Global Emerging Markets

Outlook 2022

2022

Federated Hermes International

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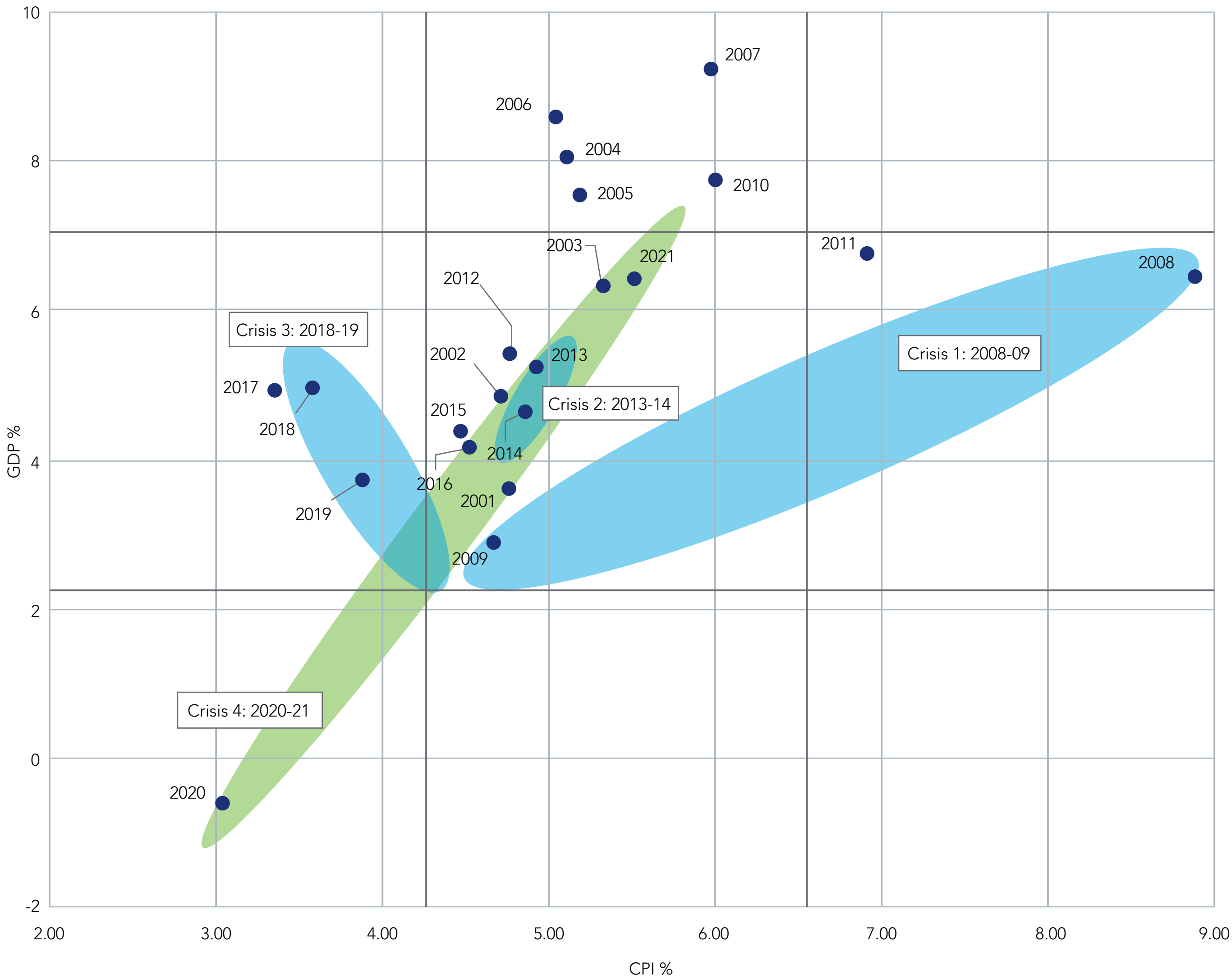
Key points

- Recent data points suggest inflation is close to peaking. Growth and not inflation is likely to be a key challenge in the future
- While inflation will moderate going forward, it might stay at an elevated level compared to history driven by factors such as – supply chains slow at adjusting, structural shortage of critical commodities, and spending towards infrastructure/ decarbonisation (effectively acting as a fiscal boost)
- Political and geopolitical uncertainty remains high globally, with some crucial political events occurring in 2022 that are likely to change the course of policy
- The portfolio is avoiding vulnerable parts of EM and displays characteristics of growth and value without sacrificing quality (higher ROE) and ESG to navigate an uncertain environment

Emerging Markets – growth and inflation

Figure 1: Emerging Markets in a moderate growth and inflation environment historically



Source: Bloomberg as of 6th Jan 2022, FHI Analysis.

