Global Emerging Markets

Outlook

H2 2022

Federated Hermes Limited

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Key points

- Unless controlled, rising inflation is a risk for the global economy. Fiscal policies are urgently needed to complement monetary tightening.
- Ongoing macro and geopolitical events have longer-term implications and, in some instances, will result in new winners and losers globally.
- Recent events are re-defining how market participants evaluate 'vulnerability' that is typically associated with emerging and frontier markets, with several developed markets suffering from record inflation and possibly energy rationing.
- With a few exceptions, relative to developed markets, emerging markets are well placed to navigate the challenging environment due to relatively better inflation management, fiscal room to boost the economy, access to critical resources (food/energy/metals), and structural advantages such as demographics and low per capita consumption.
- Continuity of reforms is vital for emerging markets to sustain their advantage, boost growth potential and reduce vulnerability.

As long-term investors in emerging markets, we regularly see volatility caused by short-term factors. We occasionally use the volatility to our advantage, buying quality companies at reasonable valuations and ignoring speculative trading opportunities arising from near-term events or short-term factors. Over the last two years, the global economy has endured the coronavirus pandemic, supply chain disruptions, a shortage of semiconductors, high energy prices, the conflict in Ukraine, food supply issues, and energy security on top of problems relating to climate change. While some of these developments have shorter-term repercussions, we believe there are long-term implications too.

In some cases, the events are likely to result in a change of regime, creating new winners and losers. We have assessed the shifts at the global, sectoral, and regional levels. At the global level, conditions that will help emerging markets outperform the developed world are evolving. At a sectoral level, we see the importance of energy and select materials enhancing focus on resource-rich regions. As the global economic cycle matures, growth will become scarce. Therefore, we are focusing on regions that can deliver high growth relative to the rest of the world and megatrends that benefit from structural drivers that will help mitigate slowdown concerns.

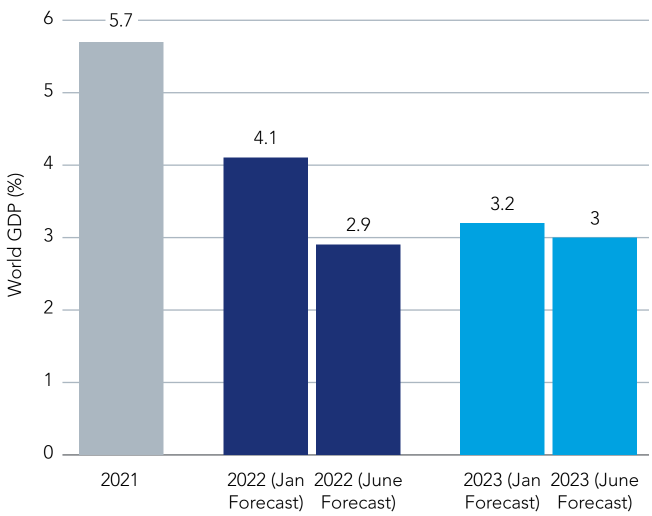
At the start of the year, we did not anticipate geopolitics to deteriorate significantly (causing monetary policies to adjust vigorously to combat inflation and impact growth prospects).

Inflation is one of the factors affecting our global, sectoral and regional considerations. As long as inflation remains elevated (due to essential resource constraints), global growth prospects will deteriorate. In addition, several businesses will not be able to pass on inflationary pressures to their customers. Free cash flow for heavily leveraged companies will shrink as debt service obligations magnify.

Inflation is unlikely to reverse soon; fiscal measures to complement monetary tightening

At the start of the year, we did not anticipate geopolitics to deteriorate significantly (causing monetary policies to adjust vigorously to combat inflation and impact growth prospects). However, our assessment that growth will ultimately be a critical future challenge remains relevant. Global growth estimates are moderating[1], and investors are beginning to assign a higher probability of a recession in the US in the near term.

Figure 1: Global growth forecasts are moderating



Source: World Bank as at June 2022.

Our initial assessment assumed normalisation of the post-Covid cycle – lowering inflation and moderating growth as pent-up demand normalises with a less favourable base effect. The Russia/Ukraine crisis altered geopolitical equations globally – with the West uniting against Russian aggression and economies such as China, India, and the Middle East surprised by the invasion and choosing to remain on the sidelines.

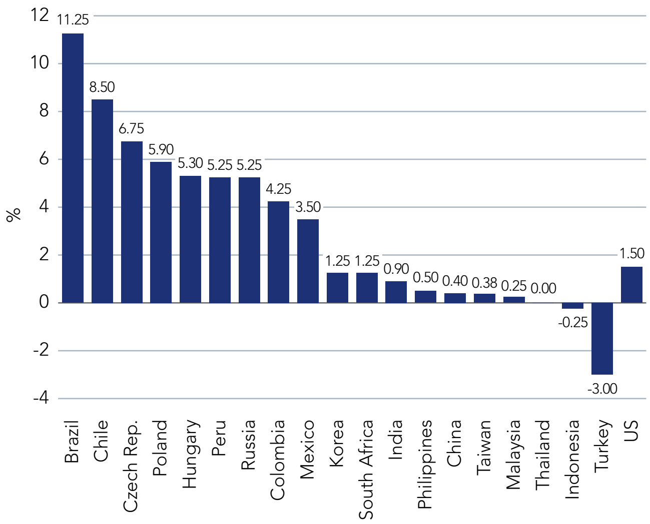
[1] IMF expects further cut in global growth outlook | Reuters

In addition to geopolitics, several nations are redrawing their foreign and defence policies to adjust to the emerging world order while devising policies to control inflation. Central banks worldwide carry the mandate to control inflation (generally independent of other considerations) and are doing all they can to break the back of inflationary pressures.

