Headwinds Abate for Emerging Markets Equities

January 25, 2022

With emerging markets (EM) equities trading near record discounts to developed markets equities, it is important for investors to assess how the diverging short-term and longer-term outlooks for EM equities could affect their positioning in this critical asset class.

In the second half of 2021, emerging markets (EM) equities faced a host of headwinds that caused the asset class to pull back sharply from its midyear highs.

The surge in COVID-19 cases related to the Omicron variant interrupted the progress that many EMs had been making in reopening their economies.

In China, slowing economic growth was accompanied by uncertainty largely centered on the implications of ongoing reforms in the Common Prosperity initiative for Chinese technology, education, healthcare, and other critical segments of the country’s economy.

In addition, varying monetary policy measures, both within EMs and between emerging and developed markets, have created a backdrop that is challenging for EM equities from a cyclical perspective in 2022.

We expect these challenges, however, to dissipate as we progress through 2022, leading to what could be an array of attractive valuation opportunities in mid-2022.

Fears of Another “Taper Tantrum” Are Overblown

EM equity investors are naturally concerned about surging U.S. inflation, acceleration in the tapering of the U.S. Federal Reserve's (Fed) asset-purchase program, and the fact that expectations for increases in the federal funds rate have been pulled forward.

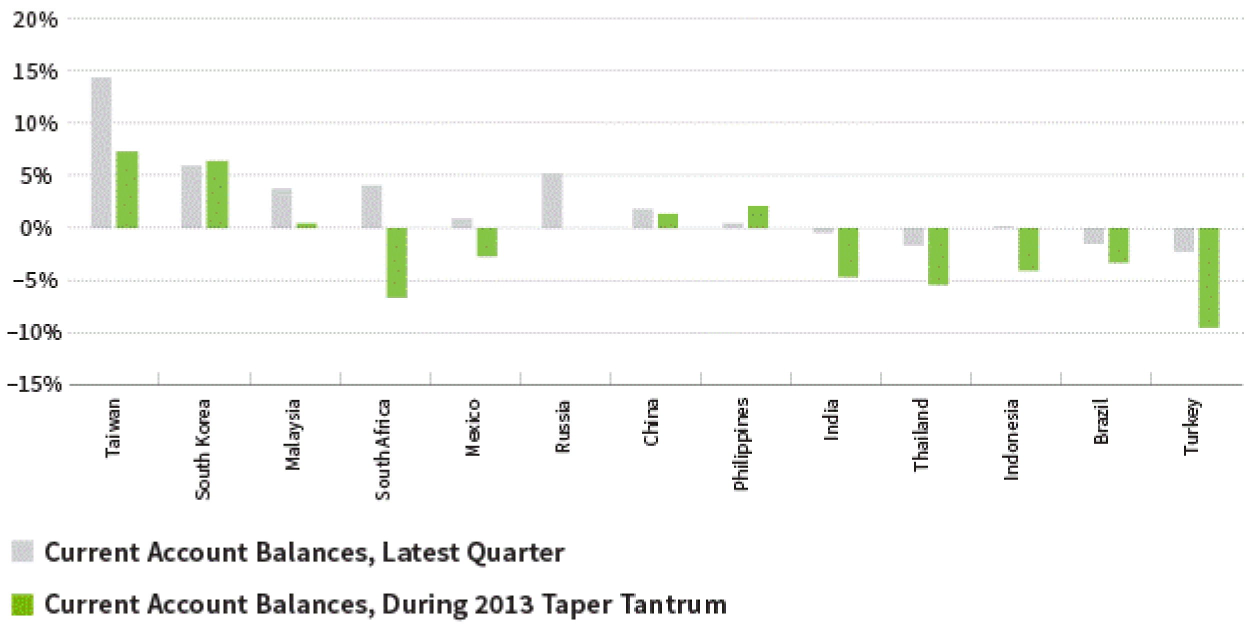
Historically, EMs have underperformed developed markets during periods of rising U.S. interest rates and a strengthening U.S. dollar (USD). More pointedly, many EM investors have vivid memories of the 2013 "Taper Tantrum," during which EM equities dramatically underperformed developed markets as Ben Bernanke's Fed began to taper its asset purchases.

While U.S. monetary tightening and a strengthening USD will likely present headwinds for EM equity markets, we do not expect 2022 to be a repeat of 2013. Going into 2013, EMs had significantly outperformed developed markets during the runup to the Taper Tantrum. EMs also had generally higher inflation and larger current account deficits than they do today, along with somewhat overvalued currencies. This was especially the case with the so-called "fragile five": India, Indonesia, Turkey, Brazil, and South Africa.