Since 2001, growth in EM has ranged between 3-6%. Growth pre-GFC (2003-07) was consistently above 7% but barely crossed 5-6% in the last several years (2010-11 being an exception). EM has generally been in a moderate growth and moderate inflationary environment (except Turkey, Brazil, and South Africa, which suffer from persistently higher inflation) until Covid-19 struck the world. Economies contracted (except for China), and inflation dropped to the lowest in over two decades as demand for most goods and services was impaired due to mobility restrictions in 2020. With vaccines, the economic activity rebounded in 2021, along with a spike in inflation.

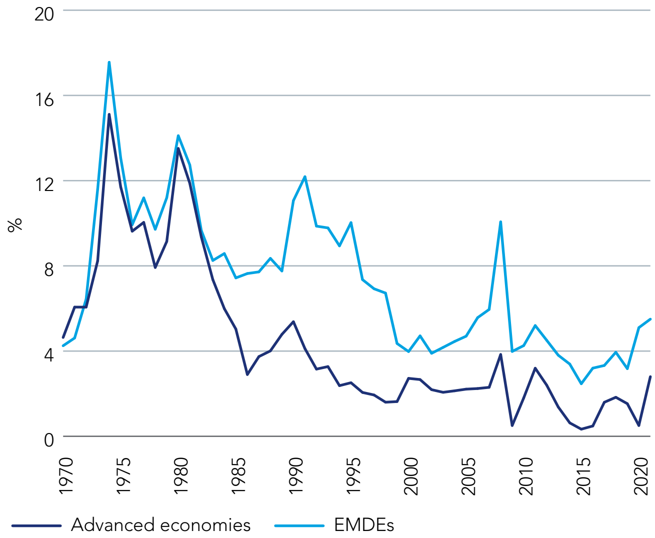
Growth and inflation behave differently post-crisis, reflecting the conditions that led to the crisis initially. For instance, growth deteriorated significantly post GFC, and inflation moderated as the GFC impinged on credit-fuelled consumption. Post-2013 taper tantrum, growth and inflation moderated marginally in EM. Similarly, the 2018 Trump tariffs impacted growth somewhat and led to a marginal increase in inflation, possibly due to tariffs and supply chain disruption. In most prior crisis periods, growth and inflation have moderated as demand pulled back with no commensurate supply chain issues. However, the Covid crisis that engulfed the world in 2020 had a severe impact on demand initially (due to mobility restrictions). However, subsequently, supply could not keep pace with the release of pent-up demand with the zero-Covid policies of the east primarily responsible for shortages in supplies.

Crisis	Explanation	Growth 1-year post-crisis	Inflation 1-year post-crisis
2008	GFC	357bps deterioration	420bps reduction
2013	Taper tantrum	55bps deterioration	9bps reduction
2018	Trump tariffs	120 bps deterioration	29bps increase
2020	Covid	700bps improvement	245bps increase

Source: Bloomberg as of 6th Jan 2022, FHI Analysis

In addition, a shortage of semiconductors is resulting in double-digit inflation for several products such as automobiles. Furthermore, limited supplies of crude oil and rising demand for energy is adding to inflationary pressures.

Chart 2: Uptick in inflation: one off or beginning of a trend?



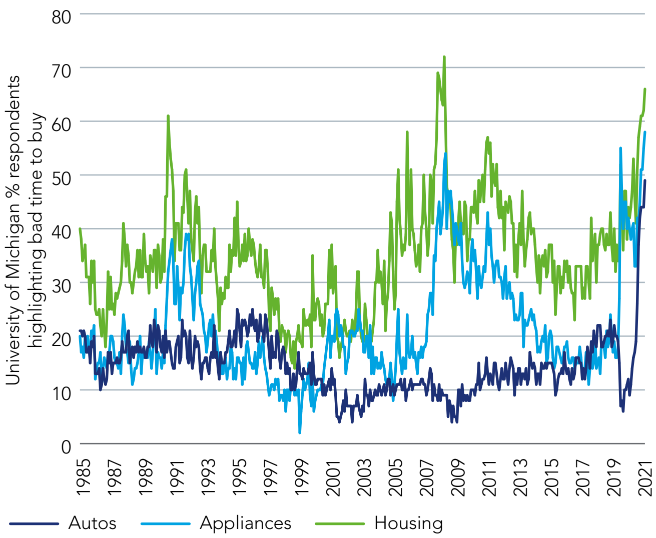
Source: World Bank, IMF World Economic Outlook, 2021.

It is essential to analyse the key components of inflation. According to the most recent US inflation report, energy and used vehicles prices are the primary sources of inflation. Non-energy prices also grew partly due to rising energy prices fuelling inflation in non-energy sectors. Emerging economies' inflation basket is different from the US, but energy prices, rising logistics costs, and supply constraints for essential products are likely to be the key determinants.

It isn't straightforward to contemplate the actions of OPEC+ in setting production targets and the impact on oil prices. However, oil prices have risen c.100% since June-2020, and further gains in oil prices will likely moderate, helping cool off inflation.

