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Equity insights
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The Third EM Cycle: How AI is redefining emerging markets

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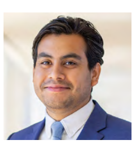

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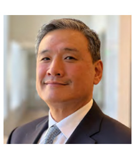

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- EM has rallied since 2025, outperforming developed markets and signaling a third cycle – one driven by innovation rather than commodities.
- A push-pull framework helps explain EM capital flows, with inflows sustained by momentum and reversals triggered by crises. Today's fundamentals point to greater durability.
- Structural compounders – high-value, less cyclical firms – define this cycle, but other segments remain undervalued with strong earnings prospects.
- While political and governance risks persist in EM, established frameworks can mitigate them, with active management historically proving most effective.

Emerging markets (EM) are celebrating their 40th anniversary as an asset class amid a strong rally that started in early 2025, outpacing developed markets as profitability surged. This marks a major reversal of more than a decade of U.S. market dominance. Various indicators suggest a new multi-year growth cycle is underway and it appears more sustainable than past commodities-driven episodes.

In addition to growing projections of globally rising capital expenditure (capex), which support traditional EM strengths such as commodities and manufactured goods, new fundamental factors are creating new opportunities. The composition of the EM economies has shifted to include more technology, healthcare and other innovation-driven sectors. Additionally, the growth of technology hardware producers and other artificial intelligence (AI)-related supply chains, as well as domestic internet companies, may help sustain earnings and create a more durable growth cycle.

Moreover, this dynamic appears to be in its early stages. While Taiwan and South Korea have demonstrated remarkable leadership, China has lagged so far. But this underperformance could become a catalyst for a new move higher, as a turnaround would bolster the entire EM group, given the size and prominence of many Chinese companies. China's home-grown leadership in AI, robotics, electric vehicles, renewable energy, along with critical rare earths and multiple capital goods industries, suggest the country is well-positioned for growth.

MSCI EM Index forward profit margins are rising

Emerging markets forward profit margins are rising

Sources: LSEG Datastream, Yardeni Research. Forward earnings per share divided by forward revenues per share. Based on analyst average earnings and revenue forecasts. Data as of 5/14/2026.

Markets in Peru, Chile and Brazil also climbed to new highs earlier this year due to the surge in demand for raw materials as AI infrastructure gets built out, as well as specialty metals used in semiconductors and electronic devices.

Across all markets, profitability and earnings growth expectations are surging. Yet, valuations remain attractive relative to developed markets, with a forward price-to-earnings ratio at 12.2 for the MSCI Emerging Markets Index versus 21.2 for the S&P 500 Index as of May 31, 2026.

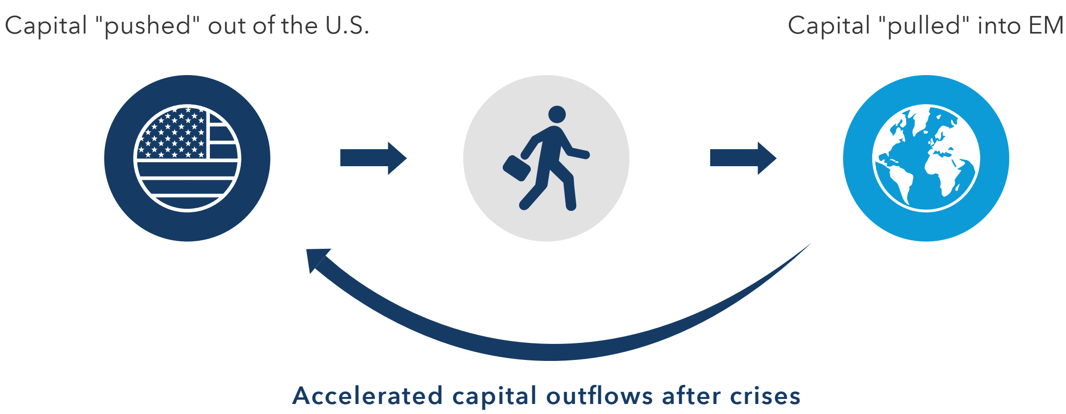
Amid these dynamics, institutional allocators are reassessing their exposure and turning to active managers in pursuit of higher returns. According to a 2026 Cogent survey, 49% of pension plans are looking to increase their EM allocation over the next three years, up from 29% in 2024, and the largest anticipated change of any asset allocation category.[1]

