A Time of Reckoning in Emerging Markets

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KEY FINDINGS

- Since 1991, there have been distinct phases in the performance of non-US investments, with significant underperformance since the Global Financial Crisis in 2008.
- It is time to evaluate the performance of emerging markets to determine which have succeeded and which have failed since the early 1990s. Given the evidence, the categories of developed, emerging, and frontier markets may no longer be appropriate.
- There should be discussion and debate about alternative frameworks for categorizing global markets. The IMF categories of advanced and less-developed economies are an example of a possible alternative.

ABSTRACT

"Emerging markets" has been a positive label for selected markets in developing countries since the mid-1980s. This is a good time to review the progress of those countries and others to see which have succeeded and which have not. Despite the well-known success of China, many countries have failed to measure up to their early promise. This article examines the relative gains and losses of each country versus the developed world's average GDP per capita from 1991 to 2026 (based on IMF estimates). Brazil and Mexico, for example, have lost ground during that period. Because of those findings, this is a good time to consider changing the "emerging" label and possibly creating a new framework for grouping markets. The IMF list of advanced economies is considered as one possibility. It is important to stimulate discussion of the appropriate categories for investors in creating their opportunity sets for investing and making asset allocation decisions in the years to come.

> *"To everything there is a season, and a time to every purpose under the heaven:*
> *A time to get, and a time to lose…."*
>
> Ecclesiastes 3, King James Version, 1611

This Journal was born in 1991, shortly after the 1987 launch of the MSCI Emerging Markets (EM) Index.

The name of the index was chosen to polish the image of places once called "Third World"[1] and to imply that these countries were emerging out of poverty and that growth would be inevitable.

[1] In 1981, IFC's Antoine van Agtmael felt that "Third World" was a term that connoted extreme poverty, shoddy goods, and hopelessness to many at the time, but "Emerging Markets" suggested progress, uplift, and dynamism. IFC History, Establishing 'Emerging Markets.' https://www.ifc.org/wps/wcm/connect/corp_ext_content/ifc_external_corporate_site/about+ifc_new/ifc+history/establishing-emerging-markets.

Now is the time for a reckoning. Which countries have succeeded? Which have failed? And what should we do about it?

1991 marked the end of the Cold War. It was a time of optimism that peace, prosperity, and democracy would flourish. Soviet communism had failed. Reforms in China had succeeded. It seemed that further progress and reforms lay ahead. It was easy to predict that China would become the low-labor-cost factory for the world while Russia could become a technology powerhouse rivaling Silicon Valley.

Other bets seemed safe as well:

- Demographic change would lead to the aging of the developed world and maturing of the developing world.
- A rising middle class in emerging countries would trigger a boom in consumer products.
- Emerging countries would emerge and grow faster than the developed world.
- Emerging stock markets would offer excellent relative returns.

With hindsight, the bet on demographics has proved true, but the other results are mixed.

This article is an effort to put the progress of developing countries in perspective. Some countries have done better than expected in both economic and investment results. Others have been disappointing overall, although there have been rallies on the expectation of economic reforms or commodity price increases.

The current framework of asset allocation based on the MSCI Indexes of US, EAFE, Emerging, and Frontier deserves to be reviewed considering the realities of today's world contrasted with the environment of 30 years ago. After presenting the evidence, this article presents one of the alternative frameworks that could gain acceptance. It is time to have this discussion.

OUR INVESTMENT EXPERIENCE

> *"Experience is a comb that life gives you after you lose your hair."*[2]
>
> *Judith Stern*

> *"Where is the wisdom we have lost in knowledge?*
> *Where is the knowledge we have lost in information?"*
>
> *T.S. Eliot, The Rock, 1934*

We have certainly had some interesting investment experiences in the past 30 years. And we know a lot more than we did in 1991, but are we wiser?