However, in most instances, the cure for inflation (high prices) is high prices themselves. Consumers in the US are now beginning to feel less confident of rising inflation as it impacts their ability to spend at the same rate. A University of Michigan survey highlighted that an increasing number of respondents see limited value in purchasing big-ticket items such as housing, autos, and appliances.

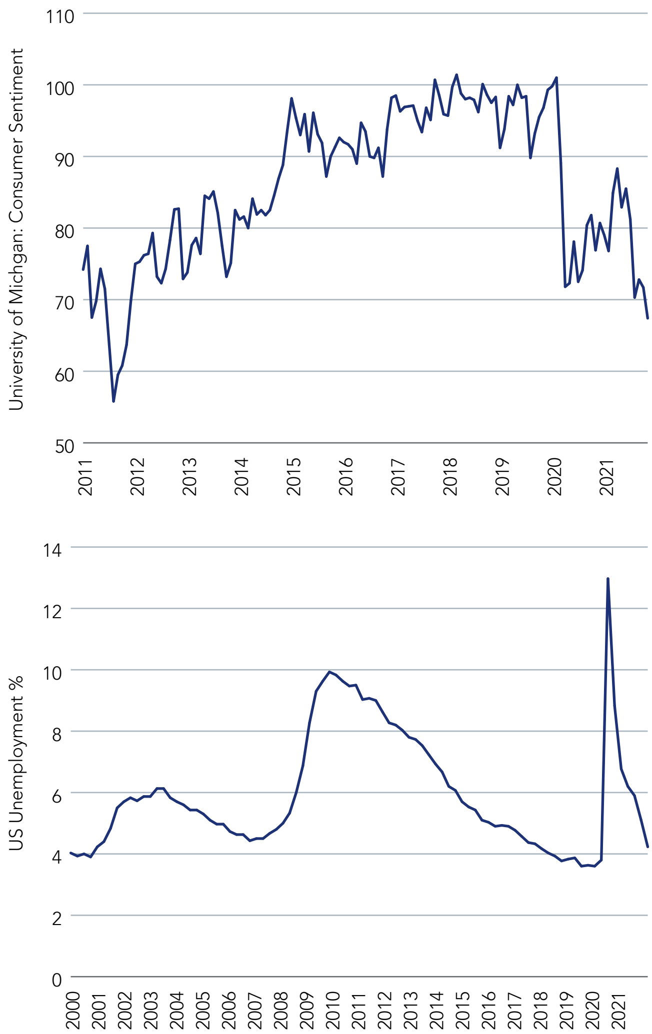
Chart 3: High prices deterring spending



Source: https://data.nasdaq.com/data/UMICH-consumer-sentiment (accessed on 12 January 2022).

The survey outcome suggests that the demand conditions are unlikely to remain benign, helping cool inflation somewhat. The University of Michigan consumer sentiment survey has also declined to levels seen in 2012 primarily due to rising prices. However, the unemployment rate in the US is almost back to pre-Covid levels, and wage growth in the US remains robust.

Charts 4 & 5: Consumer sentiment survey was weak while US unemployment moderates

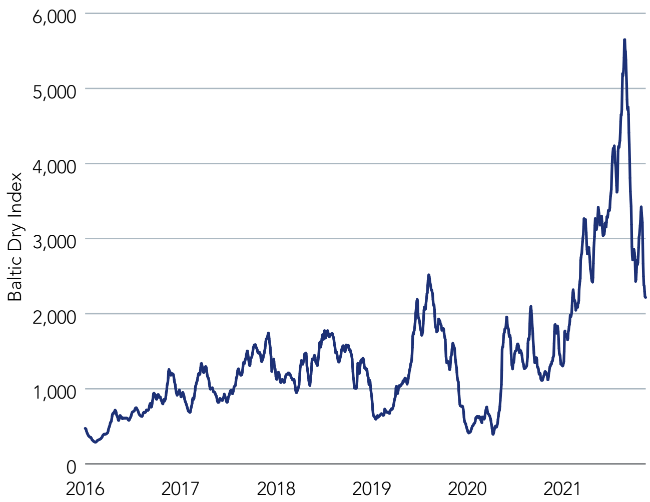


Source: The University of Michigan, Bloomberg as of 6th Jan 2022

The likely way forward

The Baltic Dry Index measures global shipping rates and is considered a leading inflation indicator. The index declined c.50% recently after hitting a peak in October, suggesting that supply chain/logistics bottlenecks (which were a key driver for rising prices for internationally traded goods) are subsiding.

Chart 6: Logistic bottlenecks are subsiding, but the level is still higher than pre-Covid



Source: Bloomberg as of 6th Jan 2022

In addition, there will be a likely shift from consuming products to consuming services given how, during the pandemic, consumers postponed services due to mobility restrictions (e.g. holidays, eating out, theatre/cinema, outdoor experiences, etc.).