A new EM cycle four decades in the making

Emerging markets have always been closely tied to developed economies and their capital markets, making them susceptible to boom-and-bust cycles. We have observed a "push and pull" framework that helps illustrate this pattern. Given the size of most EM countries (with the notable exception of China), these economies and markets are highly influenced by external confidence, sentiment, exchange rate changes as well as capital flows.

During prior boom cycles, we saw capital flows pushed out of the U.S. by a weaker dollar and pulled into EM's attractive growth opportunities with reasonable valuations, and then supported by the momentum that subsequent investment flows created.

Investment "push/pull" framework



The first EM cycle

The Plaza Accord of 1985 marked a dollar devaluation phase amid already falling U.S. yields, acting as a push factor. At the same time, major debt restructuring and capital market liberalization – including privatization and easing of foreign ownership – occurred across the EM landscape. These markets were undercapitalized and undervalued, which pulled investments into the large companies within telecommunications, commodities and banks, primarily in Latin America and Asia.

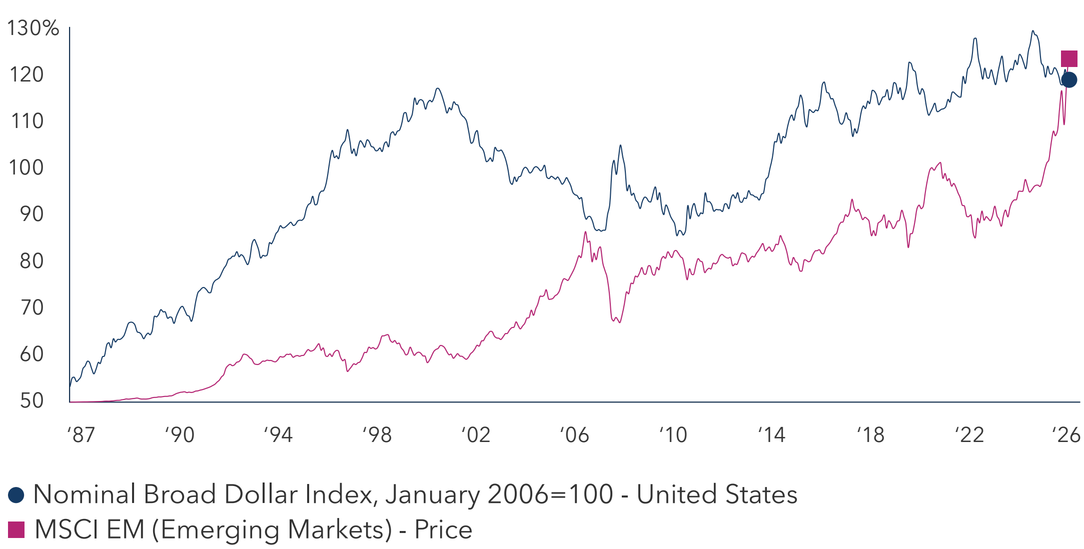
But after a decade of growth, valuations were extended (investors began to talk about why EM should trade at a premium), and capital began to flow out. The resulting fiscal crises, in Mexico in 1994, and later that decade with the Asian Financial Crisis, accelerated outflows that hurt these economies and collapsed earnings growth and valuation multiples, ending the first EM cycle.

The second EM cycle

Commodities led the next boom in the early 2000s. A weakening U.S. economy and dollar (the "push" factor) coincided with a commodities supercycle driven in large part by China's rapid industrialization and economic development (the "pull" factor). Refined metals and energy were in high demand. As such, resource-rich countries benefited as capital flowed into these sectors.

