate investors for taking the risk of investing in economies with relatively more uncertain but potentially higher growth. Does this premium exist in equity markets? It depends on how far back you look. Since the turn of the millennium, emerging markets have outpaced world equities by around 2.2% per annum[1]. But the story so far appears to be split into two halves. EM equities outperformed world equities in the first decade but lagged in the second. Investors may choose to dissect periods of relative performance as they like. The key learning outcome is that the outperformance has not always been steady.

It is therefore pertinent to ask whether the year ahead will be conducive for EM equities. Were the strong relative returns of EM equities in January ephemeral or was the performance a harbinger of the outlook for the rest of the year? There are no certainties when it comes to the future. There are, however, existing tailwinds which can give investors comfort in overweighting the EM risk premium within an equity portfolio this year.

Monetary and fiscal accommodation from major central banks around the world is expected to persist this year. This will continue to lend buoyancy to risk assets across the spectrum. A vaccine-led end to the pandemic promises to accelerate the economic recovery this year – something that will be welcomed by equity markets across the board. Many EM economies hit hard by the pandemic like India, Brazil, Mexico, and India will be seeking to rebuild their domestic economies. Others that have fared better in suppressing the pandemic like China, Taiwan, and South Korea will be looking to their trading partners in America and Europe to bring their economic recovery on track.

But monetary and fiscal accommodation in the US also means low to negative real Treasury yields and a weak US dollar. This could continue to be the case until the US economy is strong enough for policy tightening to become justifiable. Is it possible for this scenario to unfold as early as this year? If not, negative real yields may push more capital towards emerging markets while a weak dollar will make it easier for emerging markets to service their dollar-denominated debt. Both are very good outcomes for EM equities.

And how important is China going to be? The country wields a weight of over 39%[2] in the MSCI Emerging Markets Index making the country’s fortunes inextricably intertwined with broader EM indices. Its new 5-year plan for 2021-2025 sets out a ‘dual circulation’ policy built on domestic growth as well as international trade. China’s economic growth last year contrasts sharply with other major economies as the country was able to pull itself out of recovery mode very promptly. Its recent investment and trade deals with the European Union as well as partners in the Asia-Pacific region also reaffirm its global ambitions.

And how will US foreign policy shape up under the Biden administration, particularly on the trade front, and especially towards China? While it would be naïve to assume that economic and technological rivalry between China and the US is going to disappear, it might be reasonable to expect the relationship to be less confrontational. The bottomline is that asset markets abhor uncertainty and welcome clarity. A stable and less uncertain relation between the two largest economies in the world will bode well for EM assets.

A moment in markets – Navigating equity markets in the year ahead introduced a possible framework for investors to build an equity portfolio this year. The approach was built on three key components: a core made of quality; diversity through cyclicals; and growth through thematic exposures. An emerging market overweight sits within the 'diversity through cyclicals' basket being a segment of global equity markets that not only offers diversity but stands to benefit from an economic upswing.

Sources

[1] Bloomberg. Data as of 02 February 2021. Emerging market equities refer to the MSCI Emerging Markets Index in USD and world equities refer to the MSCI World Index in USD.

[2] MSCI as of 02 February 2021.

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