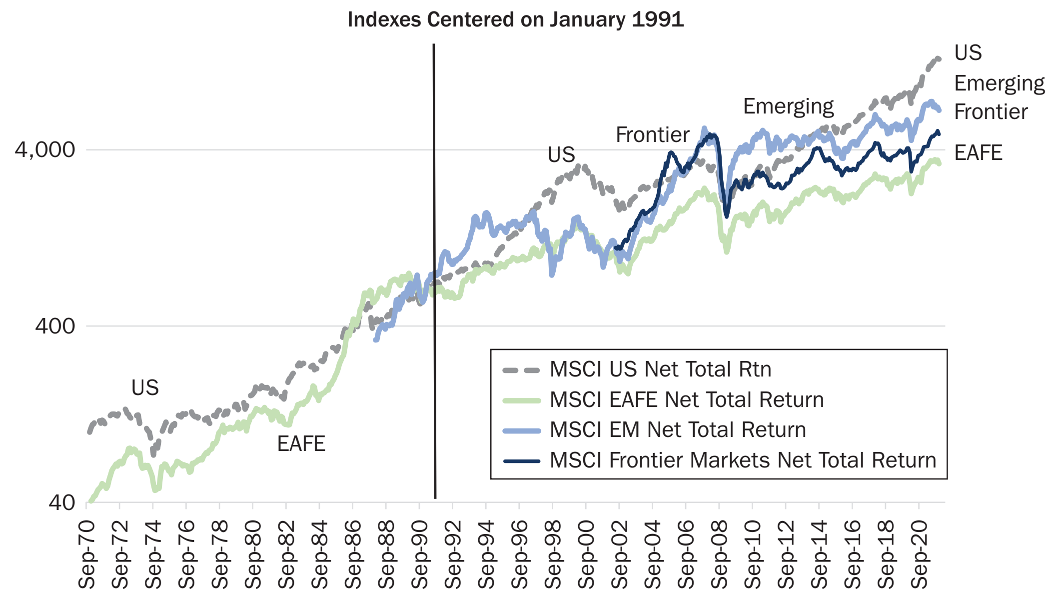
The good news is that since 1991, the major stock indexes have gone up, despite traumas of the internet bubble, 9/11, the Global Financial Crisis, the rise of populism, and the impact of climate change.

By 1991, we had seen the collapse of the Japanese stock market from its high at nearly 60% of the EAFE Index in 1989 (Siegel 2009). The MSCI EM Index, introduced in 1987, was hot, but it was hit in the late 1990s by a real estate bubble, broken currency pegs, and a resulting five-year index decline. After the internet bubble burst in the early 2000s, emerging markets recovered, and newly discovered frontier markets also did well.

[2] In his March 1955 syndicated newspaper column, "Try and Stop Me," Bennett Cerf credited the line to Mrs. Edgar Stern.