Despite the recent correction, the index remains elevated and above the pre-Covid level. An elevated level is likely to continue, driven by rising demand across dry bulk commodities. Along with the Chinese consumption of essential commodities, the US infrastructure spending plan will be crucial for the dry bulk index.

Hence, while consumer sentiment is weaker and likely to cool goods inflation, rising demand for services might offset the downward pressure somewhat, and the infrastructure spending program could sustain inflation at a higher level.

According to the IMF, inflation in emerging economies will moderate slightly from 5.5% in 2021 to 4.9% in 2022, which will be c.100bps higher than the pre-Covid level and in line with the long term average.

There are several factors that will influence the medium/long term trajectory of inflation:

- Global demographics driving demand for certain products/services
- Adjustments in global healthcare systems to ensure resilience to future shocks
- Diversifying global supply chains
- Size, scope, and execution of the infrastructure spending program
- Role of technology/automation in improving productivity/efficiency
- Spending towards decarbonisation goals

These factors will drive inflation in different directions. Still, we believe that the overall trajectory is unlikely to be significantly lower as several factors are likely to be sticky/structural.

EM vulnerability assessment

Inflation continues to rise in most emerging markets. There are very few markets where inflation is subdued and below the central bank target. In most markets, inflation is either within the band or has risen above the target level, prompting a turn in the monetary policy.

Rising near-term inflationary pressure and normalisation of the US monetary policy will prompt EM central banks to tighten, impacting demand.

Although rising global yields imply improving economic prospects, it becomes an issue for vulnerable economies. Creditor economies do well vs. indebted countries. EMEA and parts of LATAM are vulnerable to rising bond yields; Asia (over 75% of the index) is relatively resilient – including the traditionally vulnerable India/Indonesia as high FX reserves provide a buffer to any currency shocks. Many commodity-exporting countries are experiencing high inflation, for example, Brazil and South Africa. Russia is a slight exception, and Peru and Chile have political issues to consider.

EMEA (ex-Russia) economies are the most vulnerable due to low import cover, high inflation, and a high proportion of ST foreign debt. In addition, rising US 10-year bond yields (in real terms) will have implications across EM, especially those with high dependency on foreign capital. Most EM economies have a positive spread over the US 10-year in real terms despite maintaining negative real policy rates.

Table 1: Fewer emerging markets are vulnerable this time

	FX reserves USD billion	Import Cover in months	Current Account (% of GDP)	Inflation (CPI YoY%)	Short Term Foreign Debt USD (Billion)	Short Term Foreign Debt as % of GDP	Short Term Foreign Debt as % of FX Reserves	Real Policy Rate	Local 10 yr yield Spread vs US 10 Yr	Spread vs US 10 Yr (REAL)
Asia (Average)	**675**	**12.0**	**3.3**	**2.5**	**267**	**12.7**	**38.9**	**-0.22**	**1.99**	**4.03**
China	3,222	15.8	1.5	1	1439	9.8	44.7	3.4	1.0	4.7
South Korea	439	8.6	4	2.3	165	9.2	37.5	-1.3	0.7	3.1
Taiwan	548	17.3	12.8	1.9	198	26.3	36.2	-0.8	-1.0	1.8
India	634	14.8	-0.9	5.4	102	3.8	16.1	-1.4	4.8	4.1
Indonesia	132	9.1	-0.7	1.6	48	4.6	36.7	1.9	4.7	7.8
Malaysia	107	5.9	4.3	2.5	101	30.1	94.8	-0.8	1.9	4.1
Thailand	222	12.7	3.7	1.2	72	14.3	32.2	-0.7	0.3	3.8
Phillippines	94	11.8	1.45	4.3	12	3.4	13.2	-2.3	3.4	3.8
LATAM (Average)	**197**	**10.4**	**0.7**	**6.2**	**50**	**6.6**	**32.0**	**0.08**	**6.60**	**5.14**
Brazil	337	18.4	-0.8	8.3	75	5.2	22.3	0.9	9.7	6.1
Mexico	202	5.3	2.0	5.7	51	4.7	25.1	-0.2	6.0	5.0
Chile	51	7.3	0.9	4.5	25	9.9	48.7	-0.5	4.1	4.3
EMEA (average)	**177**	**9.5**	**0.4**	**8.6**	**69**	**10.1**	**72.6**	**-1.43**	**9.72**	**5.87**
South Africa	43	6.1	1.3	4.5	29	8.5	66.1	-0.8	8.2	8.4
Poland	129	5.7	3.2	5	62	10.4	48.3	-2.8	2.3	2.0
Turkey	77	3.8	-5.1	18.1	125	17.4	163.1	-4.1	21.7	8.3
Russia	460	22.5	2.2	6.6	60	4.0	12.9	1.9	6.7	4.8

Source: Bloomberg as of 6th Jan 2022, Federated Hermes Analysis

Rising uncertainty

While inflation is a vital issue, it is just one of several challenges for enterprises globally. Uncertainty (economic, political, social, environmental) rose steadily before Covid and was c.3x higher than the uncertainty in 2000. Uncertainty shot up significantly during the covid crisis in 2020 and, though it has subsequently subsided as economic growth prospects have improved, it remains a concern.

