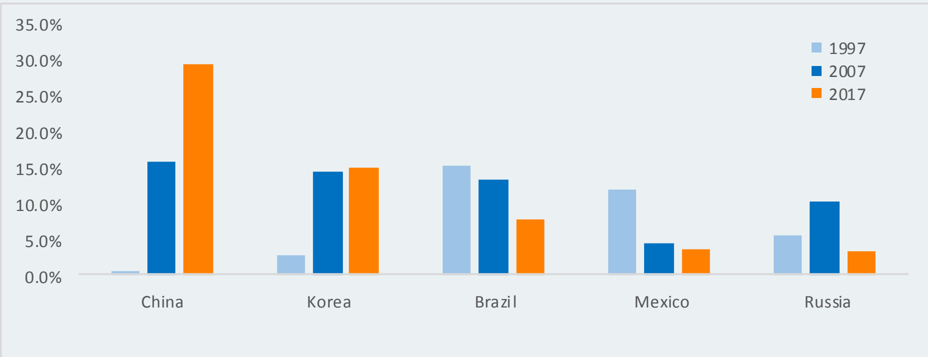
The Changing Face of Emerging Markets Equity

FIGURE 1. MSCI EMERGING MARKETS INDEX COUNTRY WEIGHTS

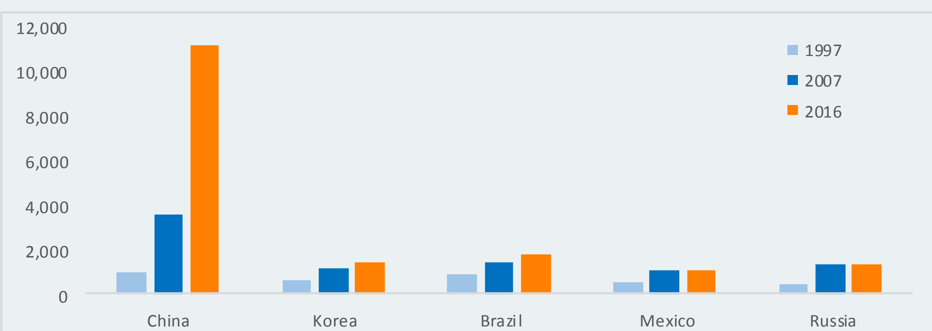


Source: MSCI

The MSCI Emerging Markets Index has undergone dramatic changes over the last two decades. The most conspicuous of these changes have been China's growing dominance within the index and sector weightings that have become heavily skewed towards Information Technology and Financials. These changes have significant implications for Emerging Markets Equity investors as they have altered the behavior of the index both on a standalone basis and relative to other asset classes.

Index providers have included or excluded specific companies and countries over time. The changes have primarily been driven by differentials in economic growth and development, which directly stem from the relative success or failure of country-specific economic policies. This is visible in the evolution of the Nominal GDP numbers in the table below.

FIGURE 2. NOMINAL GDP (1997-2016)



Source: World Bank

China joined the WTO in December 2001, setting in motion a profound shift in the global economic landscape and corresponding equity market indices. Economic development was initially driven by infrastructure spend and state-sponsored industrialization supporting more cyclical sectors such as energy, materials and industrials, as well as asset intensive plays like telecommunications and utilities. As the Chinese economy evolved, there was a gradual shift towards more locally oriented sectors. Technology and domestic consumption related sectors began to overtake the deeper cyclical sectors.