With a few exceptions, focusing on monetary policy normalisation in emerging markets began ahead of the developed world as central banks pre-empted the US Federal Reserve, which began tightening in 2021. The pace of tightening in the emerging world (except in China) has been vigorous in the first half of 2022. According to Nikkei Asia, rates increased 80 times in the first six months of 2022, and emerging markets accounted for 60 of those 80 rate rises[2]. Central banks in emerging markets have learned lessons from earlier crises (such as the 2008-2009 global financial crisis and the 2013 taper tantrum) and are keen to prevent a significant run on their currencies. As a result, tightening in 2021/22 has been at a much faster pace than in previous cycles.

Figure 2: Tightening monetary policy across EMs

(Interest rates, June 2022 vs. January 2021, %)



Source: Bloomberg as of June 2022, Global rate hikes reach fever pitch in race against inflation - Nikkei Asia

Current inflation, coupled with inflation expectations, and a requirement to maintain a positive real spread vs. the US 10-year treasury yield underpin the 'quantum of hikes' in emerging markets. It is therefore vital to understand the drivers of inflation and possibilities in the near term.

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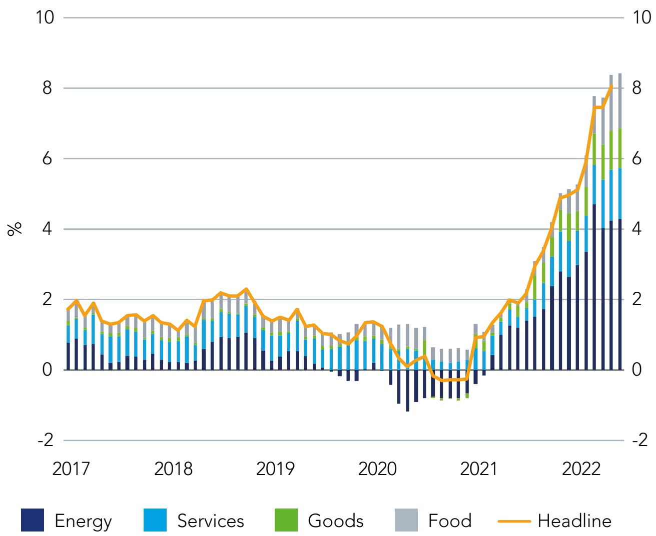
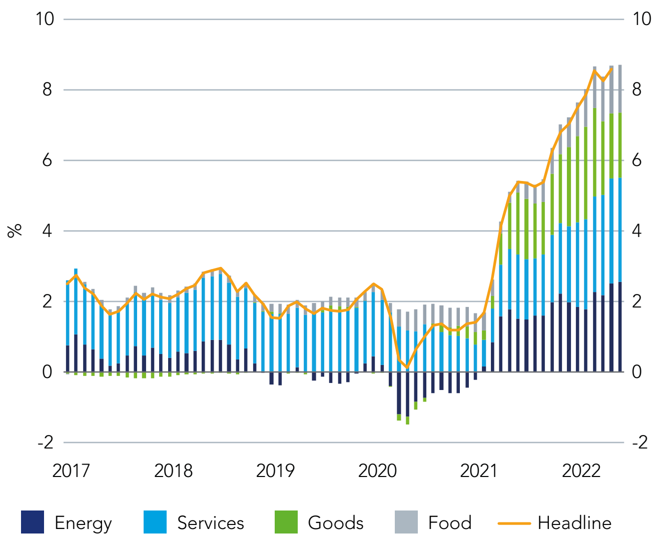
Figure 3: Rising inflation is a risk to the global economy

EU: Consumer Price Index (CPI)



Source: Refinitiv Datastream as at June 2022.

US: Consumer Price Index (CPI)



Source: Refinitiv Datastream as at June 2022.

[2] Global rate hikes reach fever pitch in race against inflation - Nikkei Asia

The consensus view is that inflation will remain higher for longer. Goods inflation, food, and energy prices are driving the momentum in inflation at the present time. We believe that inflation is primarily a result of recent events rather than any fundamental shift in underlying macroeconomic conditions or drivers. For instance, post-Covid disruptions in supply chains and logistics coinciding with economic reopening and release of pent-up demand are driving inflation in goods prices. The spike in energy prices was initially driven by easing mobility restrictions post-Covid (demand) along with a limited increase in supply from the OPEC+ group of oil-producing countries, leading to a demand/supply mismatch. Energy markets have been further affected by the Russia/Ukraine crisis as opposed to any fundamental shift in energy consumption patterns. The surge in food prices has been primarily caused by the stalled trade in Russian and Ukrainian food commodities and fertilisers and a rise in food nationalism[3] as countries halt exports of certain products to protect domestic consumers.

There are, however, signs that Indonesia is reopening edible oil exports, and India will export wheat to neighbouring countries. Rising food supplies will help alleviate the situation to an extent.

