LetkoBrosseau

# Emerging Markets

Macroeconomics

MARCH 2019

# Fast-growing emerging markets offer long-term opportunities

Emerging markets have taken a key role on the world economic stage. Propelled by favourable demographics and rising incomes, these economies are growing at a pace twice that of their developed counterparts. They now represent well over one-half of world GDP and generate more than three-quarters of global economic growth.

Yet, on a nominal basis, emerging markets represent less than one-third the value of total world stock market capitalization. This substantial discount offers an enticing opportunity to participate in some very compelling, real-growth investment opportunities.

The populations of many emerging market countries are decades younger than those in the developed world. Health care is becoming increasingly accessible and, since the 1980s, post-secondary enrolment rates have increased more than ten-fold. Over this same period, GDP per capita has increased by more than 7.5 times.

Energized by these dynamics, emerging market consumers are having a profound impact on the global economy. Their new demand for infrastructure, utilities, health care and other goods and services is creating excellent investment opportunities.

**74%** of global growth comes from the emerging world

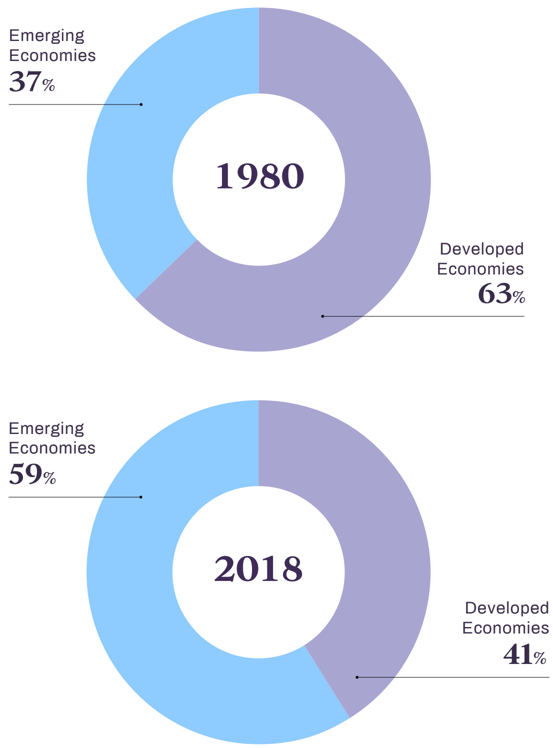
## Redefining global growth

In terms of structural development, much of the emerging world is still in its infancy. Typically, as working-age populations grow in size and incomes increase, consumer spending is driven higher. This trend facilitates an important economic transition – the movement towards a consumption-driven economy from an economic model contingent on commodity prices and export performance.

Compounding the economic returns of this transition is the evolution of consumption itself. As per capita incomes rise, it diversifies away from being primarily focused on commodities toward durables and services.

Much of the emerging world is now entering this transformative period and, given the promising demographic environment and rising incomes, the stage is set for an era of global growth defined by the emerging market consumer.

Figure 1 **Share of world GDP**




Source: International Monetary Fund, share of world GDP based on purchasing-power parity

Figure 2 **Contribution to real GDP growth**
(% of total)

| | 2018 | 2019F | 2020F | 2021F | 2022F |
|---|---|---|---|---|---|
| Developed world | 26% | 23% | 18% | 17% | 16% |
| Emerging markets | 74% | 77% | 82% | 83% | 84% |
| | | | | | |
| **World growth rate** | **3.7%** | **3.5%** | **3.6%** | **3.6%** | **3.6%** |

Source: Derived from International Monetary Fund estimates based on purchasing-power parity.

## Younger, more educated, healthier

In general, emerging market populations are younger than in developed markets, becoming better educated and living healthier lives. These three factors combine to create a powerful workforce capable of driving global output going forward. At present, 85% of the world's population lives in a developing country. What's more, with annual population growth in these countries of around 80 million people since 1980, these populations are growing at a faster rate than those in the developed world.

Emerging markets' working-age populations are also growing. In India, this segment grew by 21 million in 2017 alone. India's median age is just 28 – in stark contrast to Japan, which has a median age of nearly 50.

Much of the emerging world exhibits this favourable age structure. Having large, youthful, working-age populations means these countries house great productive potential and a growing consumer base.

The benefits of youth are two-fold. From a supply-side perspective, a young workforce provides a malleable economic input – investments in human capital can greatly improve the productive capacity of an economy. On the demand side, career aspirations and the desire to consume more tend to increase from one generation to the next.