EXHIBIT 1

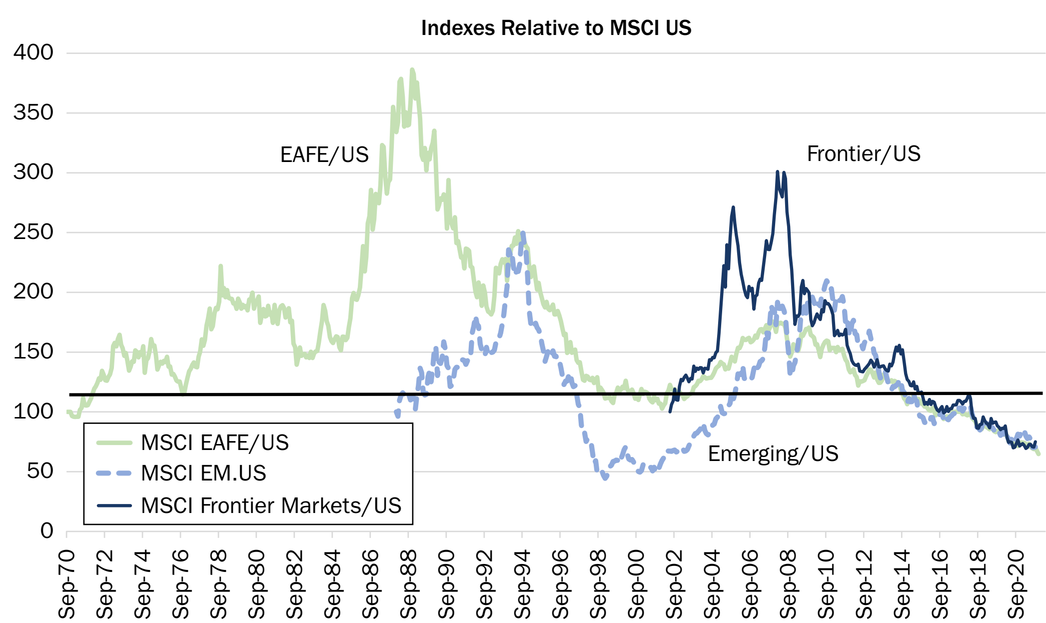
Cumulative MSCI Index Returns



SOURCE: MSCI, Bloomberg, November 2021.

EXHIBIT 2

MSCI Index Returns Relative to MSCI US

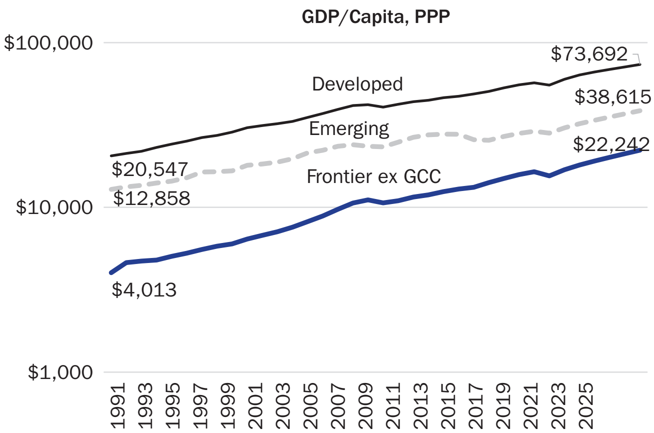


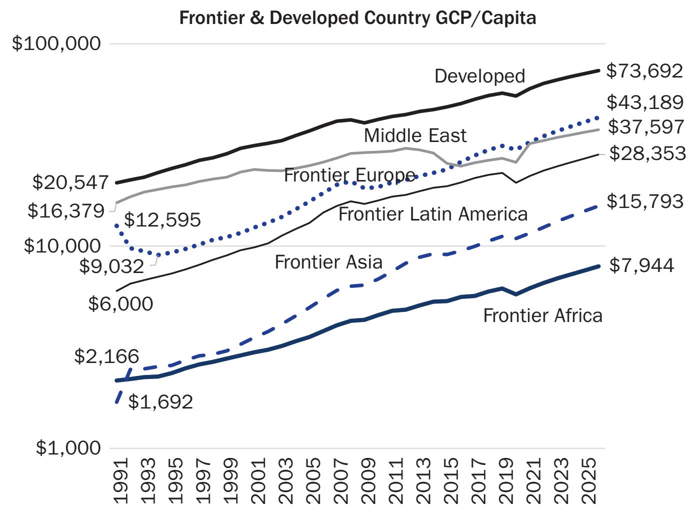
SOURCE: MSCI, Bloomberg, November 2021.

However, the 2008 Global Financial Crisis marked a relative peak not only in emerging markets but also in all non-US investing. The US has led the world for the past dozen years as shown in Exhibits 1 and 2. Emerging and frontier markets have been especially disappointing given their high expectations.

EXHIBIT 3

GDP per Capita (PPP) from 1991 to 2016 (IMF estimates)





SOURCE: IMF October 2021.

A RECKONING FOR EMERGING MARKETS

Despite the promise of emerging markets 30 years ago, their image has been tarnished by the sluggish performance of many countries.

Which are the developing countries for whom “emerging” is more than just a catchy name?

One measure of progress is closing the gap with the developed world in terms of GDP/capita. The IMF World Economic Outlook (International Monetary Fund 2021) provides GDP per capita data, on a purchasing power parity (PPP) basis, including projections through 2026.

