

Decoding Markets

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Emerging markets are now much less dependent on the volatile commodities cycle, but outdated perceptions linger. An active approach to EM can be the best way to capture the opportunities these markets offer today.

The emerging markets (EM) of 2026 bear little resemblance to the asset class that shaped a generation of investor thinking. The crises that defined these markets in the late 1990s — the 1997 Asian contagion, the 1998 Russian default and the commodity-driven boom-and-bust cycles that followed — forged mental models that are increasingly ill-suited to today's reality. While EM equities once moved in lockstep with oil prices and mining cycles, they are now anchored by world-class technology leaders that are helping to transform the global economic landscape.

Valuations have not kept pace with this transformation, however. Current pricing still reflects assumptions that the asset class is tethered to commodity cycles, even as its underlying composition has shifted decisively toward technology and consumer-driven businesses that are benefiting from the emergence of an expanding middle class. The market, in short, is pricing yesterday's EM.

This disconnect between perception and structural reality, combined with a supportive macro backdrop, makes a compelling case for a strategic allocation to these markets. Given the breadth of these markets, the return dispersion across them, and the idiosyncratic risks inherent to them, we also believe that allocation is best pursued actively.

Twenty years of structural transformation

The structural foundations of emerging markets have evolved over time and now appear materially more resilient than they were two decades ago. The lingering perceptions that these are fragile economies and not major players on the world stage have no basis in today's on-the-ground realities.

- EM's global economic weight has surged, but its index representation hasn't. EM economies now account for 46% of the world's nominal Gross Domestic Product (GDP), yet they represent just 11% of the market capitalization of the MSCI All Country World Index (ACWI). In 1995, more than half of world trade flowed between developed markets (DM), according to the World Trade Organization. As EM took on a much greater role in global commerce, DM's share of global trade fell to 39% by 2022 (the most recent year for which this data is available).
- Credit quality has materially improved. In the late 1990s, over 90% of EM sovereign debt carried high-yield ratings. Today, almost 70% of this debt is investment grade, and it is underpinned by more credible policy frameworks and improved fiscal management.
- FX reserves provide a deeper buffer. EM foreign exchange reserves have grown from under \$2 trillion in 2005 to more than \$7 trillion today. That larger stock of reserves has considerably reduced the currency vulnerabilities that once defined the asset class.
- Corporate governance is advancing. South Korea's "value-up" program, now in its second year, aims to address the longstanding "Korea discount" by encouraging companies to strengthen corporate

governance, raise valuations and return more capital to investors. Those efforts follow the path of Japan's decade-long governance overhaul. China's central government has urged state-owned enterprises to focus on market valuations and shareholder returns. The trajectory is positive even where the starting point lags developed market standards.

- From cyclical to secular. The asset class that was once a leveraged bet on global industrial demand is now anchored by semiconductors, internet platforms and a growing consumer base. That shift is evident from the changes in the sector weights of the MSCI Emerging Markets Index, as illustrated in Figure 1. Energy and materials have effectively switched places with Information Technology, and IT now has the greatest market-cap weight across these markets. We expect this trend to continue as countries like South Korea and Taiwan have become indispensable to global semiconductor supply chains and the accelerating buildout of AI infrastructure. The world's largest hyperscalers — the dominant cloud-computing providers like Microsoft, Amazon, Alphabet, Meta and Oracle that operate massive data-center networks globally — have announced capital expenditures for 2026 that will collectively reach \$650 billion, mostly driven by investments in AI infrastructure.^[1] Much of that will flow through EM-based hardware suppliers. This positions EM's technology-oriented economies as key beneficiaries of one of the most powerful investment cycles of the decade.

Figure 1: Information Technology is now the dominant sector across emerging markets
Average monthly weights of four key sectors in the MSCI EM Index, late 1990s versus now

Source: MSCI Emerging Markets Index. Late 1990s = avg. monthly weights 1997–1999; Current = avg. 2023–2025.

Capital markets may not fully recognize it yet, but the transformation is real. Fragility has been replaced by structural resilience, and EM is now also a direct beneficiary of the AI supercycle.

Macro tailwinds and supportive market conditions

Macro and market conditions are now reinforcing these structural shifts, while some near-term catalysts are providing additional support for these markets.

- A weak US dollar regime. No variable has mattered more to EM returns than the direction of the dollar. Dollar appreciation was a drag on these markets for 15 years through the end of 2024. Since the start of 2025, however, the USD has declined 10%, and many analysts would argue it remains overvalued. As Figure 2a below shows, EM equities tend to outperform global equities when the trade weighted US dollar real effective exchange rate (REER) is weakening, and to underperform when the dollar is strengthening. A weaker dollar eases financial conditions in EM and gives EM central banks more room to maneuver with their monetary policy.
- Further dollar weakness seems likely, given the United States' reliance on foreign capital inflows to fund its fiscal and current account deficits (see Figure 2b), alongside the additional challenges of a rising debt-to-GDP ratio, uncertainty about Federal Reserve policy, and a narrowing differential between US bond yields and those in the rest of the world.

