

Does Growth Pay?

Economic growth and EM equity returns

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27 June 2025

Does growth matter for emerging market investing?

Whether economic growth drives equity market returns is a divisive question. I once failed a job interview for daring to suggest that growth might matter when investing in emerging markets (it was a value fund – I should have known better).

This report examines equity market returns across emerging markets (EM) over the past two decades and finds that growth *might* matter – certainly more than sceptics often claim.

The case against

There's no shortage of good reasons to downplay economic growth as a driver of equity returns. Among the most common:

- Markets may already price in higher growth through richer valuations.
- Rapidly growing economies are often more vulnerable to credit bubbles, macroeconomic imbalances and subsequent volatility.
- Growth can mean-revert. If that also triggers to a valuation reset, the impact on returns can be doubly painful.
- High-growth environments often encourage companies to reinvest rather than return cash to shareholders – a key component of total returns.
- Faster-growing economies frequently see more equity issuance and IPO activity, which can dilute returns.

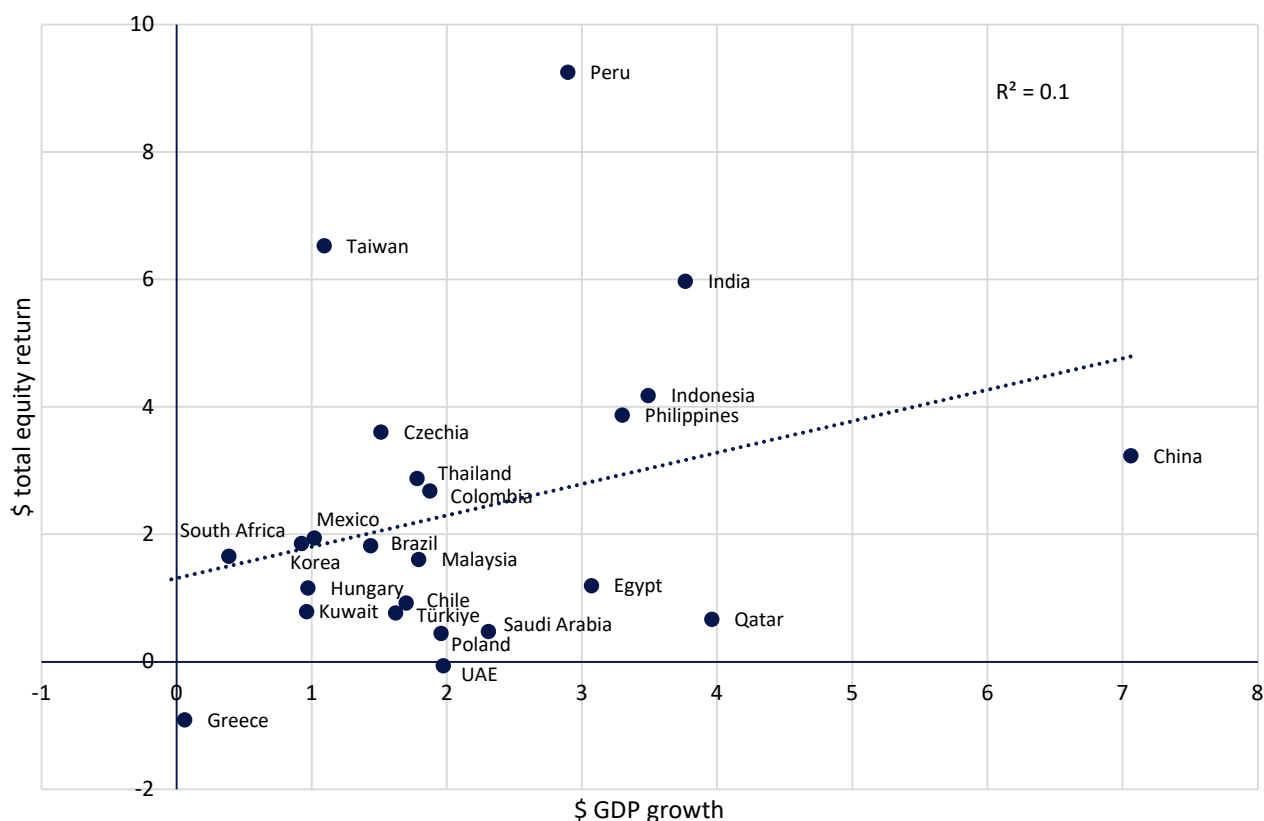
The initial evidence

So, is this an open and shut case? At first glance, it might seem so. A plot of dollar GDP growth against dollar total equity returns for EM countries since 2005 – chosen as a relatively neutral starting point, post-1990s EM crises but pre-GFC peak – reveals only a very weak positive relationship. Statistically, the R^2 is just 0.1.

(You can zoom in on the charts in this report for a closer look.)

GDP growth doesn't seem to have worked well in driving EM equity returns

\$ total equity returns vs \$ GDP growth



Note: \$ GDP 2005-2024; \$ MSCI country index total return (gross), end-2005-end-2024

Source: IMF, MSCI, Weighhouse

Still, intuitively, if stock markets reflect the broader economy, and if profits as a share of GDP and valuations tend to remain within certain bounds, then, over the long term, shouldn't economic growth drive corporate profits and therefore, equity returns?

Two important caveats

Our analysis suggests that these are big *ifs*, and two key factors complicate the picture:

1. Concentration

Many EM indices followed by global investors are poor reflections of their underlying economies. In six countries – Colombia, Czechia, Egypt, Hungary, Peru and Taiwan – a single stock makes up for more than half of the MSCI country index. In Czechia, for instance, a modern and diverse economy is represented by just one utility company and a couple of banks.