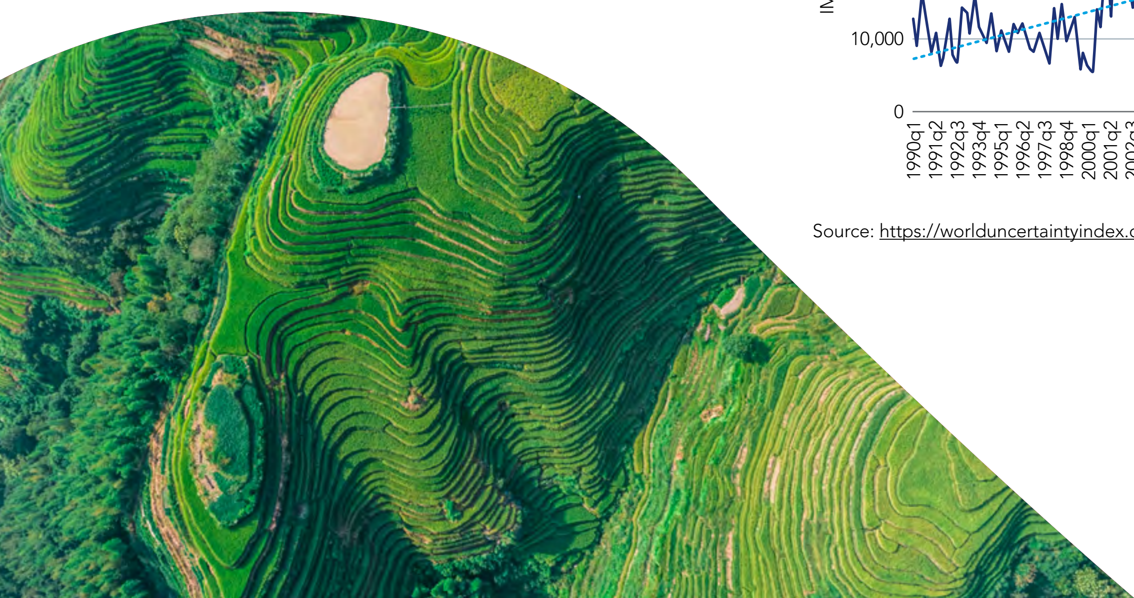
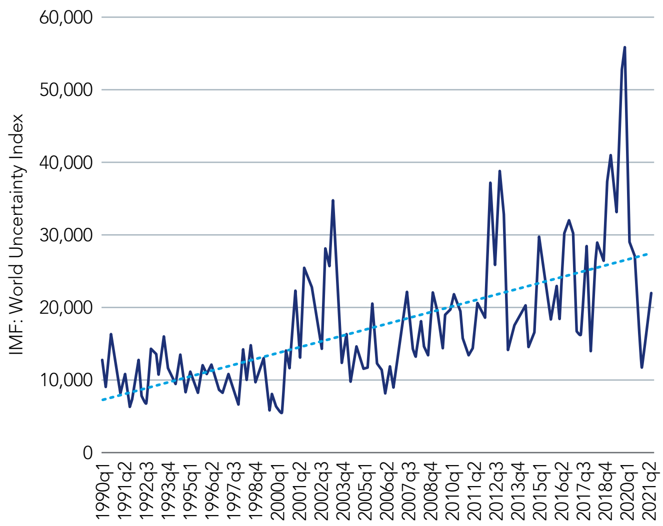


Chart 7: Global uncertainty remains high compared to the last two decades



Source: https://worlduncertaintyindex.com/ as at 30 September 2021.

