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INSIGHTS WEBINAR SUMMARY

# Undiscovered and Overlooked: Unlocking Opportunities in Emerging Markets Equities


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**Ernest Yeung, portfolio manager of the Emerging Markets Discovery Equity Strategy, and Chuck Knudsen, portfolio specialist, recently discussed economic and geopolitical trends in global emerging markets and resulting potential investment opportunities for long-term investors.**



## A Challenging Period for Emerging Markets

- Chuck Knudsen, portfolio specialist, noted that emerging markets (EMs) equities have faced challenging conditions over the last 10-plus years, having meaningfully underperformed their U.S. and other developed market (DM) peers. This marked a sharp reversal for the previous decade as EMs outperformed through China's supercycle.
- Ernest Yeung, portfolio manager of the Emerging Markets Discovery Equity Strategy, attributed the underperformance to three principal reasons: (1) The U.S. dollar's strength relative to EM currencies; (2) China's concentration within the MSCI EM Index; and (3) growth versus value challenges, particularly around commodity-exporting nations.
- Mr. Yeung noted that the strength of the U.S. dollar against most currencies had put downward pressure on EM, European, and Japanese equity markets.
- Today, with global risk tolerance at current lows, the U.S. dollar's strength has appreciated. However, Mr. Yeung noted that, if markets begin to anchor their expectations around the severity and magnitude of any potential recession, some of the extreme U.S. dollar positioning could start to unwind.
- On China, Mr. Yeung referenced the country's concentration in the MSCI EM Index—over 31% as of September 26, 2022—and shared that the country has its own policy cycle that is very distinct from both the U.S. and the rest of EMs. Between 2010 and 2015, policy decisions led Chinese equities into a bear market, weighing on returns for the broader asset class. However, favorable policy helped fuel innovation and subsequent returns for Chinese equities from 2016 to 2020. From 2020 until now, policy has oscillated between accommodating and restrictive, causing greater volatility in equity prices.
- Mr. Yeung highlighted countries like Brazil, South Africa, Indonesia, and Malaysia. Although they comprise a smaller portion of the index, their economies are much more levered to commodity production and exporting. Mr. Yeung reminded listeners that commodities performed poorly from 2010 to 2020, attributable in part to a severe divergence between the growth and value styles of investing. He noted that commodity-exporting nations have staged a solid rally over the last two years, representing a different return driver for the index.

## Current Macroeconomic Backdrop and Implications for EMs

- Several key macroeconomic factors are currently weighing heavily on global equity markets: high inflation, hawkish DM central banks, and slowing growth. Mr. Knudsen inquired about what the impact to EM could be, given this backdrop.
- Fundamentally, EMs' earnings downcycle began in the first quarter of 2021, coinciding with China's latest policy cycle. Mr. Yeung noted that EM investors were nearly 18 months into this earnings downcycle, which is beginning to show signs of reaching a bottom as companies start to cut costs. He noted that U.S. equities are perhaps less well down the road, and he, therefore, expects to see more downgrades. Relative valuations for EM stocks are nearing trough levels.
- From a top-down perspective, DM central banks have been behind the curve and only recently started to tighten monetary policy to combat inflation, making it challenging to tell when, and at what level, interest rates may peak in DM countries. Conversely, EM central banks have taken a more orthodox approach to monetary policy and are generally ahead of the curve. Mr. Yeung believes that many EM countries may be near peak interest rates, potentially allowing central banks to ease policy.

