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MARKETS | FEATURE

Emerging Markets Struggled in 2023. Here's Why Next Year May Be Better.

By Reshma Kapadia

Emerging markets will get a much-needed catalyst for improvement in 2024: central banks around the world pivoting to lower interest rates.

For this year, the MSCI Emerging Markets index is on pace for another trouncing by the S&P 500 index—returning 5% to date, compared with a 26% gain for the S&P. China's sputtering economic recovery and investor apprehension about the country's prospects were a major drag.

Markets outside of China have fared better, with the iShares MSCI Emerging Markets ex-China exchange-traded fund up 15% on the back of strong rallies in Indian, Brazilian, and Mexican stocks.

Those gains could be supercharged as many central banks shift from raising rates to pausing or even cutting. Emerging markets with large current-account deficits—broadly, those that buy more than they sell abroad and are reliant on foreign capital for financing—are vulnerable to interest rate swings.

Higher rates allow investors to get decent yields without venturing into riskier assets like emerging markets. That drains capital flows from countries, hurting investment, domestic consumption, and growth. The reverse happens when rates fall, paving the way for cheaper borrowing for companies and boosting earnings.

With potential rate cuts ahead, the dollar looks set to weaken, creating an inflection point for markets like Brazil and Mexico, says Michael Kass, manager of the Baron Emerging Markets fund. A weaker dollar has historically been a positive for emerging markets, boosting returns of U.S. investors as they repatriate their profit, and reducing borrowing costs for countries with dollar-denominated debt.

These countries are heading into a favorable rate backdrop in an already strong position. Companies poured money into Mexico to build manufacturing facilities as they diversified their supply chains away from China, mitigating the hit from higher rates in the past year.

Meanwhile, Brazil's fiscal health benefited from an increase in its oil production, as well as higher demand for its agriculture and energy as countries looked for alternative sources amid Russia's war in Ukraine.

The iShares Latin America 40 ETF is up 34% over the past year, reflecting these developments. But the region's stocks are still not widely owned, and they're cheap. The MSCI EM Latin America index trades for less than nine times forward earnings. A change in rates could be a powerful incentive to move stocks higher still.

"With inflation rolling over, the potential for lower interest rates is strong. And there are few drivers as strong for equity market reratings as the combination of decent economic growth and falling interest rates," wrote Louis-Vincent Gave, head of Gavekal Research, in a client note that highlighted Latin America as one 2023 bull market that could see further gains next year.

One of the biggest beneficiaries could be Brazil, where interest rates are among the highest in emerging markets and have the furthest to fall. The central bank has already started to cut its benchmark rate and signaled that more is ahead. Within Brazil, Kass favors financially sensitive companies that stand to benefit the most from the shift, such as Brazilian stock exchange operator B3 and XP Investimentos—the country's version of Charles Schwab.

Laura Geritz, head of Rondure Global Advisors, has also invested aggressively in Latin America, including in Brazil's Itau Unibanco, software company Totvs, and Petrobras. The draw: much improved balance sheets, sharply falling interest rates, and cheap stocks.

Geritz also has holdings in Mexico that benefit from shifts in supply chains, including Prologis Property Mexico, which provides warehousing and distribution to multinational businesses, and rail operator GMexico Transportes.

The other bright spot in emerging markets is India. The country, now the world's most populous, has become a market darling as investors—and companies—seek out an alternative to China.

India's government has aggressively invested in infrastructure, adding to the country's appeal as a location for companies looking to diversify production. Meanwhile, cheap oil imports from Russia and myriad reforms have made the government fiscally stronger and able to reinvest in the economy.

India isn't cheap, with the MSCI India index trading at 20 times forward earnings. But the valuation doesn't bother some investors. Baron's Kass says the higher multiples come with the country's improved visibility and sustainable growth prospects. "They are probably where China was 10 to 15 years ago but with an institutional and corporate-governance regime that is far more powerful," he adds.

The divergence in India's and China's economic prospects, with faster growth in the former and a faltering performance by the latter, is also creating a convergence in the countries' weightings in the MSCI Emerging Markets index.

China is down from a weighting of 40% in late 2020 to 27%, while India's has gone from 10% in 2020 to 17%. That shift gives the index a better chance to outperform, even if China's recovery doesn't pick up steam.

China's policy makers have stepped up stimulus to stabilize the economy, mitigating concerns about an implosion. But the troubled property market, which accounted for a quarter of economic activity; flagging consumer and business confidence; and no sign that Beijing will roll out even more aggressive stimulus, point to a middling recovery.

Beijing's proposed curbs on online gaming, which sent shares of companies like Netease and Tencent Holdings tumbling Friday, has done little to ease investors' concerns about sudden policy shifts.

The economy could see a slow cyclical pickup next year. Combine that with rock-bottom prices and Chinese stocks may bounce in the near term, even if investors' apprehension about President Xi Jinping's policies and the tense rivalry between the U.S. and China make it short-lived.

"If those stocks join the party, it could be a big year for emerging markets," Rondure's Geritz says. "But if they don't, it could still be a good year because the impact of China on the index is fading."

In other words, the rest of emerging markets could end up taking the spotlight on their own, especially if the Federal Reserve hands them the gift of rate cuts.

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For information pertaining to competitor funds, please refer to that firm's website.

Portfolio holdings as a percentage of net assets as of December 31, 2023 for securities mentioned are as follows: B3 S.A. - Brasil, Bolsa, Balcao 1.1%; XP Inc. 1.1%.

Baron Emerging Markets Fund

Top 10 Holdings as of December 31, 2023

Holding Name	% of Net Assets
Taiwan Semiconductor Manufacturing Company Limited	6.9
Samsung Electronics Co., Ltd.	5.3
Tencent Holdings Limited	3.7
Bajaj Finance Limited	2.5
Suzano S.A.	2.3
Alibaba Group Holding Limited	2.2
HDFC Bank Limited	2.2
HD Korea Shipbuilding & Offshore Engineering Co., Ltd.	2.0
Bharti Airtel Limited	2.0
Bundl Technologies Private Limited	1.9
Total	**30.9**

Portfolio holdings are subject to change. Current and future portfolio holdings are subject to risk.

The **MSCI EM (Emerging Markets) Index Net (USD)** is designed to measure equity market performance of large and mid-cap securities across 24 Emerging Markets countries. The **MSCI India Index** is designed to measure the performance of the large and mid cap segments of the Indian market. With 122 constituents, the index covers approximately 85% of the Indian equity universe. MSCI is the source and owner of the trademarks, service marks and copyrights related to the MSCI Indexes. The **S&P 500 Index** measures the performance of 500 widely held large-cap U.S. companies. The indexes and the Fund include reinvestment of dividends, net of foreign withholding taxes, which positively impact the performance results. The indexes are unmanaged. The index performance is not Fund performance; one cannot invest directly into an index.

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