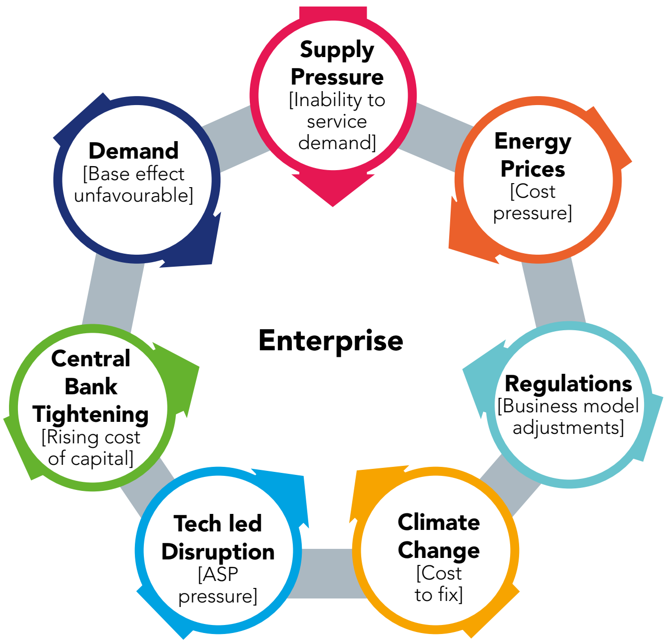
While fewer emerging markets are economically vulnerable this time (vs. the 2013 taper tantrum), political and geopolitical uncertainty is higher. In addition to elevated inflation, geopolitical tensions between US/Russia, US/China, and Iran are likely to persist or perhaps escalate. The global political calendar is heavy in 2022 and increases the risk of further complicating the existing situation.

- **China:** The upcoming National People's Congress will likely indicate President Xi Jinping's intention to govern China beyond the second term, potentially extending to a third and a fourth term
- **India:** A heavy election calendar is planned for 2022 with five state elections. Here, results in the states of Uttar Pradesh and Punjab will set the tone for general elections in 2024 when the ruling party – the BJP and Prime Minister Modi – seek a third term
- **Brazil:** We are likely to witness a bitter battle for the hearts and minds of the Brazilian electorate between President Bolsonaro and ex-President Lula, who has a solid lead over the incumbent
- **Korea:** The incumbent Democratic Party is on the back foot due to prevailing social issues – youth unemployment and the rising cost of living.

In addition to these larger emerging nations, elections will occur in Hungary, the Philippines, and Colombia. There will be mid-term legislative elections in the US and presidential elections in France, Sweden, and Australia. While there will be no change at the top in the US, Biden's approval ratings have fallen. Republicans are looking to make inroads in Congress, potentially complicating Biden's legislative plan.

In addition to rising political risk, businesses must deal with challenges such as slowing demand, a changing regulatory landscape, the increasing cost of capital, climate-related risks, and technology-led disruption.

Figure 1: Inflation is not the only challenge for enterprises globally



Federated Hermes GEMS positioning

The GEMS portfolio has exposure to structurally attractive themes benefiting from secular drivers that should help companies compound earnings over the long term. We believe such an approach mitigates the risks arising from a complex operating environment with demand conditions moderating over the next several quarters, rising costs for a climate-related transition, and a rising cost of capital.

The team believes that while recent inflationary pressures are transitory, inflation will remain above trend. We are positive on the prospects of copper and aluminium doing well over the medium/long term as these are crucial for decarbonisation efforts. Hence, the portfolio has exposure to two of the world's most critical copper-producing countries – Chile and Peru. While these countries have political considerations, the long-term prospect is positive.

The portfolio has some exposure to gold as a hedge against inflation. We are also positive on the prospect of financials as a key beneficiary of rising rates and for their sensitivity to an improving macro environment. We also like the industrials sector given how several companies in the sector are benefitting from the electrification, automation, and logistics themes. In addition, an improving macro environment coupled with government spending on infrastructure will provide a positive tailwind.

Copper: Critical for decarbonisation (electrification)

We will need more copper as we transition towards net zero. We need more renewable power, more investment in the grid, electrified transportation systems, electrified heating systems, and an electrified industrial setup. In short, an increasing amount of global investment will require copper as a critical element.

Figure 2: Intensity of copper use is increasing with decarbonisation

More than 65% of the world's copper is used in applications that deliver electricity.

Electric vehicles use up to four times more copper than internal combustion engines.

Renewable energy technologies use four to five times more copper than fossil fuel power generation.

Copper consumption associated with electric vehicles and renewable energy technologies to grow rapidly.

Source: Freeport

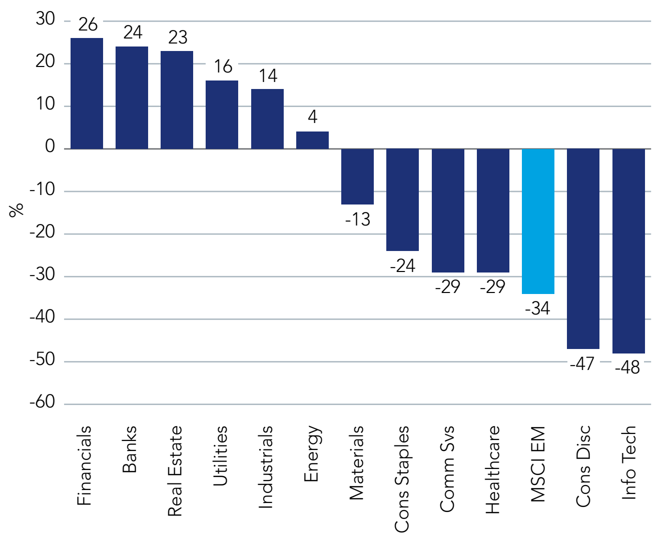
Unfortunately, most commentators on environmental matters, or economic policy, have failed to acknowledge the increased difficulty of sourcing and extracting copper reserves. Copper mining has become ever more capital intensive as existing mines age. Civil society in copper-rich countries (such as the Andean countries and the US) has made it harder to develop mines. Mining companies themselves have become increasingly risk-averse after the supercycle – which threatened many of them with bankruptcy – ended in 2012.

