ADVERTISING SUPPLEMENT

EMERGING MARKETS

A Supportive Cycle

THE STARS ARE ALIGNING

Fueled by a robust mix of factors expected to drive strong returns, emerging markets equities appear ready for takeoff.

Are the stars aligned for emerging markets equities in 2024? Many institutional managers are confident that this will be the year in which the asset class finally breaks its streak of disappointing returns.

EM equities, as measured by the MSCI Emerging Markets index, have underperformed their developed-world counterparts in the MSCI World index in nine of the past 14 years, and they have underperformed through April of this year. The last time they outperformed was 2020.

The potential for a mid- to long-term upside for EM equities rests on a number of compelling conditions — more than the usual macroeconomic suspects. Institutional asset owners should take the opportunity to rethink their risk-return appetite for EM allocations accordingly.

HOW DID WE GET HERE?

To fully appreciate the bullish case for EM equities, it's helpful to understand how the investment environment has changed. Jack Nelson, analyst and portfolio manager at Stewart Investors, has seen an evolution in the way investors think about emerging markets.

The consensus view had long been that the economies of poor countries would grow more quickly than those of rich ones, and that this superior growth would deliver superior equity returns.

"We've seen that some countries have raised their income levels to be more in line with developed markets, most obviously in Asia, but others are falling further behind," Nelson said. "And even when there has been strong GDP growth in some markets, it hasn't necessarily translated into attractive equity-market returns for all sorts of reasons related to corporate governance, politics and countries' economic models."

After years of underperformance, he said, "it would be reasonable for asset allocators to ask, 'What is the point of investing in emerging markets that have lower returns and higher volatility than developed markets?'"

However, "despite emerging markets benchmarks having not really gone anywhere for years," he said, "the universe has become much bigger, and thus more appealing and more likely to deliver strong returns through active management."

Not so long ago, emerging markets were dominated by "old economy" businesses, such as banks, telecoms, mining, oil and gas and consumer companies. Now emerging markets contain some of the world's best e-commerce, renewable energy and fintech businesses, Nelson said. As a bottom-up active equities manager, Stewart Investors focuses on finding high-quality companies that can deliver attractive long-term returns regardless of location or sector.

WATCH U.S. MOVES

By all accounts, the Federal Reserve is likely to start to cut interest rates in 2024. According to Jorry Nøddekær, head of Polar Capital's emerging markets and Asia team, Fed easing should serve as an inflection point for EM equities in important ways.

The first is that it should prompt countries where growth and consumption are solid — notably India, Vietnam, Indonesia, Brazil and Mexico — to aggressively cut their own rates. Considering the pent-up consumer demand and tight monetary and fiscal policies in these countries, a fresh round of easing should have a multiplier effect on their economies. The full impact of lower rates will materialize in 2025 or 2026, Nøddekær said.

Fed easing also could help to reduce emerging markets' risk premium. "There's no question that the implied risk premium in emerging markets is very high," he said, "driven by negative perceptions about China as well as generally tight monetary policy and inflation nervousness. Domestic easing should lead to lower risk premia, which would help to lift valuations and raise multiples in many markets."

Devan Kaloo, global head of equities and head of global emerging markets equities at abrdn Investments, additionally pointed out that emerging economies didn't receive the degree of government-funded support during the pandemic as did the developed economies — meaning that they didn't experience the same degree of inflation. As a result, he said, "inflation has come down quickly in emerging markets, and you don't have the same issues that you have in many of the developed markets. The scope for interest rate declines in emerging markets, thus, is much greater than it is in the U.S. or developed countries more broadly." (See chart on EM central bank moves.)