Figures 2a and 2b: A weakening dollar could help EM returns, and the United States' increasing reliance on foreign capital to fund deficits could keep the dollar weak

Source: Bloomberg, Schroders, Macrobond, BA. Latest available data as of March 2026. REER is the Real Effective Exchange Rate. Current performance trends are not a guide to future results and may not continue.

- Investor positioning is light. EM equities account for 7% of global equity fund assets[i] despite making up over 11% of the MSCI ACWI. Given the recent strong performance that has drawn capital back to these markets, that gap is likely to close.
- A chance to pursue higher growth at a lower multiple. In earnings terms, emerging markets are projected to outpace developed markets in 2026 and 2027. Despite those brighter prospects, EM equities still trade at a meaningful discount to stocks in both the US and other developed markets. For investors, that provides an opportunity to obtain growth at a far more reasonable price.

Figure 3: EM equities have much higher projected earnings growth rates, but they are trading at lower multiples than US and other developed market stocks

Source: FactSet, MSCI, Yahoo Finance/GuruFocus and Confluence Investment Management / Bloomberg. Latest available data, as of July 22, 2026. Forecasts are not guaranteed and may change.

Active strategies may offer the most appealing access to these markets

For investors who recognize that all the factors noted above make the case for removing any current underweight to emerging markets, there are also a number of compelling reasons to access these markets with an active investment strategy.

High return dispersion: EM is not a monolithic asset class. There are 24 countries in the MSCI Emerging Markets Index, and they comprise multiple currencies and vastly different political regimes. The dispersion of returns in EM — across countries, sectors and individual securities — is significantly wider than in developed markets. That creates fertile ground for skilled active managers to add value.

Benchmark inefficiency: Passive EM exposure carries meaningful embedded risks. Index construction means investors inherit large weights in state-owned enterprises, politically sensitive sectors, and markets with weaker governance standards. Active management allows investors to navigate around these structural inefficiencies.

Risk management through selective exposures can be managed by active strategies, but not by passive: Even amid all the new opportunities, emerging markets still demand selectivity, which only active managers can apply. Passive managers simply have to replicate the country and security weights of the index, which in these markets can include state-owned enterprises that don't have maximizing shareholder value as their top priority.

A target-rich environment across styles. Roughly 60% of the world's cheapest quartile of stocks sit in EM, as do roughly 60% of the fastest-growing companies. (See Figure 4.) That creates considerable opportunities for value- and growth-oriented active managers, and even more for those that are unconstrained by any style mandates.

Simply put, while passive exposure may capture EM's structural transformation, only active management can look to exploit the return dispersion and inefficiencies within these markets.

Figure 4: An abundance of value and growth opportunities in EM

While EM represents 50% of the global stock universe, it has a 60% share of the cheapest quartile of stocks and a similar share among the fastest growing quartile

Source: FactSet, Schroders, as of 6/30/26. Universe includes constituents of the MSCI All Country World (ACWI) Investable Market Index (IMI). Developed Markets (DM), Emerging Markets (EM) and US classifications follow MSCI definitions. The "cheapest quartile" represents the 25% of stocks with the

lowest valuation metric(s), and the "fastest-growing quartile" represents the 25% of stocks with the highest earnings growth metric(s) within the universe. Percentages shown reflect the proportion of stocks by count, not market capitalization. For illustrative purposes only and not intended as a recommendation to buy or sell any security, sector, country or region. Past performance is not a guide to future performance and may not be repeated.

Conclusions: More portfolios may need to recognize EM isn't what it used to be

Emerging markets as an asset class have matured. Today, they are more institutionally sound, more innovative and more integrated into the global economy than they were at any prior point in history. Macro conditions are reinforcing that shift in ways that could benefit investors. Return dispersion within the universe also suggests that selective ownership, which can be achieved only with active strategies, can be rewarded.

Despite the structural transformation and favorable market conditions, most portfolios today still reflect an outdated view of EM. The gap between what EM has become and what most investor portfolios hold has rarely been wider. Closing that gap requires rethinking both the size and approach of one's allocation.

The asset class that broke during the 1990s and traded on commodity cycles in the 2000s looks fundamentally different today. It may be time to escape the mental models that have shaped decisions about EM allocations for decades and embrace all the opportunities that today's realities in these markets present.

- Source: "How Much Is Big Tech Spending on AI Computing? A Staggering \$650 Billion in 2026," Bloomberg, 2/6/26
- Source: "2026 Mid-Atlantic Allocator Outlook," by Kevin Gordon at the MarketsGroup, 7/16/26

Learn more about the Schroder Global Emerging Markets Fund.

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