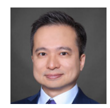
Is the Value Rally in Emerging Markets Sustainable?

Value investing is coming in from the cold.

August 2021

KEY INSIGHTS

- Our EM "Discovery" thesis seeks to invest in forgotten stocks about to experience fundamental change. The transition to green energy provides one such opportunity.
- The way EM governments employ fiscal stimulus has changed to targeting the consumer directly. This is another fundamental change that we intend to capture.
- With a capex-depreciation ratio around 1.0, nonfinancial EM companies have been underinvesting. This is poised to change, bringing new investment opportunities.



Ernest Yeung
Portfolio Manager, Emerging Markets Discovery Equity Strategy

After a decade of strong value outperformance in emerging market equities from 2001 to 2010 came a decade of sustained underperformance. In 2020, the value/growth divergence in EM reached an extreme not seen before, driven by the deep recession created by the global coronavirus pandemic (Figure 1). Before examining the disappointing performance of EM value since 2010, we should first ask ourselves "What drove value's outperformance between 2000 and 2010?" We believe there were two key factors at work. First, there was the Chinese economic supercycle as China spent a staggering USD 12 trillion on infrastructure and industrial capacity over this period. This benefited "old economy" sectors globally, such as steel, cement, nonferrous metals, industrial machinery, and energy. Second, the world was starting to recover following a number of EM shocks (1994 Latin American tequila crisis, 1997–1998 Asian financial crisis, 1998 Russian crisis) during which a large amount of capex and many banks had been destroyed.

Is This Episode Relevant to Investors Today?

We believe that it is, since although history does not repeat itself, it very often rhymes! We are of the view that the goal of carbon neutrality by 2050 (2060 for China) will boost many traditional or old economy industries during the long transition period. To meet green energy and carbon emission targets, the world will need to spend heavily on traditional industrial sectors during the transition years.

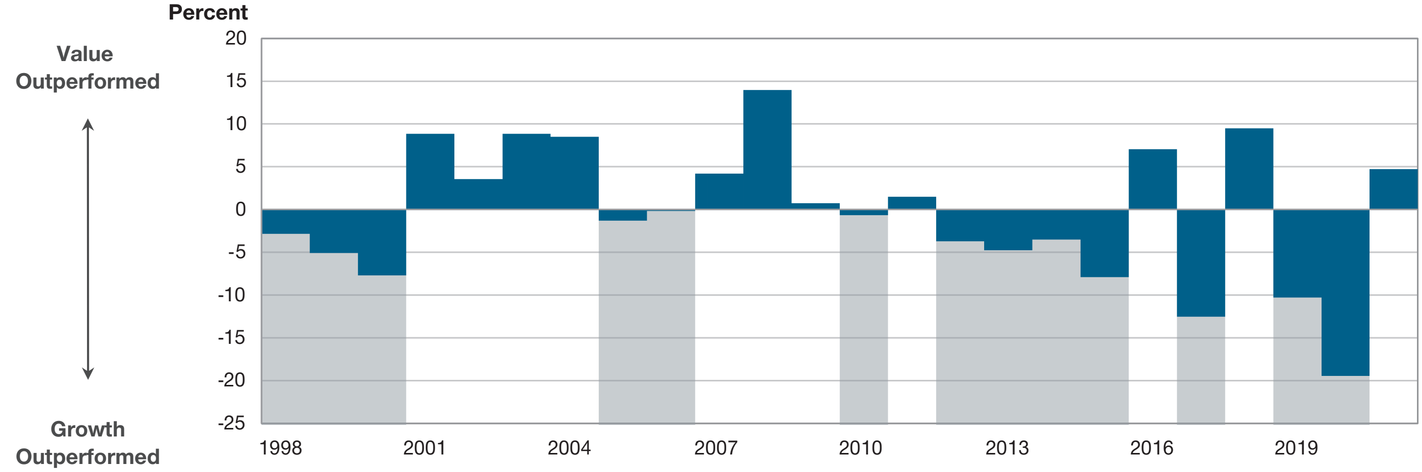
The massive USD 12 trillion of infrastructure spending in China between 2000 and 2010 was one factor contributing to a decade of outperformance for global value investors. Today, China is projected to need to spend around USD 10–15 trillion to transition to a more energy-efficient economy with zero net carbon emissions

> "China is projected to need to spend around USD 10–15 trillion to transition to a more energy-efficient economy with zero net carbon emissions by 2060....