After several years of this growth, the world heralded the BRICs (Brazil, Russia, India and China) as unstoppable economic forces. However, the boom ended with the beginning of the Global Financial Crisis in 2007, causing a sharp decline in demand for most goods and hurting commodity prices. This strained the leading, asset-heavy companies of the time that relied on the high commodity prices to maintain profitability.

EM has rallied during periods of U.S. dollar decline



Sources: FactSet, MSCI, U.S. Federal Reserve System. Data as of 5/31/26.

The start of a third cycle: A new boom driven by structural changes

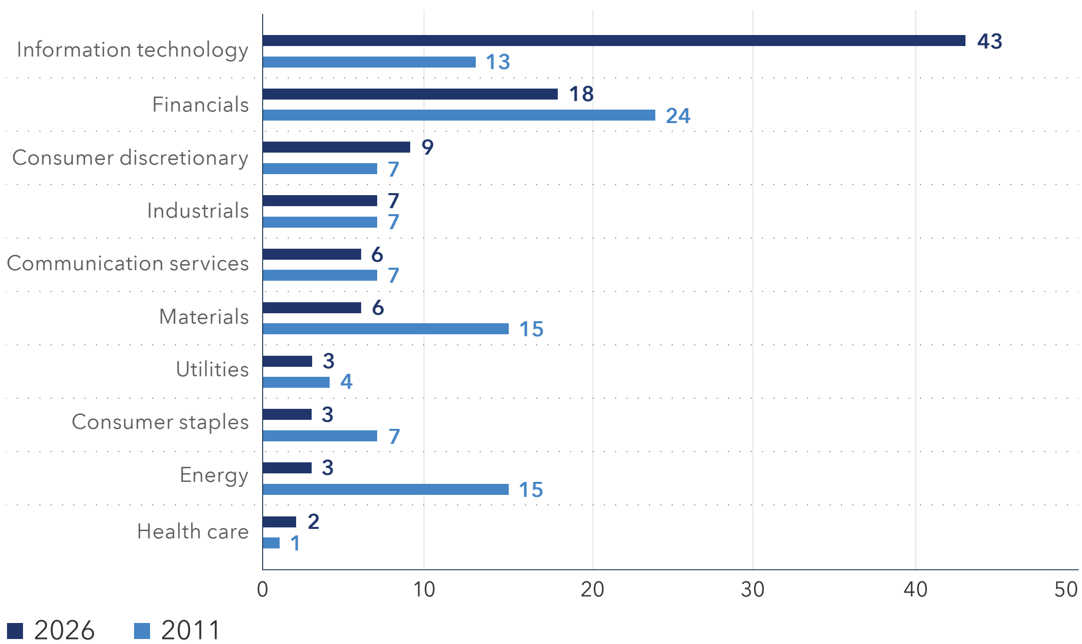
EM economies have evolved significantly over the last 15 years. With the exit of Russia from the investable group, EM is now much less dependent on energy, commodities and banking. At the same time, the demand for semiconductors, memory chips and other hardware – the physical components of the AI revolution – has caused a technology boom.

Consider these emergent technology leaders benefiting within EM economies:

- Taiwan Semiconductor Manufacturing Company is widely regarded as the most advanced semiconductor manufacturer in the world, recently introducing 2-nanometer technology, and making significant strides in cooling and energy demand efficiency – two factors critical to advanced AI.
- Samsung Electronics is the world's largest memory chip manufacturer with a leading market share operating across multiple segments, including logic chips. As of June 2026, the mean consensus earnings estimate for the next 12 months is higher than that of Nvidia.
- Korea's SK Hynix is another leader in memory semiconductors, specializing in Dynamic Random-Access Memory (DRAM) and non-volatile (NAND) flash memory with a strong presence in server and personal computer memory markets.
- MediaTek is a large supplier of chips to China, India and Japan, generating most of its revenue from these countries.
- Alibaba and Tencent have entire digital ecosystems, similar to Alphabet, Amazon and Apple in the U.S., but serving the vast population of China.