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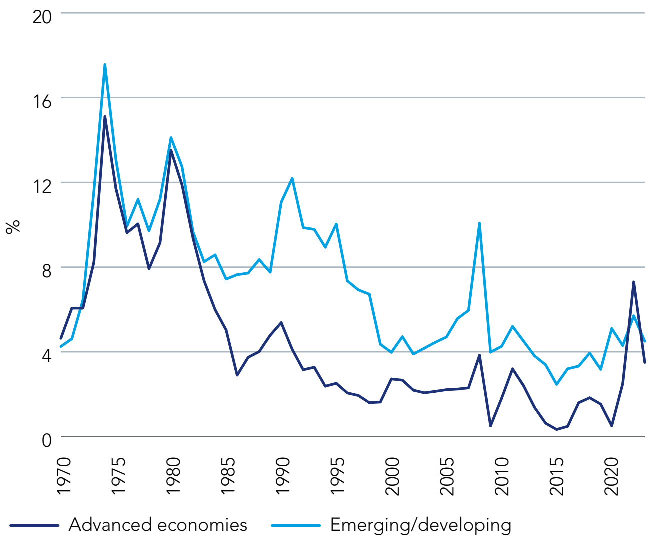
Monetary policies are insufficient to control inflation as the crisis has not solely been caused by an excess of liquidity chasing limited goods and services. Instead, the underlying cause of the problem is disruptions triggered by recent events. Therefore, fiscal measures to boost the supply side are needed to complement monetary policy. However, there has been limited progress on fiscal actions. Fiscal measures to increase supplies take time and are often ineffective as alternative supplies are not immediately available. The lack of alignment between a government's interests (lower prices) and the private sector's interests (higher prices = higher profits) is another impediment. As a result, certain countries are talking about imposing additional taxes on sectors earning super profits[4].

Fiscal measures are, nonetheless, as vital as monetary policy to tame inflation. Efforts to boost manufacturing productivity and efficiency as well as incentives in select areas such as food production and renewable energy will be helpful. Some emerging economies have resorted to export controls for key agricultural commodities, fuel subsidies, and a reduction in indirect taxes on fuel as means to control inflation. These measures are not optimal due to unintended consequences such as limiting the private sector's incentive to invest and increasing the fiscal deficit. In the near term, the course of the conflict will be a crucial determinant for inflation. One possible scenario is that global leaders arrive at a diplomatic solution to either end the conflict or find a viable solution to evacuate essential commodities from Ukraine and Russia, cooling inflation down. However, such a scenario is difficult to predict; hence, we continue to assume that inflation will remain higher for longer. Medium term, there are factors such as evolving global demographics (aging populations), diversification of supply chains, the role of technology/automation, and crucially, the spending to achieve decarbonisation goals and availability of critical materials (copper, lithium, cobalt). Several factors are likely to be inflationary, while technology adoption is deflationary, driven by automation and productivity gains.

Macro conditions favour emerging economies

Figure 4: EM consumers have more experience living with high inflation

Emerging markets vs. developed markets CPI



Source: World Bank, Bloomberg, June 2022.

Some emerging economies have resorted to export controls for key agricultural commodities, fuel subsidies, and a reduction in indirect taxes on fuel as means to control inflation.

[3] 'Food nationalism' worries rise after India, Malaysia export bans - Nikkei Asia

[4] U.S. Senate finance chair to propose tax on excess oil profits | Reuters
Sunak orders plan for windfall tax on electricity generators | Financial Times (ft.com)

Our 2022 annual update outlined how emerging economies have remained in a moderate growth and inflation environment during the last two decades. Over the last few years, the growth differential between emerging and developed economies has narrowed. However, the growth in emerging economies is likely to outperform the developed world meaningfully. There are several reasons underlying this expectation.

Wages are unlikely to rise

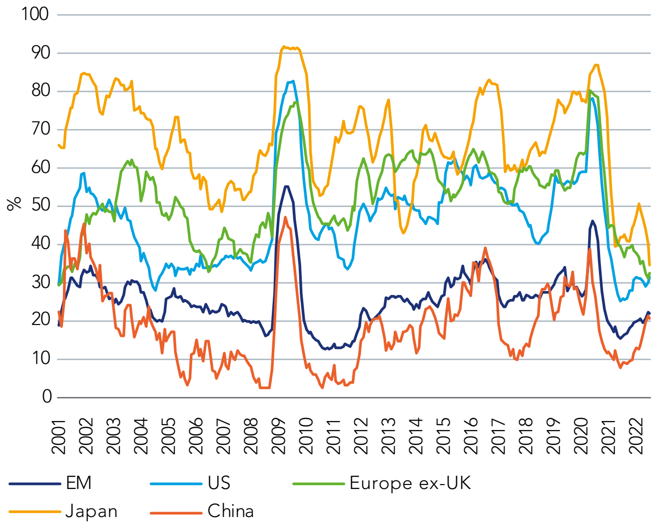
8-10%

in the developed world, squeezing consumers and possibly resulting in labour unrest and loss of economic output.

First and foremost, consumers and businesses in the emerging world have adjusted to moderate/high inflation in the past, unlike their developed-world counterparts, experiencing inflation at levels not seen in a long time. If inflation sustains at a high level, significant adjustments will be needed to the standard of living unless wage growth is equal to or greater than inflation. However, wages are unlikely to rise 8-10% in the developed world, squeezing consumers and possibly resulting in labour unrest and loss of economic output. Mid- and low-income consumers in the developed world will need to downtrade – reducing the quality of purchases – and cut back on consumption. Such a phenomenon regularly occurs in emerging economies, and branded goods companies deploy strategies to mitigate consumers' downtrading, preserving share and margins rather than being outmanoeuvred by discount retailers and private labels. Emerging markets will have their share of issues to deal with in a rising inflation and slowing global growth environment. For instance, export-oriented economies or countries heavily dependent on commodities will suffer, and we are yet to see the bottoming of the Chinese economy from the recent Covid shock. However, demographic advantage, large domestic markets with low per capita consumption/penetration across most categories, abundant/low-cost labour, and frugal processes are positive drivers that will help many emerging economies grow 4-5% per annum.

