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Emerging Market Stocks: Growth Potential But with More Volatility

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Emerging Market Stocks: Growth Potential, Volatility, and the Surprising Disconnect with GDP

Emerging market stocks are often touted as the growth engine of global investing. The logic is compelling: countries like India, China, and Brazil are expanding rapidly, so their stock markets should deliver outsized returns. Yet, decades of research and real-world results reveal a more nuanced—and sometimes counterintuitive—story. As we close out 2024, understanding what really drives emerging market returns is essential for investors seeking both opportunity and resilience.

What Are Emerging Market Stocks?

Emerging market stocks are shares of companies based in economies that are in the process of rapid industrialization and modernization but have not yet reached developed status. The MSCI Emerging Markets Index, the industry standard, covers more than 1,400 companies across 24 countries, with the largest weights in China, Taiwan, India, and Brazil.

Historical Returns and Risk

Emerging markets have delivered periods of spectacular growth and painful drawdowns. Since 2001, the MSCI Emerging Markets Index has returned an annualized 8.3%, outpacing developed markets over the same period[1]. However, these returns are volatile: in 2024, the index returned about 7.7%, well behind the MSCI World Index’s 21.9% gain[5]. Markets like Taiwan soared (up 29.4% in 2024), while others struggled amid political and economic headwinds[5].

Emerging markets often lead global returns during commodity booms or when the U.S. dollar weakens, but can lag badly during crises or when global capital flees riskier assets. Investors must be prepared for sharp swings and extended periods of underperformance.

The Myth: GDP Growth Equals Higher Stock Returns

It seems intuitive that higher economic growth should translate into stronger stock market returns. After all, if a country's economy is booming, shouldn't its companies—and their shareholders—prosper? Surprisingly, the data says otherwise.

Multiple studies have found little to no correlation between a country's GDP growth and its stock market returns. A 2022 study by Jason Hsu, Jay Ritter, Phillip Wool, and Yanxiang Zhao examined 15 emerging and 21 developed markets over periods ranging from 32 to 120 years. Their conclusion: the cross-sectional correlation between annual real per capita GDP growth and stock returns in emerging markets was a statistically insignificant 0.17 (p-value 0.55)—essentially zero[1]. In some cases, the relationship was even negative, as seen in China, where rapid GDP growth coincided with negative stock returns for U.S. dollar-based investors over long stretches[1].

This finding is echoed by other research, including the influential book *Triumph of the Optimists* by Dimson, Marsh, and Staunton, which found a negative correlation between per capita economic growth and stock returns over a century of global data[1]. The reason? Stock prices already reflect expectations for future growth. If a country's economic prospects are bright, those expectations are quickly "priced in." Moreover, much of GDP growth can come from new businesses, state-owned enterprises, or sectors not represented in the stock market, and the benefits of growth may accrue more to workers and consumers than to shareholders[1].

What Really Drives Returns: Earnings and Dividends

If GDP growth isn't the answer, what matters? The same 2022 study found a strong, statistically significant relationship between stock returns and the growth in earnings per share (EPS) and dividends per share (DPS)[1]. In other words, what ultimately matters for investors is not how fast a country grows overall, but how much the companies you own are growing profits and returning cash to shareholders.

This distinction is crucial. For example, while China's economy grew rapidly over the past two decades, the earnings and dividends of its listed companies did not keep pace, and stock returns lagged badly[1].

Current Outlook

Emerging markets are currently trading at deep discounts to developed markets. As of early 2024, the MSCI Emerging Markets Index had a price-to-book ratio of 1.8, about 40% lower than developed markets' 3.2, and a forward P/E of just 11.9[4]. Analysts expect emerging market companies—especially in Taiwan, India, and Korea—to post robust earnings growth into 2025[1]. These markets may benefit from a widening growth gap over developed economies, healthier fiscal balances, and a more diversified index as China's dominance recedes[5].

The Role of Emerging Markets in a Portfolio

Emerging markets can serve as a growth engine and a diversifier within a global equity allocation. Their returns are less correlated with U.S. and developed international markets, providing a potential hedge when U.S. stocks lag. Many advisors suggest allocating 5–10% of your equity portfolio to emerging markets, with the understanding that this segment can be highly volatile and may underperform for extended periods.

Why Funds and ETFs Are the Smart Way to Own Emerging Markets

Direct investment in emerging market stocks is challenging due to currency, regulatory, and liquidity risks. Mutual funds and ETFs—such as Vanguard FTSE Emerging Markets ETF (VWO) and iShares MSCI Emerging Markets ETF (EEM)—offer diversified, low-cost exposure to hundreds of companies across dozens of countries[3]. These funds handle the complexities of currency conversion, tax compliance, and market access for you.

Risks and Considerations

Emerging markets are inherently riskier than developed markets. Political instability, regulatory changes, currency swings, and commodity price shocks can all trigger sharp market moves. Investors should be prepared for periods of significant underperformance and should view emerging markets as a long-term allocation.

Points to Remember

- Emerging market stocks offer higher long-term growth potential, but with greater volatility and risk than developed markets.
- There is no reliable relationship between a country's GDP growth and its stock market returns; what matters most is the growth of earnings and dividends among listed companies.
- Diversification is critical—owning emerging markets through mutual funds or ETFs spreads risk across countries, sectors, and currencies.
- A modest allocation (5–10% of equities) can enhance portfolio growth and diversification, but expect a bumpier ride.
- Stay disciplined and long-term focused; emerging markets can underperform for years before delivering outsized gains.

Sources

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