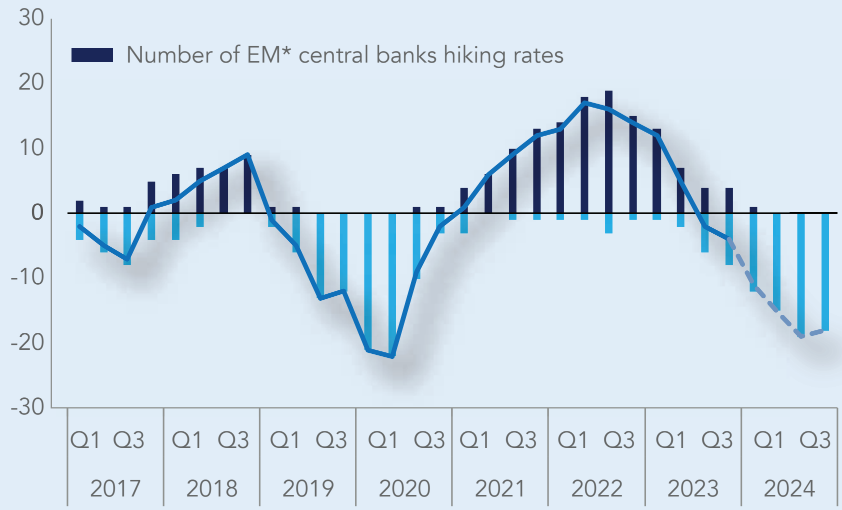
Kaloo also noted that the strong U.S. dollar has been a problem for emerging nations for some time — it raises the cost of capital for companies and governments alike. But he believes the U.S. dollar will weaken, which would be beneficial. "One of the key things we expect, in terms of supporting performance for emerging markets going forward, is that the dollar peaks and U.S. interest rates come down," he said. "What we usually see is that falling

Emerging Market Equity Annual Performance (%)

Source: MSCI. 2024 return as of April 30, 2024.

Emerging Economies Are Poised for Rate Cuts in 2024

EM central banks hikes and cuts



** Includes 24 emerging market economies in Goldman Sachs research coverage.*
Source: Goldman Sachs Global Investment Research, Haver Analytics. As of January 2024

U.S. rates allow EM central banks to cut their own rates, which are currently significant on a real basis. That, in turn, should prompt economic growth."

BULLISH CONSTELLATION

Polar Capital's Nøddekær sees several broad themes that should drive earnings growth and equity returns in emerging markets well into the future. He's particularly excited about what he calls "the new multipolar world," which refers to the movement of large-scale manufacturing away from China and into other emerging countries.

There are numerous manufacturing facilities and supply chains moving to India, Vietnam, Indonesia, Mexico, Poland, the Philippines and elsewhere, he said. In India, Vietnam and Mexico, this has coincided with an already-vibrant level of economic activity and growth.

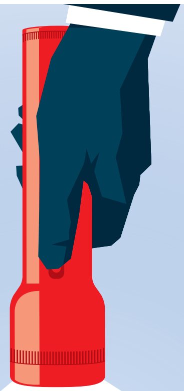
"We think this is a very bullish trend that will be the biggest driver of the emerging markets asset class for decades to come," Nøddekær said. "It will have a very positive multiplier effect on a lot of other economies, which should create more opportunities not just in terms of individual holdings, but also as a way to diversify or derisk your portfolio. Having a much broader opportunity set with less risk should be music to the ears of institutional investors."

Other themes include technology and energy infrastructure. In technology, Nøddekær sees upside in companies related to semiconductors and data centers, "where you can get a lot of really exciting exposure to nearshoring or onshore informatics." His approach to "the new energy infrastructure," as he calls it, is less about finished products like solar panels and more about what's needed to build and support them. He cited copper as an example, noting that Polar Capital's portfolios have some commodity exposure as a way to benefit from the new energy infrastructure trend.

Abrdn's Kaloo pointed to technology and the green transition as favorable themes for emerging markets. "There's great potential for autonomous driving, new handset replacement cycles, networking equipment, site replacements and much more data-heavy or data-hungry applications. All of these require investment in technology," he said.

"If you look at the last couple of cycles for technology, it's either been led by software or by e-commerce," Kaloo continued. "It's been a while since we've seen a tech cycle that's been driven by hardware. This hardware story is especially interesting to us because many of the bits that go into hardware are made in emerging markets."

Kaloo thinks similarly about the green transition. "There is significant investment to move the world to a lower-carbon future, ranging from grid networks to the electric vehicles to EV batteries and general electrification. It also goes into supporting things like artificial intelligence, which is partially an electrification story," he said. "All of these require significant commodity inputs that emerging markets either produce or process."



SPOTLIGHT ON TWO MARKETS

As the largest EM equity market, China merits extra attention from institutional investors. In South Korea, proposed reforms might eliminate the "Korean discount."

Any assessment of the prospects for emerging markets must include China. It is the largest country in the MSCI Emerging Markets index, by far — accounting for about 25% of the index's market cap — and it is the second-biggest economy in the world, trailing only the U.S.