EM Style Divergence Has Been Retreating From Extreme Levels

(Fig. 1) Annual value-growth divergence for MSCI EM indices (%).

Calendar Year Value-Growth Divergence (%)



Calendar Year Return (%)	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	YTD 2021
MSCI Emerging Markets Value Index	-26.49	44.05	-25.43	1.82	-4.33	62.87	31.19	33.64	32.53	42.71	-50.08	79.70	18.80	-17.57	16.38	-4.70	-3.60	-18.16	15.48	28.67	-10.26	12.52	5.97	10.01
MSCI Emerging Markets Growth	-24.34	51.76	-19.22	-6.46	-7.61	49.61	20.90	35.40	32.75	36.96	-56.20	78.38	19.58	-18.77	20.86	0.07	-0.09	-11.12	7.87	47.12	-18.04	25.44	31.58	5.04
Relative	**-2.84**	**-5.08**	**-7.69**	**8.84**	**3.55**	**8.86**	**8.51**	**-1.30**	**-0.16**	**4.20**	**13.98**	**0.74**	**-0.65**	**1.48**	**-3.71**	**-4.76**	**-3.51**	**-7.92**	**7.05**	**-12.54**	**9.49**	**-10.30**	**-19.47**	**4.73**

Past performance is not a reliable indicator of future performance.

As at June 30, 2021.

Source: Financial data and analytics provider FactSet. See Additional Disclosures.

> "The post-COVID-19 energy transition is the type of external fundamental change that we seek to leverage...

by 2060 that do not rely on fossil fuels (Figure 2). This is a sum not very different in magnitude to what China spent on infrastructure and industrialization over 2000–2010. The G10 group of industrialized economies may also need to spend a roughly similar amount on their own green energy transition programs to achieve carbon neutrality in 2050.

Energy Transition Is Commodity Intensive

During the transition to clean energy, the world will likely need to spend heavily on commodities like copper, nickel, lithium, aluminum, and natural gas as alternative energy and electric vehicles are metals-intensive. While a more controversial issue in developed markets, there are also few alternatives to natural gas, the cleanest of the fossil fuels, for EM during the early stages of their fossil fuel transition. In an EM context, this makes sense from an ESG perspective, since gas is less polluting than other carbon-based fuels and hospitals, schools, fire stations, etc., all need power. Renewable energy is not readily available in most EMs, and we believe natural gas will play an important role in the early stages of their transition to cleaner energy.

Investment Must Rise to Reach Net Carbon Targets

The post-COVID-19 energy transition is the type of external fundamental change that we seek to leverage under our EM "Discovery" investment thesis. It is a theme that Portfolio Managers Ernest Yeung and Haider Ali have spent a good deal of time analyzing. The world has badly underinvested in this area, and countries will likely need to ramp up capital expenditure quickly if net carbon reduction targets in 2050 are to be met.

China Supercycle vs. Post-COVID-19 Energy Transition

(Fig. 2) To meet green targets, the world needs to spend.

	China Supercycle 2000–2010	Post-COVID-19 Energy Transition 2020 Onward
Spending	Gross fixed capital formation in China: USD 12 trillion	Estimate on green infrastructure to reach carbon neutral targets: • China: 10–15 trillion • U.S.: USD 12 trillion
Focus Area	Factories and infrastructure	Renewable, grid, and factory upgrade
Beneficiary	Steel, cement, copper, oil, and coal	Copper, aluminum, lithium, nickel, and gas

As of December 31, 2020.
Sources: Haver Analytics/China National Bureau of Statistics, UBS Investment Bank and Goldman Sachs & Company.
Actual future outcomes may differ materially.

> "Following a successful vaccine rollout and strong global economic recovery, value investing has staged an impressive rebound in 2021.