As emerging economies expand and diversify, so too do their populations. Across the developing world, important investments in human capital are being made. Populations are attaining higher levels of education than previous generations. For instance, according to the World Bank, the post-secondary enrolment rate of South Korea increased by 7.5 times between 1980 and 2015.

Moreover, improvements in healthcare and nutrition across the emerging world have increased life expectancies and, in turn, the longevity of workforces.

The economic benefits of these factors are clear. The quality of the emerging market workforce is improving and workers are now able to contribute to the economy for longer than before.

## Increasing incomes

Historically, emerging market populations have devoted a larger share of their incomes toward the necessities of shelter and sustenance, compared to the developed world. But as households earn more, the share of income spent on essential items decreases and discretionary spending increases.

Across the developing world, people are moving out of poverty and low-income status into the middle class. But despite its impressive growth, emerging markets are still playing catch-up with the developed world. In terms of GDP per capita, there is still a long way to go.

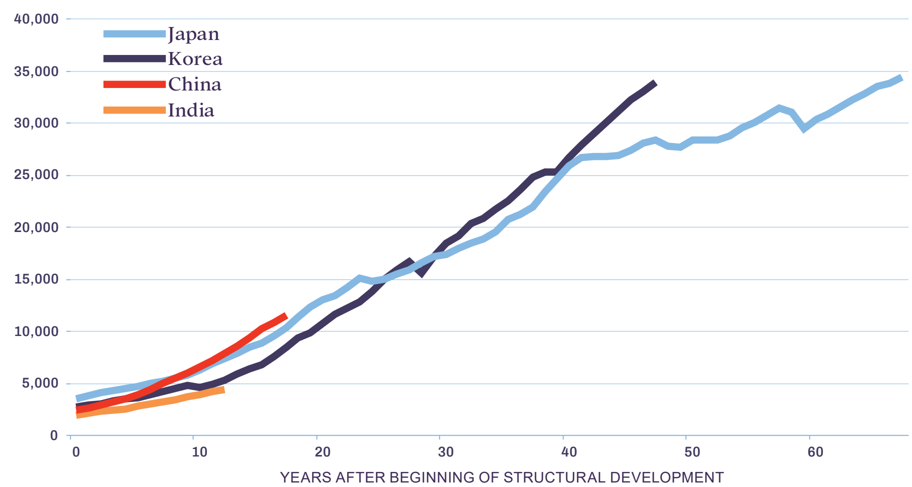
For example, China's GDP per capita is about one-third that of Japan (see Figure 3). India's lags even more, at about one-fifth. Despite the significant shortfall, China and India are expected to double their GDP per capita in the coming years.

This represents an enormous opportunity. With rising disposable incomes, emerging markets are home to a large amount of pent-up consumer demand. This demand comes in the form of both needs and wants for goods and services.

The following example comparing common household goods for two of the world's largest economies helps illustrate this gap. In the United States, virtually every household owns a refrigerator

**Figure 3**

### GDP per capita




Source: International Monetary Fund. GDP per capita amounts expressed in IMF international dollars, adjusted for inflation.

**Figure 4**

### World stock market capitalization ($US billion)

| | 2012 | 2013 | 2014 | 2015 | 2016 | 2017 | 2018 | Feb 2019 |
|---|---|---|---|---|---|---|---|---|
| **World overall** | 52,427 | 61,975 | 64,932 | 64,261 | 66,339 | 81,260 | 69,647 | 75,043 |
| **Emerging markets** | 17,475 | 17,827 | 19,895 | 20,620 | 20,695 | 26,262 | 21,749 | 23,160 |
| | | | | | | | | |
| **Emerging market weight** | **33%** | **29%** | **31%** | **32%** | **31%** | **32%** | **31%** | **31%** |

Source: Bloomberg

Above: São Paulo, Brazil, the heart of South America's largest economy. Front page: Dubai, financial powerhouse of the Arab world.

whereas in India, only about one-third do, according to the People Research on India's Consumer Economy (PRICE).

With roughly 265 million households in India, this means the country is short about 177 million fridges, were it to catch up to the U.S. in refrigerator penetration. On washing machines, India is about 212 million units behind and for TVs about 93 million units short. Consider the fact that the average American consumes 5 refrigerators, 7 washing machines and 10 TVs in his or her lifetime, and the amount of unsatisfied demand in India alone represents a significant opportunity.

## Urbanization leads to infrastructure growth

Economies and populations develop together. Fewer people in emerging markets live in urban areas than is the case in developed countries. Productive opportunities tend to increase when moving from a rural setting to an urban centre, and historically this urbanization results in greater economic output.