These two data points should be enough to attract large asset owners to Chinese equities. But the investment environment in China has been negative for the past few years: weakening economic growth following a lengthy, severe COVID shutdown; increasingly strict regulation of foreign businesses; the near collapse of the economy's crucial real estate sector; and geopolitical saber-rattling that makes investors nervous. Collectively, these factors have discouraged institutions from allocating much to China.

As Stewart Investors' Nelson put it, "The big impediment in emerging markets at the moment is the unpopularity of China and the fact that it's such a large component of the benchmark. Many asset allocators think that allocating to emerging markets means allocating to China, which can be perceived as risky these days. It's probably the biggest reason that we haven't seen more interest in emerging markets in the last year or so," he said.

Given both China's status as the largest emerging market for equities and that it is significantly out of favor, a case can be made that it should be viewed as a separate asset class. "We see China as a stand-alone investment case, considering the size of its economy and the market's depth and breadth," said abrdn's Kaloo. "Potentially, today it also offers an uncorrelated asset, because unlike other emerging markets, it's less affected by what happens with global interest rates or growth."

The core issue for China, Kaloo said, is that the government doesn't want to reflate the property bubble, meaning that it's less interested in boosting the economy by stimulating consumption. It's more interested in trying to develop a value-add, manufacturing-driven economy, he noted. While the latter strategy creates numerous investment opportunities, it also means that China's recovery could take longer than expected.

Kaloo's bottom line: "We think the Chinese market has found a floor and it wouldn't take much to see it do very well. But we also appreciate that there are meaningful risks."

LOW DEMAND FOR EX-CHINA

If investors underweight China or avoid it entirely, does that mean they'd be more comfortable with EM equities simply by subtracting China? Not necessarily.

"A lot of asset managers are offering separate China-only and emerging markets ex-China strategies," Stewart Investors' Nelson said. "But based on our conversations with asset consultants, it appears that few asset owners and allocators have switched from EM with China to without it. While EM ex-China seems to be a nascent asset class that many managers are understandably offering, it looks like institutional assets haven't, for whatever reason, moved toward EM ex-China in a material way."

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>
> — Jack Nelson, Stewart Investors

Polar Capital's Nøddekær agreed. "There is a lot of talk. We have emerging markets ex-China products that are built on our current emerging markets strategy and process. Our EM ex-China strategy has attracted plenty of interest and meeting activity."

"We sense that people are still not comfortable making the decision to exit China at this point," he said. "Those that have exited China did it a long time ago, and they're not really looking for anything in emerging markets. Maybe they'll come back. But for the moment, the amount of capital being allocated to these ex-China strategies seems limited."

RULES FOR RISK REDUCTION

Selecting Chinese stocks can be particularly difficult at present. The combination of investor pessimism and weakened economic growth has persuaded many institutions to opt out of the market.

While Stewart's Nelson isn't discouraged by this sentiment, he advised that asset owners and their managers exercise greater caution when evaluating Chinese companies for investment. He laid out certain rules of thumb that can help investors reduce their risk exposure.

The first is to seek out companies that are founded, owned and run by executives with business experience typically gained at multinational organizations. "Historically, one of the challenges in China has been obtaining high-quality information on owners, management and how businesses originated," Nelson said. "The risk is that you could be investing in a business that someone started through cronyism, corruption or political connections. This means the business could depend on the continued patronage of whoever secured a bank loan or granted a license."

"We have a number of investments in China where the founding team has set up the business after years of working at American or European multinationals," he said. "You can infer that if a large U.S. multinational respected this person in terms of their integrity and competence to give them a senior role, such as head of China, then they must meet a high standard of ability and accomplishment."

Another rule of thumb is to look at whether a business is in a sector that's aligned with the Chinese government's priorities. The government can have strong policies both in the areas it supports and areas it doesn't want, and it regulates entire sectors accordingly. For instance, Nelson said, the government has steered much of the medical supply chain to domestic firms. But it also doesn't want the population, public sector or small businesses to be exploited by potentially high pricing of medical supplies. As a result, it has taken steps to ensure that the public health care system isn't being overcharged — which caps the sector's profitability.

The best way for investors to avoid this obstacle is to stay away from such high-risk sectors and instead look for companies that provide business-to-business products or services, said Nelson. These companies tend to be off the government's radar and thus are freer to focus on operating profitably. "We look for Chinese companies that can compound their earnings even in a low-GDP growth environment, preserve attractive economics, generate value for minority shareholders and trade at reasonable valuations with a significant margin of safety," he said.