In our view, EM economies are now in a much better position to weather the U.S. tightening cycle than they were in 2013. EM gross domestic product (GDP) growth expectations are higher and current account balances are supportive, as shown in the chart below. Meanwhile, EM inflation is generally lower than it was during the Bernanke taper, with a few notable exceptions, such as Brazil and Turkey. We also expect that any increased USD strength will likely ebb toward the middle of 2022 as investors get more visibility into the path of U.S. interest rates.

EMs Are in a Stronger Fiscal Position to Weather U.S. Monetary Tightening

The current account balances of EM countries are more supportive of economic growth than they were in 2013. This improved fiscal positioning, along with stronger economic growth forecasts, should allow EMs to be more resilient to pressures that will likely accompany U.S. monetary tightening in 2022.



Source: Bloomberg, as of December 2021.

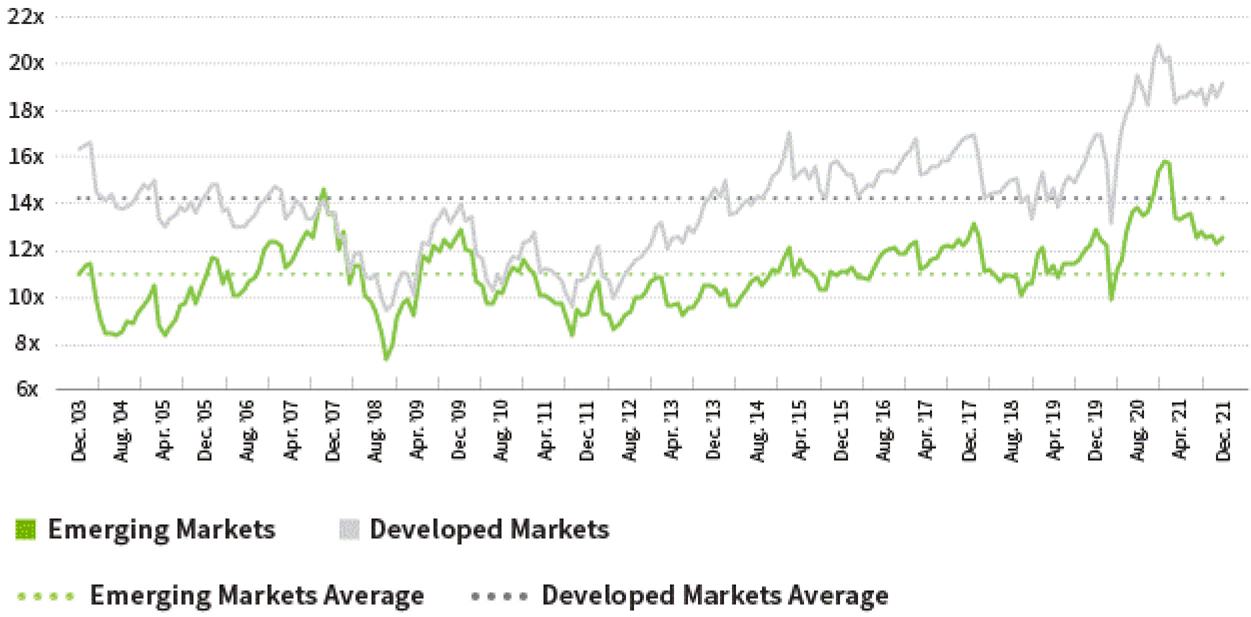
China Headlines Attractiveness of EM Valuations

In addition to strong macro fundamentals in EM countries, EM equity valuations look very attractive relative to developed markets heading into 2022. In fact, we believe the gap between EM and developed market valuations is wider now than at any point since 2003, as shown in the chart below. This reflects the probability that equity markets have already priced in the kind of economic effects that occurred in 2013.

Valuation Gaps Are Wide and Expanding

The gap between EM and developed market equity valuations reached its widest point in nearly two decades at the end of 2021. This valuation gap creates the potential for attractive entry points for EM investors, but we believe selectivity among countries and companies remains paramount.

FOLLOWING FISCAL YEAR (FY2) P/E RATIOS



Source: Factset, as of December 2021. Developed markets are represented by the MSCI World Index. EMs are represented by the MSCI Emerging Markets Index.

We believe that much of this gap is the result of EM valuations that still do not appropriately reflect the importance of technology and other growth-oriented, higher-valuation sectors within the MSCI Emerging Markets Index. In 2008, energy and materials made up about 40% of the index, while the higher-valuation IT, consumer, retail, and media sectors represented only about 10%, according to MSCI. Today, those proportions have more than reversed, and EM is the most tech-heavy region other than the United States.