The evolution of EM in the last 15 years

Sector weights %



Sources: FactSet, MSCI. Comparison between 5/31/2011 and 5/31/2026.

Astute observers may point out that this heavy concentration in technology is a mirror image of the U.S. market, but the implications of this shift are far more meaningful for EM, as it indicates an element that was largely absent in the first two cycles: Structural compounders.

Structural compounders are businesses that operate high on the value chain with low sensitivity to cycles, making them more durable, long-term opportunities. The growing presence of this group signals that this third EM wave may be more sustainable and resilient than past cycles.

To better understand the overall outlook and help navigate the broader landscape of EM opportunities, a useful framework is to plot where a company sits in the value chain versus its sensitivity to economic cycles. This reveals four distinct categories of opportunity:

- **Structural compounders** – Companies high on the value chain that have low cyclical sensitivity, meaning they are typically less volatile with fluctuations in the macroeconomy. Broadly speaking, these include the semiconductor leaders, major internet platforms and pharmaceutical innovators that can compound earnings across market environments.

  Even if AI spending were to slow, and demand for advanced AI chips were to weaken, Asian semiconductor manufacturers still produce the majority of chips used in everyday electronics, which provides a buffer against cycles.

- **Cyclical compounders** – Companies with high value-chain positioning but greater sensitivity to economic cycles. These include infrastructure builders, technology hardware manufacturers, renewable energy leaders and other companies benefiting as global capex expands.

  It's important to note that companies in this category can transform into structural compounders. Robotics could become an example of this if the technology advances and mass adoption occurs at the enterprise level, which would benefit Chinese companies. According to the International Federation of Robotics' World Robotics 2025 report, China has installed more than half the world's robots since 2021.[2]

A framework to evaluate EM opportunities

Cyclical sensitivity	Low ← Value chain position → High	
High	**Commodity cyclicals** • Vale S.A. • Rio Tinto • Petrobras	**Cyclical compounders** • BYD • Cemex • Trinasolar
Low	**Defensive** • Hana Financials Group • Kotak Mahindra Bank • LG Electronics	**Structural compounders** • Taiwan Semiconductor • MercadoLibre • Tencent

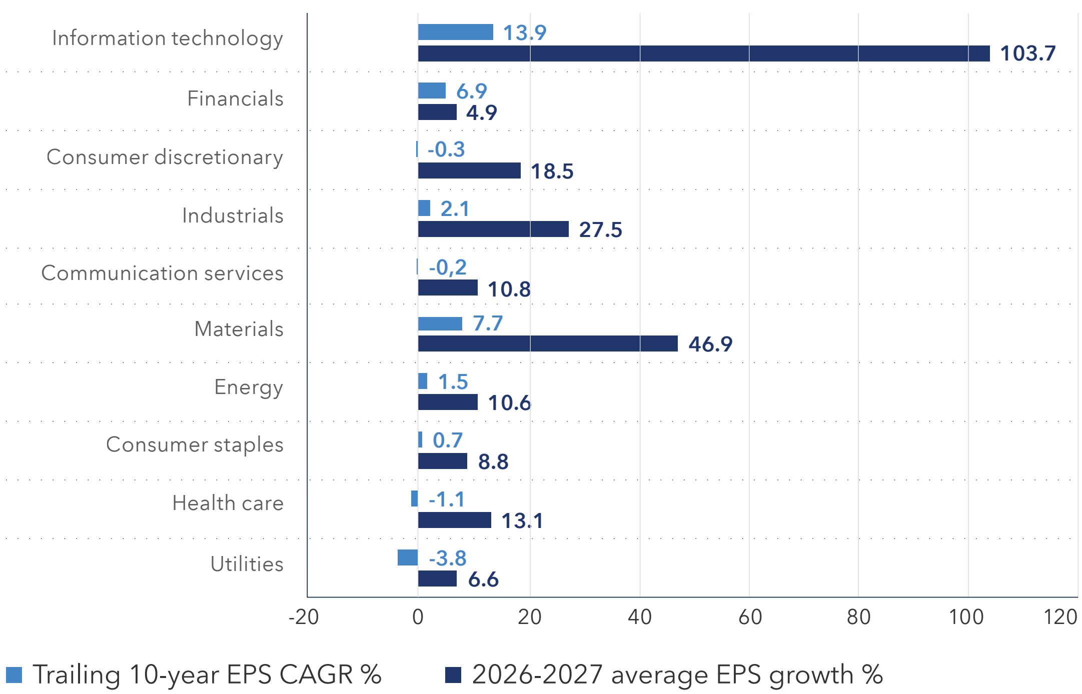
- **Commodity cyclicals** – These are traditional EM strengths in raw materials and energy that remain tied to global demand cycles but continue to play a vital role in the world economy.