Since 1991 there has been progress in this measure of economic well-being in many countries, but not for emerging markets as a whole, as shown in Exhibit 3. The average GDP/capita of emerging markets was 62.6% of the average of developed countries in 1991, and it is expected to be 54.2% in 2026. Meanwhile, however, frontier markets excluding the rich oil-producing countries of the Middle East Gulf Cooperation Council (ex GCC) have gone from 17.1% of the developed country level in 1991 to an expected 28.5% in 2026. Within frontier markets, Asia has done the best, while the Middle East GCC countries have lagged after starting from a high base. Frontier Europe GDP/capita dropped after the fall of the Iron Curtain but have made strong progress since the mid-1990s.

A real reckoning is at the country level where some countries have fulfilled the promise of “emerging” while others have failed. Exhibit 4 shows annual data for the “BRICS” countries plus Mexico with labels showing their annualized percentage charges.

China and India have been winners, but the other countries have disappointed.

South Africa had GDP/capita at 31% of the developed country average in 1991—now it is 19%.

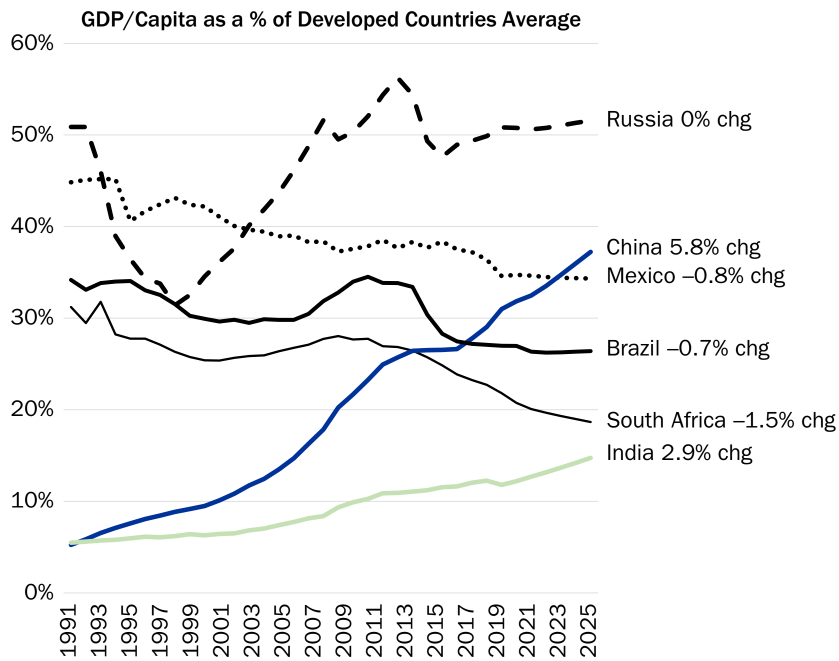
Mexico has gone from 45% to 34%, and Brazil from 34% to 26%.

With the fall of the Iron Curtain, Russia’s standing plunged, but it made a strong recovery, going from 31% of the developed country average in 1998 to 52% in 2008. Unfortunately, it has been flat since and headed lower on the Ukraine war.

Exhibit 5 shows the 25 countries that are expected to have improved the most from 1991 to 2026, according to IMF forecasts.

EXHIBIT 4

GDP per Capita as a Percent of Developed Country Average for Selected Countries, 1991–2026



SOURCE: IMF Oct, 2021. Labels show Annualized % Chg.

Eight of these are in the MSCI EM Index, with China leading the list, going from GDP/capita at only 5.2% of the developed country average in 1991 to 37.2% by 2026. Its income has gone from $1,078 GDP/capita to $21,049, and the developed country average has gone from $20,547 to $73,692. Meanwhile, India has improved from 5.6% to 14.7% ($1,127 to $10,866). Ireland is a developed country, but it is in the top 25 list, having moved from below the developed country average to above it.

Sixteen of the top 25 countries are in the frontier, led by Georgia, Iceland, Vietnam, Cambodia, and Bangladesh.

The right column, however, shows that some countries are forecast to falter in the 10 years from 2016 to 2026. Turkey has made headlines lately for its heterodox economic policies. Iceland has recovered from financial collapse in 2008, but now seems unlikely to exhibit exceptional growth. Sri Lanka is struggling economically and likely faces further challenges ahead. Many other countries, however, show continued progress.