Figure 5: EM companies expected to outgrow DM companies

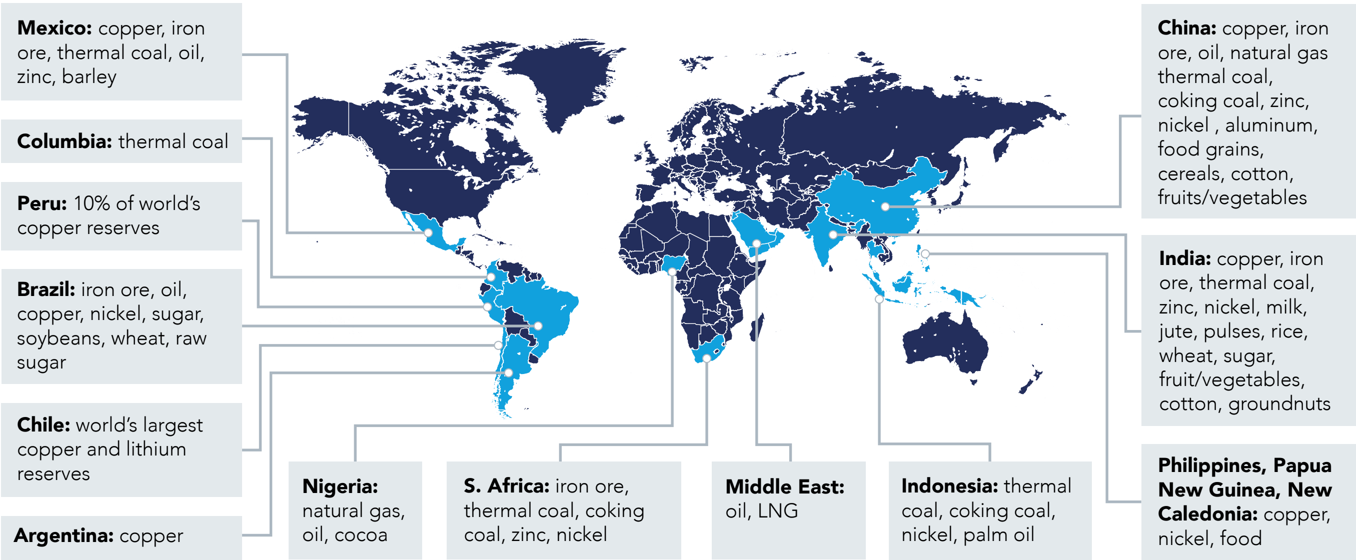
Proportion of FTSE Russell constituents with 12-month forward sales growth of < 5%



Source: FTSE Russell, Factset as at June 2022.

Second, in contrast to the developed world, which imports most of its resource requirements, many emerging markets are well placed to navigate the current resource crunch. For instance, China is a major producer of rare earth metals and has significant operations in aluminium, cement, coal, iron ore, and steel. India, which typically imports most of its crude, is a major exporter of refined petroleum products, a major food producer, and is self-sufficient in its staple food grains. India is also a significant producer of coal, iron, manganese, and bauxite. Indonesia is an important coal, copper, nickel, and palm oil producer. South Africa is a significant producer of precious metals, and Brazil is a major exporter of soft commodities and a net exporter of energy. Chile and Peru control 40% of the world's copper reserves, and the Middle East is a significant oil and gas producer. China – and India, to a certain extent – will use their financial clout to buy commodities at a deep discount from Russia to soften rising prices.

Figure 6: Emerging and frontier economies have significant reserves of essential commodities

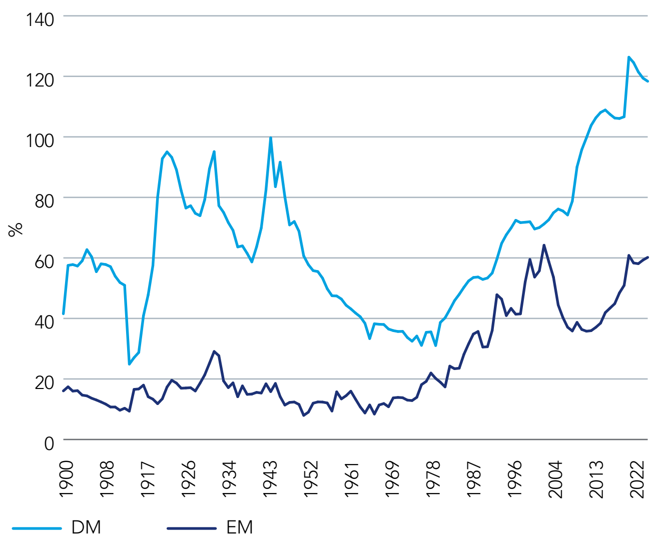


Source: Glencore, IEA and World Population review. Illustrative example of some commodities in emerging market and frontier countries.

Third, the majority of the developed world will find it increasingly difficult to stimulate their economies, having spent significant sums of money during the Covid crisis resulting in elevated leverage and stretched balance sheets. Cash hand-outs rather than infrastructure upgrades formed the majority of the fiscal stimulus in the western world. As a result, the developed world has an all-time high debt burden, with deteriorating demographics, limited resource availability, inflation, and growth challenges.