Current valuations, however, still seem tied to the outdated notion that EM economic activity is dominated by commodities and low-value manufacturing. For growth investors, we believe that the current valuation gap between EMs and developed markets offers an especially attractive opportunity to invest in EMs at undervalued prices.

Still, the valuation story within EMs is far from monolithic. This is especially true when looking at the two largest developing economies—China and India.

Chinese equities traded at the lower end of their historical valuation range at the end of 2021. While China led the world in recovering from the early effects of the COVID-19 pandemic, its economic recovery also compelled the People's Bank of China (PBOC) to normalize and tighten its monetary policy.

These efforts, together with the emergence of COVID variants, precipitated a slowdown in the Chinese economy.

Increased regulations implemented in support of China's Common Prosperity agenda, particularly those affecting internet industries, exacerbated the slowdown and negatively affected investor sentiment.

Against this backdrop, Chinese equities underperformed in 2021, with MSCI China Investible Market Index (IMI) falling 21% in USD terms as of year-end.

Given China's economic slowdown, in December 2021 the PBOC announced a reduction in the reserve requirement ratio (RRR) and cut the one-year loan prime rate—the first cut in almost two years—signaling a near-term change in Chinese monetary policy. This shift in monetary policy will also be perpetuated by China's increased focus on growth stabilization in 2022 as signaled during the Central Economic Work Conference held by the Chinese central government in December 2021.

We believe that this shift to more accommodative monetary policy and increased support for growth offer investors an attractive opportunity to increase their allocations to China. Not surprisingly, the final weeks of 2021 saw increased fund flows to China as investors sought to position their portfolios ahead of the PBOC's efforts to spur growth.

While unsettling news such as the Evergrande default, the potential delisting of many ADRs, and continued regulatory uncertainty paint a cloudy picture for Chinese equities, overall we are incrementally more positive on Chinese equities in the near term, thanks to the supportive macro policies mentioned above.

While Indian equities are currently trading at a premium to most other EMs, we believe that this reflects the fact that India generally has very attractive secular growth characteristics. Factors such as demographics, increased technology adoption, improving but still vast underpenetration in financial services, rising demand for consumer staples, and strong corporate management teams indicate to us that current valuations are justified.

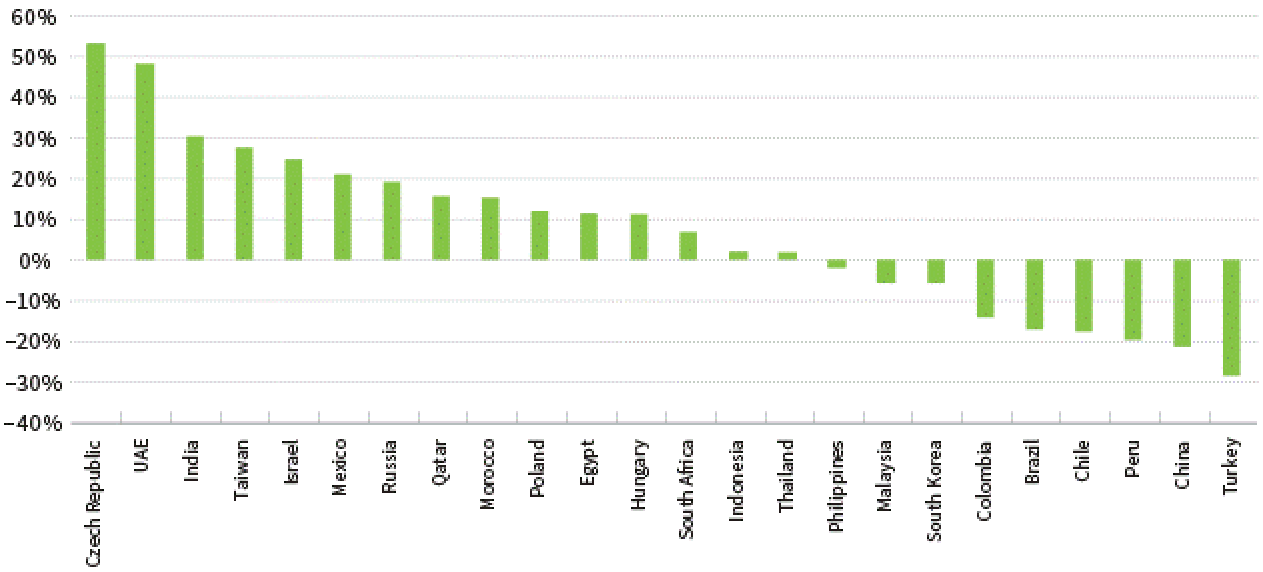
Consistently strong earnings growth among Indian companies is supportive of these valuations and suggests that Indian equity multiples may have additional room to increase going forward.