Unfortunately, many countries have declined on a relative basis during the 35-year period, with the weakest 25 in Exhibit 6.

Mexico, Brazil, and South Africa are among the eight emerging countries that have lost ground, along with oil-producing countries such as UAE and Saudi Arabia, which started very rich and are relatively less rich today. The list also includes Greece, which was among the MSCI Developed countries from 2001 to 2013.

Eleven frontier countries (ex GCC) are on the list of decliners, including Zimbabwe and Lebanon (for whom the data end in 2020).

Of the six developed countries in the exhibit, Japan and Italy have seen their percentage standing drop by more than 25%.

As the right column shows, there has been little change among the losers in the expected 2016 to 2026 period. Senegal is one country showing improvement; another is Ivory Coast, which is still recovering from its 2002–2007 and 2010–2011 civil wars.

EXHIBIT 5

Countries Showing Greatest Progress from 1991 to 2026

Classification	Country	1991 % of Developed Avg	2026 % of Developed Avg	1991–2026 % Chg Annualized	2016–2026 % Chg Annualized
Emerging	China	5.2%	37.2%	5.8%	3.4%
Frontier Europe	Georgia	7.7%	32.8%	4.8%	2.6%
Frontier Europe	Iceland	90.4%	100.2%	4.4%	–0.6%
Frontier Asia	Vietnam	6.4%	23.7%	4.0%	3.7%
Frontier Asia	Cambodia	3.2%	9.7%	3.3%	2.6%
Frontier Europe	Lithuania		74.3%	3.2%	2.0%
Emerging	India	6.1%	14.7%	2.9%	2.5%
Frontier Asia	Bangladesh	4.5%	12.0%	2.9%	4.0%
Developed	Ireland	73.8%	189.5%	2.8%	3.0%
Frontier Europe	Estonia	33.3%	76.1%	2.5%	2.1%
Frontier Europe	Latvia	28.0%	63.1%	2.4%	–0.6%
Emerging	Poland	31.4%	67.9%	2.3%	2.0%
Frontier Asia	Sri Lanka	11.2%	25.4%	2.2%	0.5%
Frontier Latin Am	Panama	27.6%	56.3%	2.2%	0.2%
Emerging	South Korea	43.3%	83.9%	2.0%	0.7%
Emerging	Taiwan	57.3%	106.5%	2.0%	1.3%
Frontier Europe	Romania	30.3%	62.4%	1.8%	2.7%
Frontier Africa	Rwanda	2.8%	4.7%	1.7%	2.1%
Frontier Africa	Mozambique	1.3%	2.6%	1.6%	–0.5%
Frontier Europe	Montenegro		38.8%	1.4%	0.8%
Emerging	Turkey	36.9%	57.5%	1.4%	0.9%
Frontier Africa	Mauritius	26.9%	41.7%	1.4%	0.2%
Emerging	Indonesia	16.6%	24.9%	1.3%	1.7%
Frontier Europe	Croatia	38.6%	58.2%	1.2%	1.7%
Emerging	Thailand	24.5%	34.8%	1.2%	0.6%

NOTE: Georgia data inception from 1994 and Estonia from 1993.

SOURCE: IMF, World Bank, 2021.

Given the results since 1991, the term “emerging market” has embodied a misleading promise. Of the initial 11 emerging markets in 1988, only Portugal has been promoted to developed market status today, while many of the others have failed to make progress.

Countries covet their inclusion in the MSCI EM Index, yet that designation is no ticket to prosperity. There have been major turning points in some countries, such as China’s reforms under Deng Xiaoping in the early 1980s, Vietnam’s Đổi Mới opening in the late 1980s, and India’s liberalization in the early 1990s. Still, these have been unicorns.

Furthermore, countries that have been elevated from frontier to emerging market status, as were UAE and Qatar (2014), Pakistan (2017, downgraded to FM in 2021), Argentina (2019, downgraded to Standalone in 2021),[3] and Kuwait (2020), have been ignored by emerging market investors, as are other small emerging markets.