Figure 7: Public debt in EM did not rise significantly during Covid-19

Public debt-to-GDP ratios

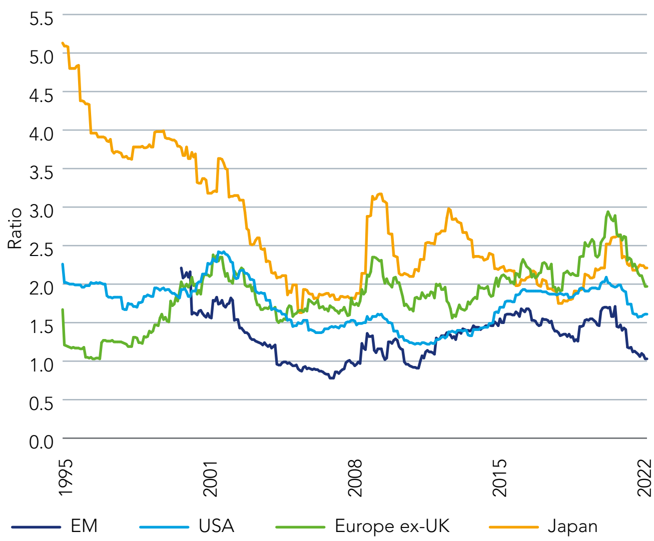


Source: HSBC as at June 2022. NB: Based on public debt (average, assumes blanks = zero).

Contrary to the developed world, China and India did not spend significantly during Covid; instead, pursuing targeted support measures.

Figure 8: Manageable leverage in emerging markets

Net debt to EBITDA %



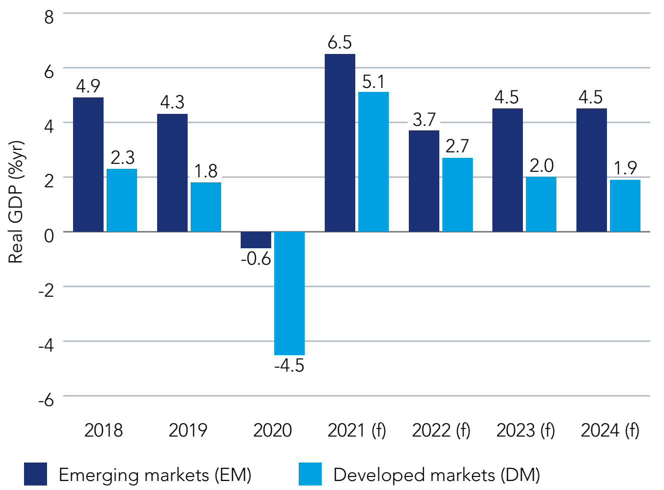
Source: HSBC as at April 2022.

Contrary to the developed world, China and India did not spend significantly during Covid; instead, pursuing targeted support measures. China has the means to provide additional budgetary support to boost the domestic economy. India continues reforming its economy and pursuing a production-linked incentive programme to boost manufacturing and investments. The Central Bank of Brazil is significantly ahead of the curve in tightening monetary policy to control inflation, taking the Selic rate from 2% in March 2021 to 12.75% in May 2022[5]. Traditionally vulnerable economies such as South Africa and Indonesia benefit from favourable trade terms due to commodity shortages. Taiwan and South Korea are net creditor economies and do not suffer during a rising interest rate environment. Mexico is benefitting from supply chain diversification. Together, China, India, Indonesia, Taiwan, Korea, Brazil, Mexico and South Africa account for more than three-quarters of the emerging market universe.

[5] Brazil's Central Bank Raises Key Rate to 12.75%, Sees Smaller Rate Increase at Next Meeting (wsj.com)

As a result of these factors, emerging markets will continue to outgrow the developed world. After the inflation/tightening-induced hiccup in 2022, the EM/DM growth differential will increase in favour of emerging economies.

Figure 9: The growth differential between EMs and DMs is set to widen



Source: HSBC, Bloomberg as at June 2022.

Despite ongoing cyclical (commodity, energy, food) and secular tailwinds (demographics, reforms, digital/infrastructure), emerging markets continue to trade at a 30-40% discount to the developed world – implying negative sentiment and muted investor interest. We are not suggesting that emerging markets are perfect. Emerging economies will require reforms on an ongoing basis to mitigate macro vulnerability and improve competitiveness. However, reforms have never been consistent and political instability in many emerging economies remains a hinderance. Developed economies are significantly ahead in technology leadership, quality institutions, and access to highly skilled workforces and have demonstrated an ability to scale businesses globally. The Global Emerging Markets strategy holds several innovative companies in developed markets with substantial emerging market exposure and indirect exposure to US hyperscalers – the tech giants that increasingly dominate cloud services as well as numerous related verticals – via Taiwanese and Korean companies in the technology supply chain.

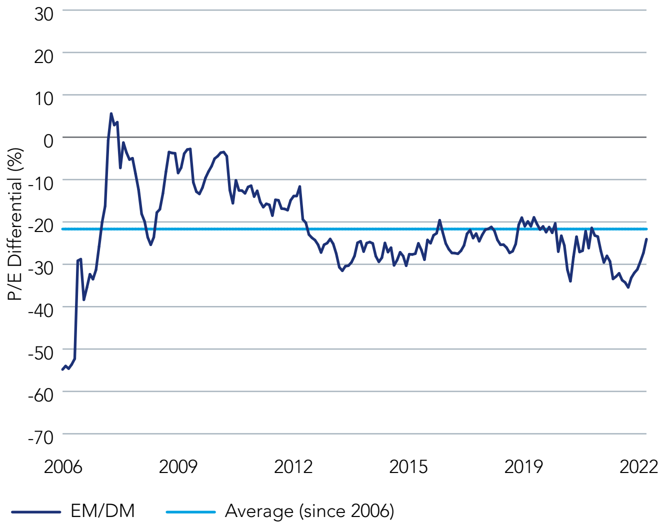
However, the business environment we operate in today is far from ordinary, and we believe it will impact developed market consumers and businesses relative to emerging market peers. Over the medium- and long-term, as growth becomes scarce, the relevance of emerging economies will increase along with the resource-intensive path to net zero.