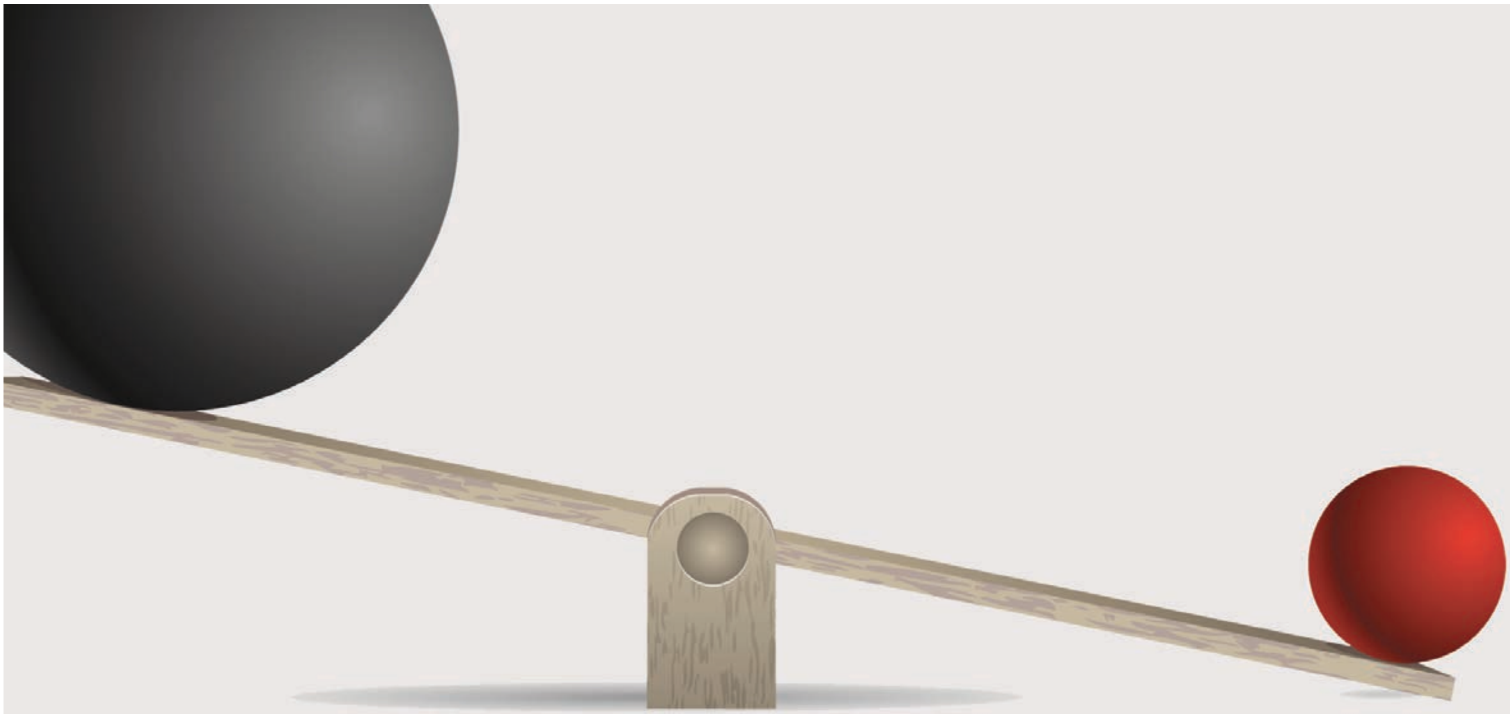
MAJOR REFORM IN SOUTH KOREA

In South Korea, the government is actively encouraging reform in corporate governance. It's far too soon to tell whether the effort will gain traction — the plan was announced in early 2024 — but if successful, it has positive implications for Korean equities.

The government's goal is to reduce or eliminate the "Korean discount," which is the historically lower valuations of many large Korean companies compared with their global peers. Many are conglomerates, known as "chaebol," that tend to emphasize governance taboos such as cross-shareholdings and low-dividend payouts rather than earnings growth and efficient organizational structures. According to abrdn's Kaloo, 70% of listed Korean companies traded below book value at the end of 2023.