Those upgrades and downgrades as well as liquidity-based cutoffs for stocks have promoted volatility in index membership resulting in asset flows by ETFs, index funds, and others. For example, the annual turnover of the MSCI Frontier Index was 39% in 2020.

[3] Argentina was deleted from the EM Index and moved to Standalone Market status in July 2021.

EXHIBIT 6

Countries Showing Largest Declines from 1991 to 2026

Classification	Country	1991 % of Developed Avg	2026 % of Developed Avg	1991–2026 % Chg Annualized	2016–2026 % Chg Annualized
Emerging	UAE	404.4%	122.5%	–3.4%	–0.6%
Frontier Africa	Zimbabwe	11.5%	3.9%	–3.2%	–3.1%
Emerging	Saudi Arabia	182.8%	78.9%	–2.5%	–1.5%
Frontier Mid East	Oman	120.6%	49.3%	–2.4%	–1.6%
Frontier Mid East	Bahrain	154.8%	85.1%	–1.6%	–0.4%
Frontier Mid East	Lebanon	31.7%		–1.5%	N/A
Emerging	South Africa	29.5%	18.7%	–1.5%	–2.8%
Frontier Africa	Zambia	7.7%	4.8%	–1.4%	–3.1%
Emerging	Qatar	287.8%	165.9%	–1.3%	0.0%
Emerging	Kuwait	200.0%	78.4%	–1.3%	–1.1%
Frontier Latin Am	Jamaica	27.1%	18.2%	–1.1%	–0.6%
Frontier Africa	Ivory Coast	14.0%	10.4%	–1.0%	1.3%
Developed	Japan	104.6%	74.7%	–1.0%	–0.7%
Developed	Italy	103.3%	75.4%	–0.9%	–0.5%
Emerging	Mexico	45.1%	34.3%	–0.8%	–1.1%
Frontier Africa	Malawi	3.0%	2.5%	–0.8%	–0.5%
Emerging	Brazil	33.1%	26.4%	–0.7%	–0.7%
Developed	Switzerland	154.4%	125.5%	–0.7%	–0.7%
Frontier Asia	Papua New Guinea	8.2%	6.3%	–0.6%	–1.4%
Emerging	Greece	67.7%	55.6%	–0.6%	0.2%
Developed	Norway	145.4%	115.6%	–0.6%	0.0%
Developed	France	99.5%	84.3%	–0.5%	–0.4%
Frontier Mid East	Jordan	23.0%	18.6%	–0.4%	–0.1%
Frontier Africa	Senegal	7.6%	6.8%	–0.4%	1.1%
Developed	Canada	97.9%	86.4%	–0.4%	–0.6%

SOURCE: IMF, World Bank, 2021.

A FRAMEWORK OF ADVANCED ECONOMIES AND LESS-DEVELOPED MARKETS INDEXES

While criticizing the existing index framework, it is important to consider alternatives.

There are several standards that could be useful for categorizing countries without being judgmental about their prospects.

One standard is from the World Bank, which publishes annual groupings of countries: high income (>$12,695 GNI/capita in current dollars), upper-middle income ($4,096–$12,695), lower-middle income ($1,046–$4,095), and low income (<$1,046). The bank has defined “developing countries” as those in the low, lower-middle, and upper-middle income groups (Khokhar and Serajuddin 2015). The low $12.7K cutoff of “high” income, however, suggests that Mexico ($20.8K), China, ($19.1K), Brazil ($16.2K), Egypt, ($13.4K), and South Africa ($12.4K) are all “developed.”

Meanwhile, MSCI uses the following criteria for membership in the Frontier Emerging Index (MSCI 2021):

- The country’s weight in the MSCI All Countries World Index (ACWI) is below 10 basis points.