2. China

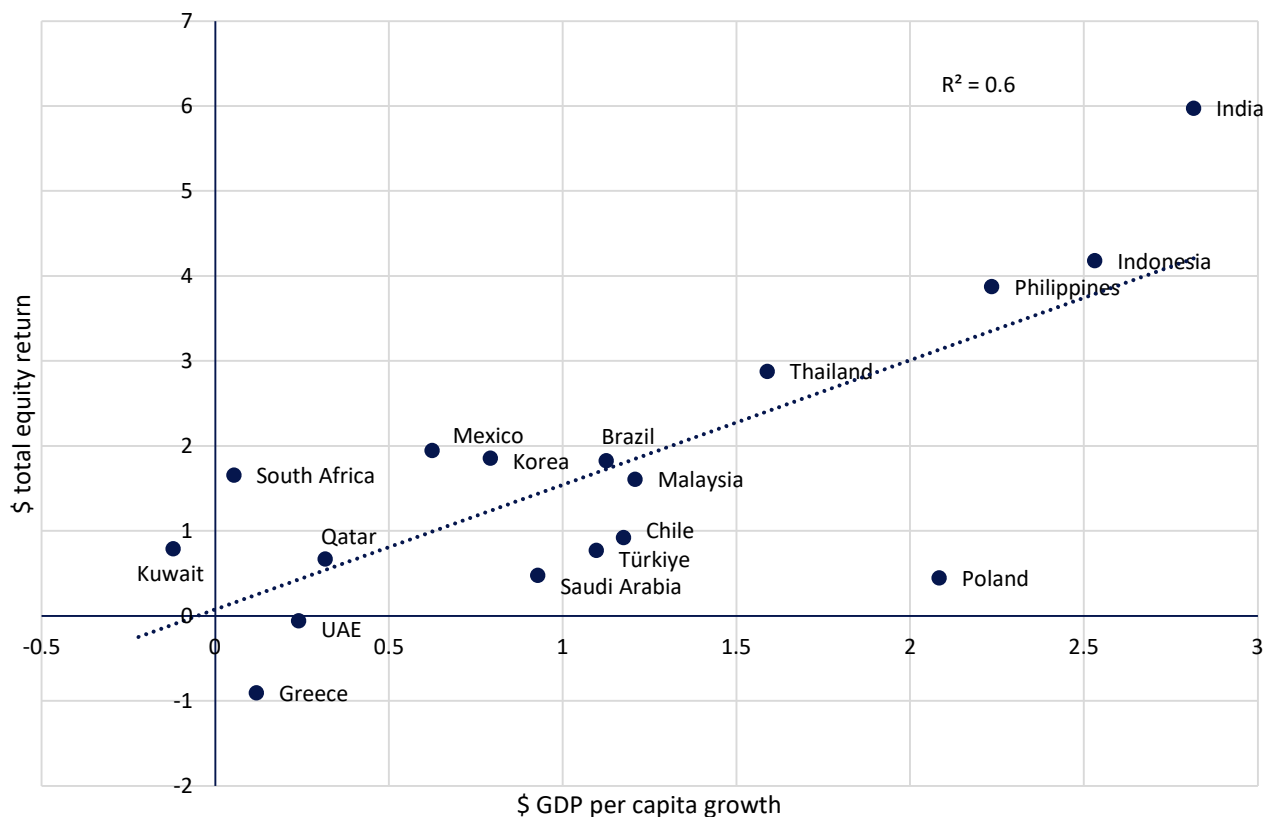
China's rapid economic growth has long stood in contrast to its underwhelming stock market performance. The reasons are well documented: heavy state intervention (particularly in tech), a dominant state sector, excess savings, capital controls and a non-transparent financial system that fosters misallocation of capital, overcapacity, and property bubbles – and more recently, rising geopolitical tensions and US investor retrenchment.

A clearer picture

Once we exclude these seven countries from the analysis, the relationship between dollar GDP growth and dollar total equity returns does improve somewhat, giving an R^2 of 0.3. But the picture looks much better when we use dollar GDP per capita, where the R^2 rises to 0.6 – not perfect, but certainly respectable.

Filtering out seven countries, and using GDP per capita shows a much stronger relationship

\$ total equity returns vs \$ GDP per capita growth



Note: \$ GDP per capita 2005-2024; \$ MSCI country index total return (gross), end-2005-end-2024.

Source: IMF, MSCI, Weighhouse

Why does per capita growth appear to work better? Probably because it's a more accurate proxy for a country moving up the value chain, driven by productivity improvements over population growth.

Note the outperformance of South Africa relative to its lacklustre per capita growth, driven in part by a significant share of shareholder-focused and internationally exposed listed corporates. India has also performed well, supported by its visible move up the value chain and the rise of a strong domestic equity culture. In contrast, Türkiye has underperformed amid investor concerns over institutional erosion and economic volatility. Similarly, Poland and Chile have lagged, weighed down by adverse reforms to their pension systems.

So where does that leave us?

It feels like an honourable draw between the growth advocates and sceptics. After adjusting for concentrated indices and the China effect, it seems that economic growth – particularly dollar GDP per capita – can matter. That said, although the seven excluded countries account for just 29% of the EM index by number, they represent a hefty 48% by free float market cap.

Conclusion: questions for investors

Before chasing economic growth through country indices, investors should ask:

- Do the key index constituents genuinely reflect the broader economy, including the sectors which are driving economic growth?
- Are profitability, governance and capital discipline strong?
- Is the regulatory backdrop supportive?
- Would a more active approach be more effective, given the index limitations?
- Are growth expectations already too optimistic or fully priced in?

Of course, forecasting dollar GDP per capita 20 years into the future is no small task – but at least it keeps macro strategists gainfully employed.

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