Our research suggests we are likely to face growing supply deficits after 2024 due to limited new projects in the pipeline today and increasing demand for the metal because of the greening of the economy. We believe this will result in a prolonged period of elevated copper prices after 2024, with copper prices comfortably above the $10,000/t level.

Financials: catch-up potential with attractive long term opportunity

While EM Financials performed relatively well in 2021 (up 5.1%, out-performing EM equities which were down 4.6%[1]) financials have underperformed EM by ~23% over the last five years.[2] Expectations for Fed policy in 2022 have moved quickly over the past six months, as the FOMC has been adjusting to an inflation overshoot and a labour market that remains robust. Financials offer relative protection against rising inflation and higher US real yields.

Chart 8: Financials have the most significant correlation with the bond yield



Source: IBES, MSCI, Datastrem, UBS as ast 6 December 2021.

EM banks' net interest margins have declined since 2011, mainly due to lower rates. With inflation driving up policy rates, these margins should rise, without detriment to loan growth or asset quality. Besides upside to margins, EM banks look well-placed to absorb any new asset quality weakness arising from the latest Covid variant. Historically, rising US real rates have weighed on the performance of EM equities. However, EM banks are aligned positively to higher US real rates.

[1] Source: Bloomberg as at 7 January 2022.

[2] Source: Ibid.

Over the past two years, the sector has built up capital as banking regulators have restricted dividend pay-outs due to Covid-related asset quality uncertainty. EM banks' core tier 1 ratio is c.14.0% at the end of 2021, c.70bps higher than the pre-pandemic level in 2019, and c.400 bps higher than 2011.[3] EM banks can distribute capital to shareholders in 2022 via increasing dividends or share buybacks. Additional dividend distributions would provide upside to the sector's 2022 dividend yield – estimated by consensus at 5.0%, which is well above the EM equities estimated level of 3.5%.[4] The sector is trading on 1x P/B and 8.9x P/E (2022E). At a 30% discount to EM equities, the valuation is attractive.[5]

Structurally, there is under-penetration of financial services and insurance across most EM markets. Insurance (both life and general) is a structural growth opportunity in EM. The pandemic reset the EM consumer perception regarding the need for protection. Given the rising middle class, wealth management is also a key growth driver for Asian banks, especially China. Also, banks are accelerating their digital transformation journeys. The shift towards digital banking should enable cost savings via branch rationalisation and smaller workforces while potentially raising fee revenues from new online products and services, such as cross-selling third parties' products and services to their existing customer base.

Industrials: a catalyst for transformation

Overall, the industrial sector re-rated from its bottom in March 2020 to half a standard deviation above long-term price/book before correcting recently to long-term average. This valuation comes at the same time as what appear to be lower levels of growth in public investment in China, deleveraging in the Chinese property market, and an ongoing question mark about what a 'new normal' in 'mobility' looks like (transportation is one-third of the industrial sector). While the sector has re-rated from the March 2020 lows, there are also many clear medium-long term drivers:

- Increases in public investment in India, Korea, the EU, and the US will drive demand for heavy construction equipment and, in turn, drive shipping volumes and port volumes
- The emergence of a new mining cycle
- Consolidation of the shipping industry into a more rational market
- Growth and consolidation of logistics businesses as e-commerce grows
- Roll out of 5G driving industrial IoT investment
- Electrification of industry, the growth of renewables and EVs driving battery volumes and investment in the grid, the rollout of charging infrastructure globally,
- A shrinking labour force in Asia is driving industry automation and the likely emergence of higher efficiency standards to reduce energy consumption.

Figure 3: Electrification and automation – key trends benefitting industrials

Source: ABB Capital Markets Day 2021

[3] Source: UBS as at 6 December 2021.
[4] Source: Bloomberg 7 January 2022.
[5] Source: *Ibid.*

Country positioning:

Country	Positioning	Key political considerations	Comments
China	OW	National People's Congress (NPC) in March 2022	• Despite a consumption slowdown due to property sector woes, the overall macro backdrop is stable • Equities are half a standard deviation cheap vs. history on P/B, and the market expects c.18% EPS CAGR in 2021-23. • Regulations are a risk to sentiment and fundamentals but are likely to remain stable going forward • Chances of the PBOC easing while the rest of the world tightens
Korea	OW	Presidential elections in March 2022	• Korea generally lacks a strong economic vision. However, the country has companies with global capabilities in select industries such as semiconductors, autos, electric vehicle batteries, and biotechnology • The market is valued in line with history and, in our view, offers mid-teens EPS growth potential as the memory (DRAM/NAND) industry bounces back
Taiwan	UW	Mayoral elections in Taipei, New Taipei, Taoyuan, Taichung, Tainan, and Kaohsiung	• The Taiwan market is 3x standard deviation above its long-term average on P/B, making it one of the most expensive markets in EM • While the re-rating from 1.8x to 3x is justified due to Taiwan's (TSMC) chip foundry capability, the growth prospects are mixed. The market expects mid-single-digit EPS growth over 2021.
India	OW	Assembly elections in 5 states – UP and Punjab being critical/larger ones that will set the tone for General Elections in 2024	• India outperformed EM by 30% points in 2021 backed by strong earnings growth (over 70% in 2021), reforms, diminishing impact from covid, and a rebound in the financial system that is helping drive the private sector capex cycle • Macro conditions remain favorable, with one of the most substantial long-term potentials within emerging markets. However, the market is 2x SD above on P/E and 1x SD above on P/B while offering c.13% EPS CAGR 2021/23 • India is entering a heavy election period so expect growth to be a significant focus (public sector capex) over reforms in the near term
Indonesia	OW		• The economy is recovering from the Covid shock and is likely to reach 70% vaccine coverage in 2022 • The World Bank expects the Indonesian economy to grow 5.2% in 2022 compared to 3.7% in 2021, while the bank expects inflation to reach 2.2% • While there are risks to the outlook, Indonesia is 1x SD below LT PB, and the market expects c.19% eps CAGR 2021/23
Russia	UW		• Tailwind from rising oil prices likely to moderate over the year • Increasing geopolitical tensions with the US and EU over Ukraine could result in sanctions on Russia • This time the sanctions could be severe compared to previous years if Russia invades Ukraine • Russian equities are trading in line with LT multiples
Turkey	UW		• Economic mismanagement and unorthodox monetary policies are resulting in high inflation and volatility in currency • It is unclear how Turkey will emerge out of the current dire situation with inflation at 36% and cost of living at a 19-year high • Turkey is in line on PB vs. history and -1.75x SD on PE. The market is positive on EPS rebound over 2021/23 – however, the outlook for the lira is uncertain
South Africa	UW		• After rebounding in 2021 (due to a low base effect in 2020 and demand for commodities), we expect economic growth is likely to normalise to c.2% • In addition to sustained high unemployment and the energy crisis, South Africa is dealing with widespread theft of rail infrastructure • The market is 1x SD below LT P/B and 1.5x SD below LT P/E, but the 2021/23 consensus growth expectations are one of the lowest in EM
Mexico	OW		• Mexico declined 8% in 2020 and rebounded c.5% in 2021, with activity slowing in 4Q21. Headline inflation rebounded to over 7% in 2021 • Economists expect Banxico to hike c.50bps in 2022 driven by high headline inflation, and an acceleration in service inflation • Mexico benefits from the US spending program. However, there is uncertainty on the scale and timing of the US spend • Mexico is 0.6x SD below LT PB and 0.8x SD below LT PE. However, the market is expecting c.8% EPS growth 2021-23, which is better in a LATAM context but significantly lower compared to Asian economies

Country	Positioning	Key political considerations	Comments
Brazil	UW	General elections in October 2022	• Brazil is currently suffering from multiple issues – high inflation, challenging growth backdrop, lack of reform, and political uncertainty in a year where external financing conditions are getting tougher • Economists expect inflation to moderate to 6% in 2022 from c.8% in 2021, and the BCB to hike further • Economists expect inflation to be tamed in 2023, allowing the BCB to cut rates • Hence, we believe Brazilian equities are likely to suffer further from a rising cost of capital along with political noise ahead of the general elections in October
Chile	OW		• After a solid 11%+ rebound in 2021, we expect the Chilean economy will normalise to a c.2-2.5% growth trajectory in 2022/23 • Politics and policies will be critical determinants since the Presidential elections in Chile • The overhang from pension fund selling is over now, and medium to long term, the economy will benefit from the country's copper reserves • The market is 1.5x SD below LT PB and 2.5x SD below LT PE – making it the cheapest market in EM right now relative to its history
Peru	OW		• Like Chile, Peru also benefitted from a robust economic rebound in 2021, but the growth rate is moderating to c.3% in 2022/23 • Castillo's economic policies will be vital in sustaining the economic momentum and ensuring Peru benefits from its position in the copper mining industry • The market is about 1 SD below LT PE and PB

Source: All data, Bloomberg, accessed 6 January 2022

Federated Hermes

International

Federated Hermes

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Our goals are to help people invest and retire better, to help clients achieve better risk-adjusted returns, and to contribute to positive outcomes that benefit the wider world.

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