EXHIBIT 7

Advanced Economy Index

	% AE	% AE ex US	MSCI Index	GDP/Capita
United States	67.7%		ACWI	$69,375
Japan	6.2%	19.2%	EAFE	$44,935
United Kingdom	4.0%	12.4%	EAFE	$48,693
France	3.1%	9.6%	EAFE	$50,876
Canada	2.9%	9.1%	ACWI	$53,089
Switzerland	2.7%	8.5%	EAFE	$78,112
Germany	2.4%	7.4%	EAFE	$58,150
Taiwan	1.9%	6.0%	Emerging	$61,371
Australia	1.8%	5.6%	EAFE	$55,492
Korea	1.6%	5.0%	Emerging	$48,309
Netherlands	1.4%	4.3%	EAFE	$61,816
Sweden	1.1%	3.3%	EAFE	$57,425
Hong Kong SAR	0.7%	2.3%	EAFE	$65,403
Italy	0.6%	2.0%	EAFE	$45,267
Spain	0.6%	1.8%	EAFE	$42,075
Finland	0.3%	0.9%	EAFE	$53,084
Belgium	0.2%	0.7%	EAFE	$55,919
Norway	0.2%	0.5%	EAFE	$69,859
Israel	0.1%	0.4%	EAFE	$44,966
Ireland	0.1%	0.3%	EAFE	$111,360
Austria	0.1%	0.19%	EAFE	$59,406
New Zealand	0.1%	0.17%	EAFE	$45,880
Portugal	0.1%	0.17%	EAFE	$36,543
Greece	0.0%	0.08%	Emerging	$31,821
Cyprus	0.0%	0.07%	Emerging	$42,832
Czech Republic	0.0%	0.05%	Emerging	$43,714
Iceland	0.0%	0.03%	Frontier	$59,268
Slovenia	0.0%	0.02%	Frontier	$43,206
Singapore	0.0%	0.01%	EAFE	$107,677
Denmark	0.0%	0.007%	EAFE	$63,405
Estonia	0.0%	0.003%	Frontier	$41,892
Lithuania	0.0%	0.003%	Frontier	$42,091
	100%	100%		

- The country's GNI per capita is lower than the average GNI per capita of countries classified in the upper-middle-income category as defined by the World Bank ($6,939 in 2020).

While this is useful in defining "Frontier Emerging," it is too restrictive for a broader universe of less developed countries.

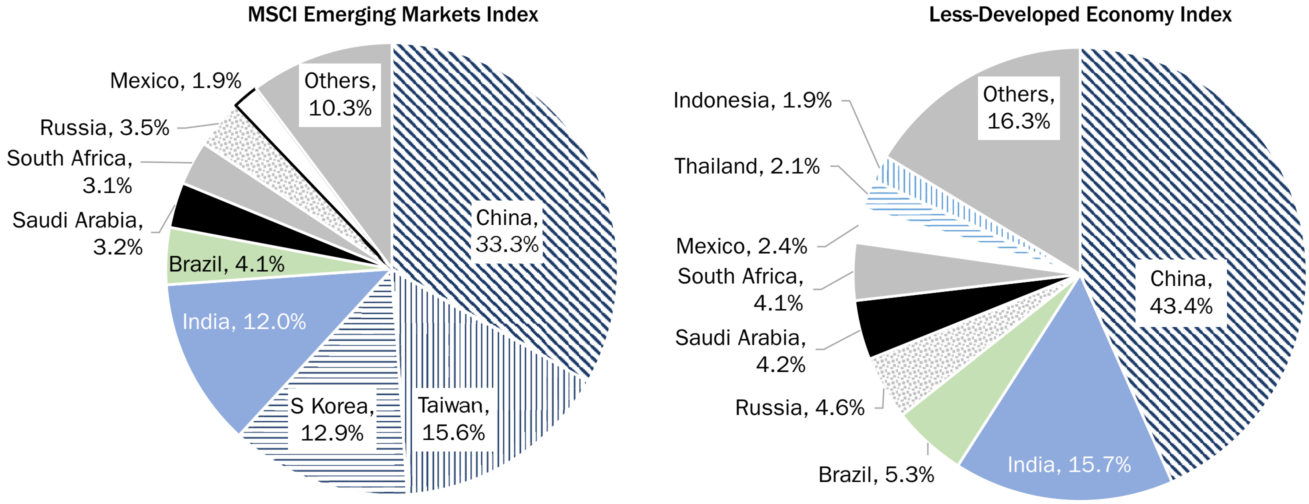
A better starting point may be the IMF list of 40 "advanced economies" (AEs), which is based on factors including high per capita income, exports of diversified goods and services, and greater integration into the global financial system. This group had 2021 GDP/capita ranging from $31,821 (Greece) to $126,669 (Luxembourg).[4] Thirty-four AE markets are in Exhibit 7.[5]

[4] IMF World Economic Outlook Groups. https://www.imf.org/external/pubs/ft/weo/2021/02/weodata/groups.htm#oae.