Figure 10: Emerging markets continue to trade at a discount

EM/DM P/B: -41% discount vs. history of -22% discount

Source: Bloomberg as at 30 June 2022. Data refers to the MSCI EM Index and MSCI World Index. P/B is calculated as blended forward 12 months estimates.

EM/DM P/E: -27% discount vs. history of -22% discount



Source: Bloomberg as at 30 June 2022. Data refers to the MSCI EM Index and MSCI World Index. P/E is calculated as blended forward 12 months estimates.

Emerging markets vulnerability – it *is* different this time

With the exception of Turkey, the macro vulnerability in emerging markets is limited as fewer economies suffer from import cover below six months, high inflation, or significant dependency on short-term foreign borrowings. Most emerging economies have resilient macro conditions and can withstand external pressures. Erstwhile fragile economies such as South Africa benefit from favourable terms of trade, India has substantial forex reserves, Indonesia is insulating its population from high inflation, and Brazil has positive real interest rates. However, interest rates are likely to increase in most Asian economies as real rates are still negative despite a positive spread vs. the US 10-year treasury yield, mitigating currency issues. As the US Federal Reserve continues to raise rates, emerging economies will need to tighten further. However, monetary conditions are already very tight in Brazil, while China is likely to loosen policy incrementally.

Figure 11: Emerging markets vulnerability assessment

Limited vulnerability in emerging economies – however interest rates will rise, especially in Asia

	FX reserves US$bn	Import Cover in months	Current Account (% of GDP)	Inflation (CPI YoY%)	Short Term Foreign Debt USD US$bn	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 of countries listed below)	**652**	**10.0**	**1.8**	**4.0**	**271**	**12.8**	**41.3**	**-1.19**	**1.38**	**4.84**
China	3,128	13.6	1.5	2.2	1446	9.8	46.2	2.2	-0.4	4.9
South Korea	425	7.5	3.3	4.5	175	9.7	41.1	-2.8	0.5	3.5
Taiwan	549	15.7	13.0	3	204	25.9	37.3	-1.5	-2.0	2.5
India	591	10.9	-2.8	6.5	102	3.8	17.3	-1.6	4.2	5.2
Indonesia	122	6.7	-0.2	3.6	50	4.7	40.9	-0.1	4.1	8.0
Malaysia	103	5.3	3.3	2.6	101	30.1	98.4	-0.6	1.0	5.9
Thailand	209	11.2	-0.9	4.75	74	14.8	35.5	-4.3	-0.3	2.4
Philippines	92	9.3	-2.9	4.6	12	3.4	13.6	-2.1	3.9	6.8
LATAM (average of countries listed below)	**190**	**8.8**	**-2.1**	**9.0**	**51**	**7.0**	**36.1**	**1.02**	**6.10**	**4.61**
Brazil	326	16.0	-1.0	9.85	75	5.2	23.0	3.4	9.7	7.4
Mexico	199	4.3	-0.8	7.3	50	4.7	25.3	0.5	5.9	6.1
Chile	46	6.0	-4.5	9.8	28	11.0	60.0	-0.8	2.7	0.4
EMEA (average of countries listed below)	**74**	**4.3**	**-1.8**	**27.7**	**75**	**12.6**	**121.4**	**-19.47**	**8.99**	**-11.23**
South Africa	45	5.9	1.8	6.15	29	8.7	65.1	-1.4	7.7	9.0
Poland	123	4.6	-3.15	13	62	10.4	50.5	-7.0	4.1	-1.4
Turkey	54	2.3	-4.2	64	133	18.5	248.6	-50.0	15.2	-41.3

Source: Bloomberg, June 2022.

Megatrends for the long term

Beyond the near-term volatility, we see megatrends such as digitisation, electrification, automation, biotechnology, financial services, and infrastructure offering multi-year opportunities. We believe exposure to these trends will mitigate the impact of any macro slowdown, volatile input costs, the rising cost of capital, and costs associated with addressing climate-related issues in the future.

The ongoing rotation from growth/quality to value/defensives offers opportunities to buy companies exposed to secular trends at a reasonable valuation. Higher energy, commodity, and food prices will inflict pain on the global economy, especially for middle and lower income households. A protracted conflict heightens the risk of a worldwide slowdown, squeezing households' disposable income and reducing discretionary consumption.

As global growth momentum subsides and bond yields rise further, growth and quality (companies generating high returns on equity with low leverage) will become scarce. We are taking a longer view and positioning our portfolio in quality companies with pricing power and an ability to compound book/value sustainably over an extended period.

THEME ONE

Digitisation

We believe technology will play an ever-important role in the changing global landscape where efficiency and productivity will boost growth and profitability. Technology has moved beyond the traditional back-office support role to driving business in most industries, underpinning market share gains, enhancing the consumer experience and providing strategic competitive advantages. While investors' concern about rising interest rates has de-rated the technology sector, we see this as an opportunity to buy exciting technology businesses with a considerable margin of safety.

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Driven by their position in global technology supply chains, Taiwanese and South Korean companies offer exposure to consumer and enterprise digitisation opportunities. Similarly, due to strengths in global systems integration, Indian IT service companies offer exposure to enterprise digitisation. Moreover, beyond these traditional areas of opportunity, we see significant scope for enterprise digitisation in emerging markets, and select Chinese software vendors offer attractive multi-year opportunities.

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We are invested in a Chinese financial technology company that offers integrated solutions and services to financial institutions such as banks, brokerages, insurance, trusts, exchanges, and asset managers. About 60% of the firm's staff are development engineers, and the company spends approximately 40% of its revenue on research and development (R&D) activities. The holding is a leader in financial IT solutions commanding a share of more than 50% of the asset management, insurance, banking, trusts, and exchange markets in China. The business has high barriers to entry, and new financial regulations/reforms, system upgrades, financial innovations, and emerging new technologies offer the holding steady growth prospects over the long term.