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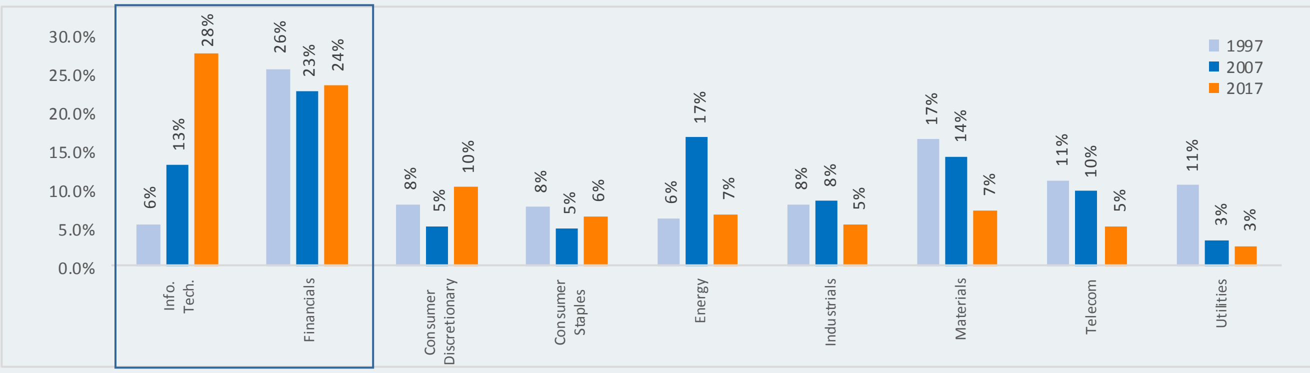
Erik Zipf, CFA, Portfolio Manager, Emerging Markets Equity, is responsible for managing the Emerging Markets Equity strategy in collaboration with Lode Devlaminck. Mr. Zipf joined DuPont Capital in 2004 and was the associate portfolio manager for the firm's U.S. Small and Mid Cap strategies until transitioning to the Emerging Markets Equity strategy in 2011. Before joining DuPont Capital, Mr. Zipf was employed for 10 years by Delaware Investments, where he held research analyst roles in both fixed income and equities. He joined the investment industry in 1994.

Mr. Zipf holds a B.S. in Economics and Finance from Albright College, and an M.B.A. from St. Joseph's University. He is a member of the CFA Institute and the CFA Society of Philadelphia.

China's growing dominance within the MSCI Emerging Markets Index has altered the behavior of the index on a standalone basis and relative to other asset classes.

China's impact on the Index has been twofold. First, the country's impressive growth story has driven China's index weight from less than 1% just twenty years ago to nearly 30% today. Combined with other economic success stories like Korea, India, Indonesia and Thailand, Asia now accounts for over 70% of the index, crowding out both EMEA and Latam. Second, given China's newfound prominence in the global markets and the evolution towards a more technology and consumer-centric economy, the Technology and Financial sectors now account for more than 50% of the index, as shown in Figure 3 below.

Figure 3. MSCI Emerging Markets Index Sector Weights (1997-2016)



Source: MSCI

What are the implications?

Given the importance of the Chinese economy and the weight of China and China-related countries in the Index, it is fair to say that their performance is having an outsized influence on Emerging Markets. For example, the Korean and Taiwanese economies, which are close to 25% of the Index, are both closely tied to Chinese demand. Such interdependence significantly expands China's overall influence on Emerging Markets. China's dominance from an Index perspective can be seen in the growing correlation between the MSCI Emerging Markets Index and the MSCI China Index, which jumped from 0.2 in 1997 to 0.8 in 2017.

China may also be reducing cyclical volatility within the Index due to their shift towards sectors that are technology or consumer-based. As a result, the MSCI Emerging Market Index has taken on more of a "growth" profile and less of a "cyclical" profile. While boom and bust cycles were formerly influenced by cyclical swings, these cycles are now more driven by technological shifts. Further, while Financials, the second largest sector in the Index, remains cyclical in nature, it is now more heavily driven by local factors such as interest rates, regulation, and credit demand as opposed to global and regional industrial production.

Asset allocators will need to be mindful of potential changes in correlations between Emerging Markets and other asset classes. It is interesting to note that, excluding Financials and Health Care, the composition of the Emerging Markets Index is now more in-line with the S&P 500 than the MSCI EAFE Index. Finally, country selection will continue to be or become an even more important source of risk and opportunity within Emerging Markets as more locally or regionally driven sectors have gained in importance.

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