  Currently, many of these raw materials are in short supply and high demand, suggesting that these industries are less susceptible to price decreases than in past cycles. The need to rebuild in post-conflict regions such as Ukraine, as well as a push by governments to build strategic reserves, creates a better long-term outlook here than in past cycles.

- **Defensives** – Lower volatility businesses in telecommunications, utilities and financial services that have historically provided relative stability and income make up this category. Improved technology capabilities have enabled many of these companies to generate stronger growth and profitability.

  For example, mobile and digital payments have grown faster in China than anywhere else in the world. India has also seen tremendous digital transformations across defensive sectors because of government initiatives.

Earnings growth is expected to inflect higher across EM sectors



Sources: Capital Group, RIMES, FactSet. Forward earnings growth is based on average consensus estimates aggregated by FactSet, as of June 11, 2026. Sectors are listed left to right in descending order by index weight.

This third EM cycle is distinguished by the depth and breadth of the structural compounders. At the same time, many cyclical compounders are well-positioned to make a jump into the structural compounder category, indicating a significant departure from the first two cycles. If this dynamic were to accelerate, it could act as a strong pull factor and extend this cycle, as major innovations in software development, robotics, automation and pharmaceuticals were undeveloped or absent in the first two cycles.

Additionally, more cyclical segments of EM — from infrastructure to commodities — offer a longer runway for returns as record levels of global capital investment flow into AI, renewables, defense and industrial modernization. Also, a manufacturing boom across various countries is also being driven by the China Plus One strategy — a deliberate move to diversify supply chains away from China, often into other EMs.

Overall, improvements across all these ever-evolving categories may help move certain economies past the middle-income trap and any Dutch disease malaise, indicating a more durable future for EM.

Evaluating political and governance risk

No discussion of EM investing is complete without addressing political and governance risks. Even though the business and regulatory environments have improved in many of these countries, certain exogenous shocks can render companies uninvestable in a short period of time. Russia went from being a flagship constituent of the second EM cycle to being removed from the MSCI EM Index entirely and reclassified as a standalone market. As of this writing, geopolitical friction, including potential scenarios involving Taiwan cannot be ruled out — no matter how small the odds may be. Meanwhile, ongoing tensions between the U.S. and China could slow export growth.

A useful lens for assessing this risk is to examine a company's sources of revenue by geography alongside the political environment of its domicile. At Capital Group, we call this the "New Geography of Investing." Companies generating a significant share of revenue from diversified global customers in hard currencies such as the U.S. dollar, euro, Japanese yen or British pound carry a different risk profile than companies whose earnings are concentrated in local-currency markets with elevated political uncertainty.