Another holding is a one-stop shop solution provider for digital solutions related to the construction industry in China. The company provides customers with digital solutions throughout the building lifecycle, covering design, cost estimation, construction, supply, and procurement. The holding has proprietary technology in Building Information Modelling (BIM), Internet of Things (IoT), Big Data, AI, and cloud-related applications for the construction industry. Since listing in 2010, the company has grown revenues at approx. 25% CAGR per annum, establishing itself as a national player. The construction industry in China is largely undigitised, and the government is focused on boosting efficiency and productivity using sophisticated tools. Applying digital technologies in construction helps clients conduct digital simulations and adjustments without costs, thus improving overall project efficiency.

THEME TWO

Electrification

Electrification is a broad term that involves replacing technologies that use fossil fuels with technologies that use electricity. The shift is complex and offers significant opportunities across the value chain. The electrification process can begin with re-designing the energy grid to make it more resilient, distributed, and sufficiently agile to incorporate renewable sources of energy in the form of solar, wind, and hydro. This requires multiple components, modules, and systems. In addition, it requires energy storage to mitigate issues relating to a potentially intermittent supply of power. In terms of end use, electrification of transportation and industry is also a large addressable opportunity. China dominates the renewable (solar) energy and electric vehicle (EV) battery supply chain. We have been actively researching these sectors and finding companies with attractive domestic and global opportunities.

We are invested in one of the largest solar inverter companies in China and globally, providing solar inverters for residential, commercial, and utility-scale applications. It is a global leader with approximately 25% market share and benefits from growth in the renewable energy industry, helping accelerate momentum in solar. In addition, the company's energy storage business is promising and likely to drive growth over the medium term. The holding is also engaged in the construction of solar farms. This business serves as a platform for cross-selling the holding's key products – inverters and energy storage systems.

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Another holding is a leading lithium-ion (Li-ion) battery equipment manufacturer covering all stages of the battery manufacturing process. China's top electric vehicle (EV) battery company is a significant customer and the second largest individual shareholder. The company benefits from a considerable ramp-up in China's top EV battery company's capacity. Over the medium term, China's tier 2 battery makers are boosting capacity and will, in our view, outpace the current EV battery leader. Our holding is diversifying its customer base and will benefit from this shift. Over the medium to long term, the holding will also benefit from its close relationship with a leading German automaker in addition to limited alternatives in Europe for battery equipment.

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THEME THREE

Resources and physical assets

Over the last decade, the rapid growth of technology and online businesses has overshadowed the relevance of resources. While the role of technology is unlikely to diminish, we believe select commodities such as copper, aluminium, lithium, nickel, cobalt, and graphite will continue to have a crucial role in decarbonising the world by enabling shifts in energy generation to low carbon formats and transportation to low- or zero-emission models.

Copper is a critical component in the electrification trend. We will need a lot 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, this huge shift in global investment will see copper retaining its central role as a key commodity. Our research suggests we will likely face growing supply deficits after 2024 due to limited new mining 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 prices after 2024, with copper selling for comfortably above US$10,000 a tonne.

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Similarly, aluminium is a crucial material in the decarbonisation effort. The metal is gaining importance in the automotive industry as OEMs (original equipment manufacturers) switch from heavier steel to lighter aluminium to meet strict emission targets. In addition to copper, renewable energy will also need increasing quantities of aluminium. The role of aluminium as a substitute for plastic in packaging is also gaining traction and, since it is almost infinitely recyclable, this makes it an attractive material when combined with renewable energy. Aluminium production is, however, energy intensive and many producers rely on coal. We hold a Malaysian aluminium producer, which uses hydropower to drive its smelters and, as a result, is the lowest emitter of CO_2 in the industry.

In addition to direct exposure to copper and aluminium via mining groups and producers, we maintain modest overweights to Chile and Peru as the two countries account for approx. 40% of global copper reserves. As demand for copper rises over the medium to long term, both economies will benefit. Over the long run, higher copper prices will incentivise a rise in capital investment in mines and, ultimately, in mine expansions and greenfield sites (which, in consequence, will also drive additional investment in roads, dams, ports, railroads, and power plants). High copper prices also tend to result in a stronger currency which, in turn, creates a positive feedback loop in the form of higher purchasing power and domestic demand (and, therefore, an expansion in capacity for firms domestically focused firms). Historically, copper prices and growth in capital goods imports are strongly correlated. Capital goods import growth strongly correlates with gross fixed capital formation, especially in Chile.

Peru is an underexplored country with significant copper, gold, silver, zinc, lead, and tin reserves. Private investments correlate well with copper prices in Peru over the medium term.

THEME FOUR

Energy – LNG

Net-zero commitments and the ongoing Russia/Ukraine crisis have intensified the focus on the energy mix and security. Energy security concerns are currently running high, especially in Europe, which remains at the mercy of Russian gas supplies and is desperately trying to diversify. Certain European countries are stepping up coal usage despite environmental concerns. Using increasing amounts of coal sustainably is not a plausible scenario. We anticipate that liquified natural gas (LNG) will act as a substitute for coal over the medium term as a critical transition fuel. Switching away from coal to natural gas is relatively easy and does not require significant investment in the grid while, at the same time, reducing emissions. Considerable modification to the grid will be a crucial consideration for China and India, which depend heavily on coal as an energy baseload. Despite the rising relevance of natural gas, supply is likely to decline due to the ageing of existing plants in Indonesia, Algeria, Brunei, and Trinidad. However, we believe capacity in Qatar is sufficient to absorb the incremental increase in demand. In addition, there is growing discomfort in Europe over dependency on Russian gas, thereby positioning Qatar favourably as the country steps up production meaningfully over the next five to 10 years.