EM Recovery Likely to Broaden in 2022, but Country Selection Is Critical

Along with our optimism about China and India, we expect a much greater number of EM countries to participate in equity market upside in 2022 than in 2021. Strikingly, 2021 produced the greatest degree of dispersion among EM returns in more than a decade, as the chart below illustrates.

Broad Equity Return Dispersion in 2021

In 2021, equity returns among EMs varied dramatically as countries progressed through phases of economic reopening from the pandemic at different paces. The continued rollout of vaccinations should lead to more broad-based upside participation in 2022.



Source: Factset, as of December 2021. **Past performance is not indicative of future results.** Countries are those in the MSCI Emerging Markets Investible Market Index (IMI). Indices are unmanaged and do not incur fees or expenses. A direct investment in an unmanaged index is not possible.

Varying degrees of COVID-19 shutdowns and reopenings drove much of this dispersion, as did the different monetary policy responses that EM central banks pursued in 2021. As 2022 begins, many EM countries appear set to reopen their economies more fully, especially Southeast Asian constituents such as Thailand, Indonesia, Vietnam, and the Philippines. We believe this should lead to a broadening of participation in the global economic recovery across EMs.

Nevertheless, country selection among EM constituents remains critical. Variations in inflation and monetary policy are likely to foster some continued dispersion in equity market returns, as will evolving political dynamics. For example, Brazilian inflation and interest rates remain high, while the leading candidate in the next presidential election (Luiz Inácio Lula da Silva) supports a socialist economic agenda, creating uncertainty for investors in Brazilian equites.

We are also monitoring developments with the Omicron variant of the COVID-19 virus. As of this writing, the variant appears more transmissible but less lethal than previous versions of the virus. EM healthcare systems tend to be less robust than their developed market counterparts, drawing into question how well certain EMs will be able to respond to large numbers of Omicron cases.

For now, we are encouraged by the relatively low and manageable hospitalization rates for Omicron cases in South Africa, where the variant was first detected. In fact, new cases and hospitalizations related to South Africa's most recent infection wave seem to have already peaked. Nevertheless, EM investors should continue to monitor the pandemic and its evolution closely.

Secular Trends Create Opportunities for Sustainable Value Creation

For investors focused on sustainable value creation, we are encouraged by the expanding opportunity set within EMs.

In 2002, EMs accounted for about 15% of the top quintile of companies globally in terms of sustainable value creation, which is an aggregate measure of returns on capital that we use to evaluate growth stocks, according to MSCI data and William Blair's analysis. In 2021, however, that figure grew to approximately 35%—a remarkable increase that highlights the opportunity to find EM companies that excel at generating high returns on invested capital.

Notably, much of this growth came from China, India, and other Asian countries such as Taiwan and South Korea. This is a prime example of how the evolution of growth investing in EMs has shifted markedly toward Asia at the expense of Latin America and other regions over the past two decades.

Within this expanding and increasingly Asian-dominated opportunity set for growth investors, we are focusing on several distinct secular themes:

- **Consumer spending and e-commerce:** The growth in spending on both staples and discretionary items among EM consumers is particularly compelling when we consider the potential for increased e-commerce activity. Despite the emergence of large, innovative local champions across EMs, e-commerce penetration is still only about half of that seen in developed markets.
- **Tech hardware:** Semiconductors and other segments of technology hardware are experiencing surging demand, fueled largely by the proliferation of 5G, cloud computing, and the Internet of Things (IoT). In addition to these secular trends, semiconductor manufacturers in EMs are benefiting from cyclical pricing power amid the global chip shortage.
- **Indian financial services:** Despite the Indian economy's evolution toward greater development, it continues to be plagued by low levels of financial services penetration. Still, the growth of Indian's digital economy and other positive trends suggest that the country is near an inflection point in terms of bringing banking, insurance, and other financial services to a broader portion of its massive population.

Despite Headwinds, EM Equities Provide Significant Upside Potential

Despite headwinds from U.S. monetary policy and uncertainty about the Omicron variant, we believe that EM equities will provide investors with ample opportunities for growth in 2022.

EM's generally strong economic fundamentals and a broadening of the global economic recovery should provide a particularly supportive backdrop for sustainable value creation.

Meanwhile, we believe that high-quality EM companies will be well positioned to capitalize on powerful secular trends amid the continuing development of these markets.

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Emerging Markets 2022 Outlook Series

Part 1: Slowflation to Expansion
Part 2: Headwinds Abate for Emerging Markets Equities
Part 3: A Brighter Outlook for Emerging Markets Debt
Part 4: China: Opportunities at an Inflection Point

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