The active advantage in EM

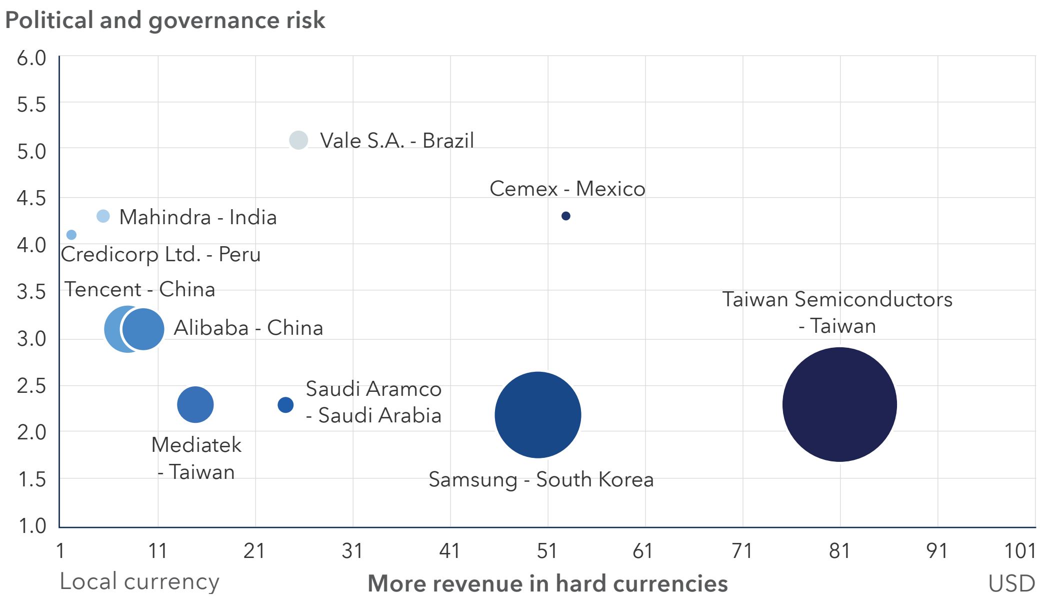
These two frameworks suggest that within EM, active risk management and stock selection are key. For example, forward earnings estimates for commodity-driven and operationally geared companies at the aggregate level in EM appear cyclical, but individual companies may undergo operational improvements that make them more attractive as long-term opportunities.

This is where diverse perspectives among fund managers and analysts, along with collaborative research, can provide a distinct advantage. Collaborative research leads to deeper insights, which leads to leveraging the highest conviction ideas and helps pursue more consistent results across market cycles with less volatility – especially important in EM, which have been historically cyclical.

Furthermore, this approach can take advantage of information inefficiencies that may exist in EM more than any other market. Morningstar's 2025 Active/Passive Barometer found that active equity managers for EM funds achieved the highest success rate among equity categories, meaning a greater proportion of funds both survived and outperformed their average passive counterpart, net of fees, over a 20-year period.[3]

While broad-based index fund investing may diversify holdings, political risk and revenue by geography, it may also bring about unintended market risks. First and foremost, the MSCI EM Index is increasingly resembling U.S. markets in terms of concentration risk. As of May 31, 2026, the top 10 constituents of the MSCI EM Index stand at 39.6% of the total index value, versus 38.4% for the top 10 of the MSCI USA Index, on an adjusted market-cap basis. Second, and somewhat ironically, the MSCI EM Index could arguably be too diversified, with more than 1,200 individual holdings versus the roughly 132 holdings of Capital Group's Emerging Markets Equities Fund (as of March 31, 2026), which can invest where its portfolio managers have the highest conviction while seeking to avoid areas with stagnant growth.

A new look at country and governance risk profiles



Sources: FactSet, MSCI, Moody's. Bubble size indicates a company's adjusted market capitalization. Country risk assessment is based on Moody's long-term issuer ratings in domestic currency, with the letter ratings assigned to a numerical value.

Bottom line

EM investing has entered a dynamic new phase that still appears to be in its early stages. The push-pull dynamic of previous cycles is still apparent. But this new third wave appears to be unfolding on a more structurally resilient foundation, with a move to higher value industries and more structural compounders in the mix, potentially indicating less susceptibility to cycles. The leadership of Asian semiconductor companies makes EM foundational to the AI revolution as well as the technology sector in general.