Figure 3 shows that the MSCI AC World CAPEX to depreciation ratio (ex-financials) is currently hovering around 1.0, pointing to the fact that companies in recent years have mostly been spending on maintenance capex, investing "for balance sheet rather than for growth." This time there was no financial crisis—rather, the underinvestment was caused by:

1. China overspending on industrial capex after the global financial crisis—we have spent 10 years digesting that excess capacity.
2. The massive performance divergence between growth and value sectors in stock market terms meant that capital exited the old economy sectors and flowed into the new economy.

We believe this will all have to change as the switch to green energy begins to gather pace and capital is required to flow back to the old economy. The share of investment spending in gross domestic product (GDP) will need to rise, becoming a new driver for economic growth during the green energy transition.

Following a successful vaccine rollout and strong global economic recovery, value investing has staged an impressive rebound in 2021. While this has been welcomed, investors in EM value funds are naturally asking whether the outperformance of value can be sustained. We believe that it can. For one thing, we believe that the way governments supported their economies with fiscal and monetary stimulus during the coronavirus pandemic marks a fundamental change from previous recessions.

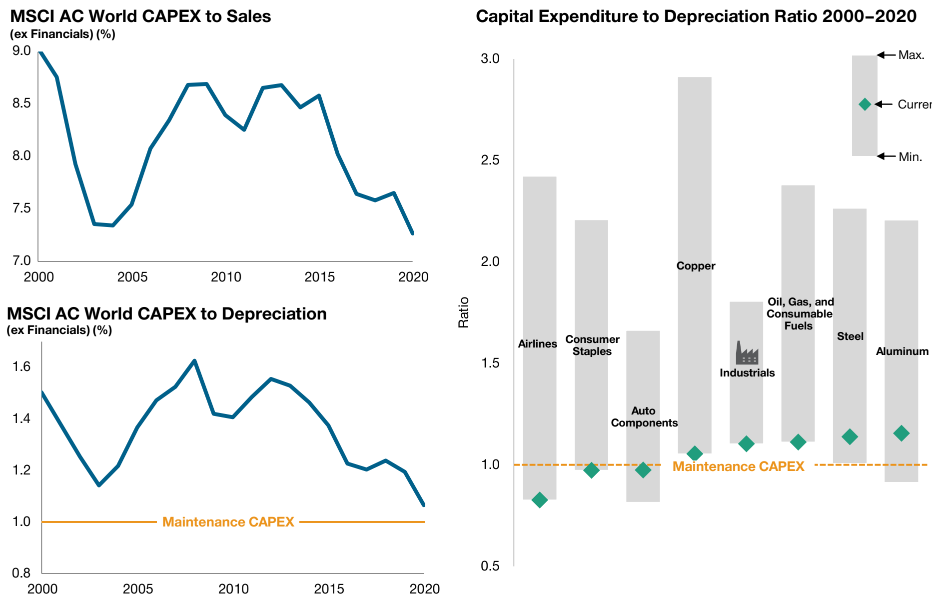
Post-COVID-19 Stimulus Targets Consumers and Green Infrastructure

Stimulus is now being targeted primarily at helping the consumer and boosting green infrastructure rather than being deployed toward supporting corporate and bank balance sheets, as was the case following the collapse of Lehman Brothers in 2008 that triggered the global financial crisis (GFC) and Great Recession. Empirical studies show that fiscal stimulus measures in the U.S. and other developed economies to support the consumer are working as intended and are having a significant multiplier effect on economies. This in turn is leading to a significantly faster economic recovery from the pandemic than was seen in 2009 after the GFC. A faster global economic recovery, in turn, can be expected to provide underlying support for the value style of investing (see Figure 4).

Current Corporate Capex Is Maintenance Only

(Fig. 3) Emission targets require a major boost in net investment.

Capital Expenditure Disciplines



Past performance is not a reliable indicator of future performance.

As of December 31, 2020.