The Korean government's plan is based on similar steps taken in Japan to make companies more appealing to investors. "If the government is serious, there's significant scope for a rerating of the Korean market," Kaloo said. "We think that Japan offers a positive example for Korean corporates to follow. While it's early days and the plan is voluntary, the results that Japan has experienced show that the plan is potentially a major catalyst for the Korean market."

Polar Capital's Nøddekær thinks the Korean plan could have an even wider impact. "The idea that corporate governance is weak has always affected emerging markets as a whole. My best estimate is that Korea's reforms could need the next three to four years to take hold; it doesn't just happen overnight. But it's something that could drive the Korean market in the right direction and help lift the valuation of the entire asset class."



NAVIGATING THE UPSIDE

Once institutions decide how much to allocate to emerging markets equities, the question becomes, "Where?" There are plenty of right answers.

There is no shortage of attractive opportunities in EM equities. Kaloo at abrdn is particularly upbeat about several countries that could benefit from the tailwinds he cited earlier: U.S. rate cuts, the technology story and the green transition.

"The market that stands out the most to us is India," he said. "Significant investments are coming through to support the Indian economy, and we think they can sustain a stronger growth rate. The caveat is that valuations are less compelling than they had been. We're cognizant of that and trying to be disciplined in how we invest there."

Kaloo also likes Mexico and Indonesia. He expects Mexico to benefit from the tailwinds and the fact that the U.S. hasn't had a hard economic landing. In Indonesia, he said, both corporate governance and the government have improved significantly, the fiscal position remains strong and there are good companies that are attractively priced.

Polar Capital's Nøddekær sees great potential in Middle Eastern markets: "The Middle East is very underestimated by institutional investors, but a decade from now, it will be a key part of the emerging market universe," he said.

While the traditional perception is that investing in the Middle East is all about oil and gas, the capital markets are broadening out

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>
> — Devan Kaloo, abrdn

with many more consumer and healthcare companies, he said. "Clearly there is a real reform agenda that is quite broad based — and with governments fully aware that there's an armed conflict that's going on. In the old days, conflict between Israel and its neighbors could have put the whole region at risk. We are now seeing a very big willingness among all the key players there to focus on the long-term objective of reforming the region."

DON'T NEGLECT CHINA

Despite China being out of favor, Nelson at Stewart Investors sees opportunities there. "We're cautiously adding to Chinese holdings because there's such a good body of quality companies now available at very reasonable valuations," he said.

Typically, one or two emerging economies tend to be in crisis at any given time. Currently, one of those happens to be the biggest economy in the EM asset class: China. "It has historically made sense to use a dash of contrarianism in such cases, to stick to your investment philosophy and process, and not just buy poor-quality companies because they're cheap. But when you can buy really good companies at reasonable valuations because of that negative sentiment, as in China now, it presents a great opportunity," he said.

Abrdn's Kaloo considers some Chinese stocks to be attractive for additional reasons. "Chinese exports are hugely competitive because costs are relatively low and domestic inflation is nonexistent. We're looking for companies that can export and not face trade barriers on their products," he said. "In addition, there will be companies that can take domestic market share and grow their businesses based on a value offering, stronger brand or better management."

MANAGING CURRENCY RISK

As with any non-U.S. market, dollar-based investors must take measures to address fluctuation in emerging markets currencies. Some managers believe that the most direct approach — hedging through futures and options — should be avoided.

Hedging is normally very expensive, said Polar Capital's Nøddekær. "It's much better to take the money you'd allocate to hedging and invest it somewhere that looks good. You should not be wasting money on hedging when you can be an active manager."

Polar Capital deals with potential currency volatility through country allocations that are based on structural considerations as well as micro- and macro-economic analysis. "Our approach directs us to certain economic areas where we want to be involved and helps us avoid places like South Africa or Turkey, where things are problematic," Nøddekær said. "On the portfolio construction level, if the economic analysis concludes that a market can have a current-account deficit or something like that in the short term, we'll manage that risk through country allocation."

Abrdn doesn't engage in hedging either, according to Kaloo. Instead, it addresses currency risk on the stock and portfolio levels. "We're wary of companies with potentially harmful mismatches, such as debt denominated in nondomestic currencies," he said. "We also carefully analyze our portfolios' dollar sensitivity and factor that into our country allocations."


Stewart Investors
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