Additionally, historic amounts of global capex are fueling opportunities beyond technology and AI in cyclical compounders and commodity cyclicals, while domestic defensives are operating with improved technology capabilities. These dynamics suggest that this cycle is broader, more resilient and fundamentally different from previous ones.

For investors, these changes may have important implications both for the allocation to emerging markets relative to developed markets and for the optimal balance between passive and active EM exposure. The pursuit of superior investment outcomes within EM revolves around fundamental research that leads to high-conviction holdings based on a long-term perspective — a view that we believe is as true today as it was in 1986, when Capital Group first began managing its first EM strategy.

[1] Cogent Syndicated, U.S. Institutional Investors, Brandscape. March 2026.

[2] International Federation of Robotics. World Robotics 2025.

[3] Morningstar's U.S. Active/Passive Barometer. Year-End 2025.

Glossary

Asian Financial Crisis: A financial crisis that started in 1997 with the collapse of Thailand's currency, and then spread rapidly across East and Southeast Asia, exposing weaknesses such as high foreign debt, fixed exchange rate regimes and exposed financial systems. The crisis led to currency depreciation, capital flight and deep economic contractions across affected economies.

BRIC: An acronym that stands for Brazil, Russia, India and China.

Capex: Capital expenditure. The amount a company spends to acquire, upgrade or maintain long-term assets that provide benefits beyond the current fiscal year.

Commodities: Raw materials like grains, gold and oil used in the production of goods and are traded in large volumes on specialized exchanges. Hard commodities, like metals and oils, are mined and extracted while soft commodities, like wheat and coffee, are agricultural products.

DM: Developed markets. Countries with mature economies, well-established financial markets and relatively high standards of living, often represented by indices such as MSCI USA or MSCI EAFE (Europe, Australasia and Far East).

Dutch disease: Dutch Disease occurs when a country's rapid growth in a specific sector, often due to the discovery of natural resources like oil, gas or minerals, causes its currency to appreciate. This makes exports from other sectors, such as manufacturing or agriculture, more expensive for foreign buyers, while imports become cheaper, reducing the competitiveness of domestic industries.

EM: Emerging markets. Countries with developing economies, financial markets and regulatory frameworks that are less mature than those in developed markets. These markets may offer higher growth potential but also carry higher risks.

GDP: Gross domestic product. The total monetary value of all goods and services produced within a country over a specified period.

Global Financial Crisis: A severe worldwide economic crisis that spanned from 2007 to 2009 which originated with a collapse in the U.S. housing market and led to widespread bank failures, recessions and government interventions.

Market capitalization: The total value of a company's outstanding shares, calculated as share price multiplied by shares outstanding.

Middle-income trap: The middle-income trap occurs when a country's GDP per capita reaches a middle-income range but fails to progress to high-income status. Since the 1990s, only about 34 middle-income economies have made the leap, while 108 remain stuck, according to the World Bank's World Development Report 2024.

MSCI EAFE Index: The MSCI Europe, Australasia and the Far East Index. A free-float-adjusted equity index which captures large- and mid-cap representation across developed market countries, excluding the U.S. and Canada.

MSCI EM Index: MSCI Emerging Markets Index. A free-float-adjusted, market capitalization-weighted index designed to measure equity market performance across emerging market countries.

MSCI USA Index: A free-float-adjusted equity index designed to measure the performance of large- and mid-cap segments of the U.S. market.

The Plaza Accord: An agreement signed in New York City on September 22nd, 1985, involving France, Germany, the U.S., the United Kingdom and Japan, which aimed to weaken the U.S. dollar to improve trade balances.

Supercycle: An extended period of above-average growth in asset prices or economic activity, often driven by structural or secular factors rather than short-term cyclical trends.

S&P 500 Index: A market-capitalization-weighted index of about 500 major U.S. stocks. Includes reinvested dividends but excludes fees and taxes.

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