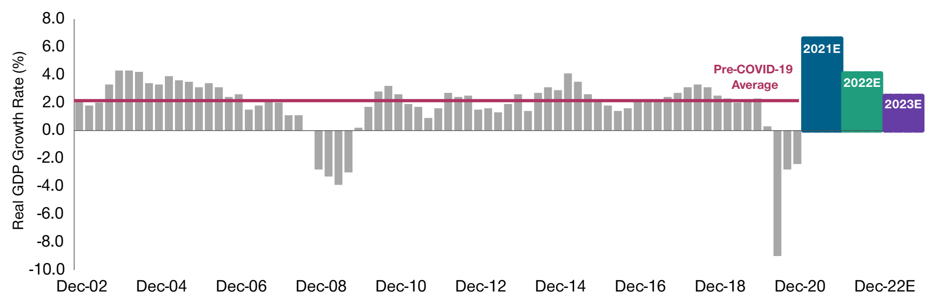
Sources: Bloomberg Finance L.P. Financial data and analytics provider FactSet. Copyright 2021 FactSet. All Rights Reserved. See Additional Disclosures.

Note: The CAPEX to Depreciation ratio divides a company's capital expenditures by its depreciation. A ratio above 1.0 indicates that the company's asset base is growing over time.

U.S. Real GDP Forecast to Grow Strongly Over 2021–2023

(Fig. 4) Above-trend GDP growth should be value-supportive.

U.S. Real GDP Growth Rate (%) YOY



Sources: Bloomberg Finance L.P. CBO Economic Forecast for the U.S. Economy, June 9, 2021 (2023 estimate=2.5%). See Additional Disclosures.

There is no guarantee that any forecasts made will come to pass.

E=Estimate

...some believe the acceleration of new technologies triggered by the pandemic could usher in a period of higher productivity.

For example, by March 2021, U.S. consumer goods spending (almost one-third of the global total) had risen to a level 9% above its pre-COVID-19 trend, a big enough shock to drive a global recovery in demand. In that month, U.S. households saw their biggest ever increase in average monthly incomes (21%) as they received their USD 1,400 bank checks under President Joe Biden's American Rescue Plan. In the past year, U.S. households have accumulated an estimated USD 2 trillion of excess savings, some of which is very likely to be spent during the next year or two.

Besides fiscal stimulus, post-COVID-19 recoveries are also supported by the extremely accommodative monetary policies implemented by major central banks. For the first time since quantitative easing (QE) began, we are seeing strong real growth rates in M2—or broad money supply—in the U.S., Europe, and Japan. In our view, the emerging markets are well positioned to benefit as global growth picks up in response to such strong policy stimulus. China, in particular, has been a big beneficiary of the stimulus-related increase in U.S. consumer goods spending, reflected in merchandise exports from China that are currently around 20% above their pre-COVID-19 levels.

Stars Appear Aligned for Value Investors

Looking at the way in which the global economic environment is currently changing, there are a number of conditions today that would appear to favor a further rotation toward value. Historically, periods of larger fiscal deficits and strong real GDP growth have often been associated with periods of value outperformance. Earnings per share (EPS) growth is another key factor for value versus growth, with the growth style of investing naturally doing better in periods when earnings were scarce. Currently, the consensus bottom-up forecasts for emerging markets EPS growth in 2021 and 2022 are 50.1% and 10.2% (MSCI EM Free Index, as at July 5, 2021), respectively, indicating that we have entered an "earnings rich" environment that ought to favor value over growth.

Interest rates are another factor to consider. Historically, real rates have shown an inverse relationship with value versus growth. As monetary policy in the U.S. and other countries begins to normalize next year, many analysts expect real interest rates to rise, which should also favor value. Lastly, some believe the acceleration of new technologies triggered by the pandemic could usher in a period of higher productivity. Such periods have tended to favor value rather than growth, as higher productivity, in turn, can be expected to result in stronger growth in earnings.

General Portfolio Risks

Capital risk—the value of your investment will vary and is not guaranteed. It will be affected by changes in the exchange rate between the base currency of the portfolio and the currency in which you subscribed, if different.

ESG and Sustainability risk—may result in a material negative impact on the value of an investment and performance of the portfolio.

Equity risk—in general, equities involve higher risks than bonds or money market instruments.

Geographic concentration risk—to the extent that a portfolio invests a large portion of its assets in a particular geographic area, its performance will be more strongly affected by events within that area.

Hedging risk—a portfolio's attempts to reduce or eliminate certain risks through hedging may not work as intended.

Investment portfolio risk—investing in portfolios involves certain risks an investor would not face if investing in markets directly.

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Operational risk—operational failures could lead to disruptions of portfolio operations or financial losses.

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