Moreover, city-dwellers tend to earn more. As the share of emerging market populations living in cities increases, this should provide another tailwind to growth in developing countries, with the consumer at the centre. About 55% of the world's population resides in urban areas. The World Bank forecasts this will rise to about 70% by 2050, with emerging markets accounting for much of this shift.

Infrastructure and utilities must keep up with the needs of growing urban populations and their demand for improvements in their quality of life. Economic progress and social progress are closely tied. Like the trend in favour of growing consumer demand for goods and services, consumers across emerging markets will likely continue to need more from infrastructure and utilities, in both quantity and quality.

Consider the growth potential of water supply and treatment networks in China, where less than one-third of the population has access to drinkable tap water, according to the National Bureau of Statistics of China. About one-half of all households are not connected to water pipelines, and three-quarters are not equipped with bathing facilities or proper lavatories. Further, two-thirds of China's 600 cities suffer from water shortages.

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China Water Affairs Group Ltd. is one of the largest integrated water and sewage operators in China, providing raw water, tap water and sewage treatment to over 8 million customers in 50 cities. It is undertaking sizeable capital investment initiatives.

Another important player in this sector is Manila Water Inc. According to UNICEF, there are some 30 million people in the Philippines who need improved sanitation facilities. Manila Water provides water, sewage and sanitation services to over 6 million people in the eastern zone of metropolitan Manila.

## Opportunities in financials and energy

There are interesting investment opportunities in other sectors of emerging markets, among these financial services and energy.

With rising wages and an increased appetite for consumption, the developing world will represent an intriguing growth market for financial services for years to come. Penetration rates of conventional banking are relatively low and, given the large-scale adoption of mobile devices, emerging markets are well-suited for a digital transformation.

Among leading financial companies in emerging markets are DBS Group Holdings Ltd., a Singapore-based bank operating across 18 markets throughout the Asia-Pacific region, and India's Axis Bank and ICICI Bank.

While emerging market consumers are beginning to purchase more durables and services than before, the developing world will continue to be a key driver of long-term demand for commodities. The burgeoning industries and transportation networks of emerging economies are already a major source of global energy demand, and as these markets continue to grow so too will their oil consumption – GDP per capita and oil demand rise together.

The developing world's energy leaders include, among others, PTT Exploration and Production PCL, one of the Association of Southeast Asian Nations' (ASEAN) lowest cost and largest hydrocarbon producers; China National Offshore Oil Corp., the premiere offshore oil operator in China; and Reliance Industries Ltd., one of the world's most complex and lowest cost refiners and petrochemical producers.

## Growth in healthcare

Another area of potential significant investment gains in terms of basic services is healthcare, particularly in China as the country moves towards establishing a universal medical system. Healthcare spending on a per capita basis in China has multiplied in recent years, reaching US$700 billion or 6% of GDP in 2016. However, this remains below the OECD average (9% in 2016), and well behind that of the United States (17%).

The Chinese government aims to provide access to basic healthcare to the entire population by 2020. According to government projections, healthcare spending in China is expected to reach US$1 trillion by 2030, as the population becomes more affluent and ages. Furthermore, the Chinese government is promoting the development of domestic manufacturers of high-end medical products under the “Made in China 2025” initiative.

Some of the key players in this growing and consolidating market are Sinopharm Holding Ltd., China’s leading pharmaceuticals distributor, and Shandong Weigao Group Medical Polymer Co. a major manufacturer of medical consumables, such as syringes and catheters.

## Diversified, disciplined strategy

Emerging market economies are growing rapidly, propelled by younger, better educated and healthier populations, whose rising incomes are fueling a substantial increase in consumer demand for both goods and services. Along with this comes a surge in demand for better infrastructure, expanded utilities and improved healthcare.

There are many direct and indirect ways to participate in this growth from an investment perspective, although there are numerous risks. Emerging markets are particularly well suited to an active investment strategy that emphasizes careful security analysis, as these stocks are generally less efficiently priced than in developed markets.

We are confident that by placing an emphasis on companies that have a low-cost structure, prioritizing balanced growth, exercising price-discipline and diversifying across a wide range of emerging market geographies, we will benefit from this engine of growth. As these economies develop, many new growth areas will emerge and our portfolio will increase its diversification to take advantage of these opportunities.

Shanghai, China’s financial capital. Emerging markets’ urban populations are rapidly growing.



## About Us

Letko Brosseau is an independent investment manager founded in 1987. The firm manages approximately $27 billion in assets for more than 420 institutional investors and several thousand private clients.

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