[5] The exhibit excludes small markets for which MSCI has no market cap: Latvia, Malawi, Slovakia, Luxembourg, and Macao. Also 18% of Hong Kong stocks are in EAFE and are reflected in the Advanced Economies exhibit while the rest are in MSCI Emerging Markets and the Less-Developed Country group.

EXHIBIT 8

Less Developed Economy Index versus MSCI EM Index Weights



SOURCES: MSCI Nov 2021. IMF 2021.

This list could be preferable to the distinctions in the present index framework because it recognizes the reality that all these economies are "advanced." An AE Index based on MSCI and FactSet capitalization weights in Exhibit 7 would have 32 AE countries, 9 of which are in the current MSCI EM or Frontier (FM) indexes.

Of the countries in the AE ex US Index, 11% are in the current EM Index, with 6% in Taiwan and 5% in South Korea.

Paired with the AE Index, a Less-Developed Country (LD) Index would include the 75 additional countries that have functioning stock markets. Twenty-one are now in the MSCI EM Index, and another 15 are in the MSCI FM Index. There are 38 more markets that have been neglected by most indexes but deserve to be recognized. Georgia is one, and it has its leading stocks listed in London. Other markets are small, but they trade sufficiently for foreign investors to participate and have many excellent companies.

As shown in Exhibit 8, the LD Index when compared with MSCI EM would have less exposure to the Asian technology sector and more to other smaller countries. While there are 16 markets totaling 10.3% in the "others" group of the MSCI EM Index, the LD Index "others" group includes 66 countries totaling 16.3%, with 4,646 companies that are covered in the FactSet database as of December 2021. Among these markets are Cote d'Ivoire, Ghana, Malawi, Rwanda, Tanzania, Bulgaria, Georgia, Latvia, North Macedonia, Costa Rica, Ecuador, Panama, and Trinidad and Tobago.

The LD Index could be accompanied by an LD ex-China Index, and this could lead investors to focus further on specific allocations to the smaller markets, which are less efficient and generally less correlated with the world.

This framework would separate index providers from the universe decision and would make index membership at the stock level based on headquarters location rather than listing location or trading volume. This could make the construction and maintenance of index funds and EFTs simpler by eliminating rebalancing trades based on the inclusion or elimination of stocks and countries from indexes.

CONCLUSION

> *"The time has come," the Walrus said,*
> *"To talk of many things*
> *Of shoes and ships and sealing wax…"*
> *—Lewis Carroll,* Through the Looking Glass*, 1871*

The Journal of Investing has remained relevant through the past 30 years of turbulent markets by responding with timely analyses of topics and perspectives that were not imagined in 1991.

The time has come to imagine new frameworks for allocating assets that may be more relevant today and during the 30 years to come.

Here are some recommendations:

1. Drop the term "emerging." It may have been appropriate in 1987, but it is not accurate today. Some countries will continue to make progress, but others will decline. An asset class designation should not imply judgment about a country's growth prospects.
2. For the designation of "developed" markets, use the IMF framework of "advanced economies." That would eliminate flaws such as the treatment of Iceland, with a current GDP/capita of $42,091, as a "frontier" country.
3. Expand the opportunity set of markets covered by the indexes to include countries such as Georgia, Panama, Malawi, Tanzania, and many others.

Moving to a new framework, such as the AE and LD Indexes, will not happen in 2022, but it is time to begin discussing such alternatives. After more than 30 years, it is time for a new perspective to guide investing and asset allocation in the next 30 years.

We hope that the coming decades will see more of the less-developed countries making real progress and joining the ranks of advanced economies.

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