## China's Upcoming Party Congress, Future Growth, Geopolitical Relations, and Implications for Foreign Investors

- Mr. Yeung, who resides in Hong Kong, spoke of how challenging it is for foreign investors to understand and grasp China's goals and President Xi Jinping's priorities.
- As a resident, Mr. Yeung stated that President Xi's no.1 priority remains the same: the survival of the Chinese Community Party.
- He noted the challenges President Xi faces to keep China's 1.4 billion population happy and that the country sometimes has to take a more capitalist position to stimulate job growth; conversely, there are times when the economy becomes incredibly imbalanced, and the country must shift toward socialist practices to help keep property values, inflation, and income inequality in check. It is this balancing act, Mr. Yeung notes, that underscores why China drives its own policy cycle.
- These policy cycles are self-created and are uncorrelated with foreign policy. While there are individuals focused on the relations between China and Taiwan, there are also officials focused on China's macro conditions and the effects that COVID-19 has had on its economy, such as slowing growth and rising unemployment. Mr. Yeung believes now is the time to take a contrarian stance and consider Chinese markets, as policy may shift to correct these pandemic-induced conditions.
- When asked about the level and direction of China's gross domestic product (GDP) growth, Mr. Yeung noted that GDP growth has decelerated from levels of around 6% to 7%, and we now expect GDP to grow in the range of 3% to 5% over the next few years. While slower than historical levels, this growth remains relatively strong compared with other parts of the world.
- Geopolitically, Mr. Yeung believes that the West's reaction to Russia in the ongoing Russia-Ukraine conflict has served as a wake-up call for Beijing. He referenced the sanctions imposed on Russia by the western world, including the impact on Russia's foreign exchange abilities and its removal from the SWIFT banking system.
- Any military action between China and Taiwan would impact U.S. supply chains and lead to potentially dire consequences and a more strained relationship between China and the U.S. Similarly, China has not supplied any Russian aid since the onset of the crisis and looks set to remain on the periphery.

## The Russia-Ukraine Conflict: Implications for Energy Markets and Looking Ahead

- While Russia has already reduced natural gas supply on the Nord Stream One pipeline to zero, there are other pipelines through which natural gas can be transported in Eastern Europe. Hungary, Mr. Yeung shared, continues to receive natural gas from Russia due to relatively better relations with Russian leaders.
- Winter could pose challenges, however, as the alternative transport infrastructure for natural gas is not in place, posing concerns this winter for countries like Germany. High energy prices, however, are a global issue and not just unique to Europe. A lack of infrastructure capital expenditure (capex) exacerbates these issues across the entire energy value chain.

- In terms of stock prices, constrained energy supply has been a tailwind to a certain group of EM countries. Some are using this energy shortage as a reason to embark on and expand their oil drilling activities. Additionally, there will need to be further investment in energy infrastructure, which could provide interesting investment opportunities.
- Looking ahead, Mr. Yeung believes that it will take a regime change to potentially make Russia investable once again. The odds of that happening in the near term are very low.

## What Trends Are Investors Potentially Missing?

- Mr. Knudsen asked Mr. Yeung if there were any key trends that are going unnoticed by investors in today's market. Sticky inflation, largely induced by nationalism, and a potential capex cycle are two key themes.
- On inflation, Mr. Yeung believes that we may be nearing peak inflation in some markets, but inflation will remain elevated largely due to political friction. He acknowledged that globalization is being deprioritized by many countries. A heightened focus on national security means that countries may seek to restock their strategic reserves of key commodities and also increase capex to bolster their industrial sectors.
- On capex specifically, Mr. Yeung noted that around the world—not just in EMs—companies have delayed meaningful investment over the last 10 years, spending less than their depreciation. In other words, they have not spent enough to keep their businesses operating as going concerns.
- From an investment perspective, this capex cycle and decreased globalization could create opportunities in select capital goods, materials, and financials companies.

## Improving Environmental, Social, and Governance Agenda

- When considering an EM company's environmental, social, and governance (ESG) agenda, investors must remember that the starting point is much lower than that of a DM company. One of the main reasons for this, Mr. Yeung shared, is that EM companies lack the internal infrastructure and processes to measure and report their progress on key ESG matters to the public market.
- However, investors are beginning to see a rising standard in ESG adoption and companies' willingness to engage on key topics. The gap between EM and DM ESG adoption remains large, however, but standards are improving across countries and regions.
- Mr. Yeung believes that incorporating an ESG lens into his investment process can help investors to avoid potential value traps.

## Pockets of Opportunities

- In Mr. Yeung's view, Mexico presents an exciting opportunity. Mexico's president, Andrés Manuel López Obrador, maintained very tight fiscal and monetary policies during the height of the pandemic, keeping the Mexican peso strong relative to many DM currencies.
- Chile is another market where taking a contrarian stance can potentially prove valuable. When left-leaning Gabriel Boric was elected president last year, the country's people actually vetoed many of his populist policies, which indicated their lack of support for the more radical policies that he might have tried to implement. This has helped temper some of the investor concerns around the new administration and potentially bodes well for the future.

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