Switching away from coal to natural gas is relatively easy and does not require significant investment in the grid while, at the same time, reducing emissions.

We are invested in the largest bank in Qatar, with over 40% share of system loans. The holding is strategically crucial to the economic development of Qatar and provides financing for large-scale LNG and other capital projects in the country. The outlook for non-LNG investments is positive. Qatar spends approx. US$20bn annually on major infrastructure projects such as rail, airport infrastructure, highways, seaport infrastructure, and worker accommodation.

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Another holding is an engineering company specialising in LNG carriers and containment solutions for onshore, offshore, and multi-gas transportation applications. The holding is a French company with majority revenues from emerging markets – primarily South Korea. The holding is the dominant player in LNG carrier membranes, with a 100% market share achieved via patent-protected cryogenic membrane technology. The holding has a unique, asset-light business model wherein it licenses its technology to South Korean and Chinese shipbuilders in return for royalty payments. While the French group has strong order visibility for the next few years, the company has a diversified growth platform that covers hydrogen electrolysers, digital shipping solutions, and LNG as a fuel.

THEME FIVE

Services – financial and healthcare

Emerging markets are home to more than 80% of the world's population and approx. 40-50% of the world's economy and growth. However, the level of informality in the provision of services is high in several emerging economies – and this is especially the case in financial services. Demand for credit continues to remain strong post Covid. The outlook for private sector capex is positive in many emerging economies, and rising rates are expected to boost net interest margins. In addition, several banks in emerging economies have adopted digital technologies and e-wallets, creating a super-app ecosystem to serve their customers better.

We are invested in the largest bank in India, with more than 400 million customers and a retail loan book larger than several of its competitors combined. Despite its size and state ownership, the holding's digital initiatives are perhaps better than many private banks in India. Its digital super app is an automated banking platform that provides customers access to financial and non-financial services such as flights, train tickets, and online shopping. It has more than 50 million registered users and a unique ability to reach tier 2/3/4 cities across India. The bank is expanding the reach of its super app to non-customers and as a result will be able to transform the app's functionality and potential. While the bank has not committed to spinning the super app into a separate entity, there is potential for value creation.

Within healthcare, we prefer investing in innovative drug companies, contract development and manufacturing (CDMO), and pharmacies.

Another holding is a leading pharmacy chain in South Africa and one of the few companies in that country to deliver double-digit earnings growth consistently. The company benefits from its focus on higher margin health and beauty, private label products, store additions, and digital initiatives. The company also benefits from structural tailwinds in South Africa as independent pharmacies lose market share and the corporatisation of pharmacies gains traction. Penetration of corporate pharmacies in South Africa is significantly lower than in developed markets and this also offers a long runway for growth. We expect a business model focused on health and beauty will remain resilient in the current economic environment while providing long-term growth prospects.

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THEME SIX

Industry leaders with pricing power

As inflation (CPI) continues to spread globally, the focus turns towards the producer price index (PPI) and whether PPI can match CPI. In essence, the question is this: are businesses able to pass on price increases and preserve/enhance their margins? Raising prices is not always possible due to competitive pressures, contractual obligations, the elasticity of demand, and general customer resistance to paying more without a higher value add. In such situations, it is crucial to consider whether companies have pricing power and hence an ability to protect their margins. Generally, leaders operating in high barriers to entry businesses display characteristics of pricing power. One of our top holdings commands a nearly 100% market share in advanced semiconductor manufacturing and can therefore increase prices due to ongoing chip shortages. Another long-term holding has successfully improved its gross margins by approx. 50bps annually due to a combination of high-value-added premium products and cost control. Supermarkets in South Africa and Mexico have maintained gross margins of approx. 22-25% despite rising prices.

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THEME SEVEN

Limited leverage and high cash balances

With rising interest rates and tight monetary conditions, the strength of companies' balance sheets will also become a key consideration. When economic conditions are benign or financial conditions are loose, a company with high leverage does not suffer as financing is readily available at reasonable rates. However, as the inflationary tide turns, companies that have not refinanced their debts with long maturities or deleveraged to a sustainable level will find themselves at the mercy of the market. Debt servicing costs will rise, pressuring earnings and free cash flow. Heavily leveraged companies will suffer from limited funds for future growth and innovation. A significant number of companies (ex-financials) in the strategy are debt free. Several have very high cash balances; in some cases, a substantial portion of the company's market value is in cash.

A significant number of companies (ex-financials) in the strategy are debt free.

Country positioning

Country	Positioning	Comments
China	Overweight	• Regulations, geopolitics, Covid, and a property sector meltdown have slowed the momentum in the economy. • Beijing accepts the economic issues and is likely to take corrective measures (although less clear on direction of zero-Covid policy so far). • Valuations are reasonable (in line with history on P/E and one standard deviation below on P/B), and China has the means to support the economy. • Households are sitting on substantial savings, which can be deployed in the economy once confidence returns. • Key risks are further damage from Covid lockdowns and rising geopolitical risks from China's relationship with Russia and attitude towards Taiwan/US.
South Korea	Neutral	• While valuations are reasonable (both P/E and P/B are one standard deviation below history), South Korean companies will suffer from a global slowdown. • Consumer confidence in South Korea is weak due to inflation and rate hikes. • Key risks are more significant than expected due to an inventory correction in the global technology supply chain and depreciation of the won.
Taiwan	Neutral	• Taiwan continues to enjoy pole position in the global semiconductor supply chain due to the technology leadership of TSMC. • Valuations reflect broader technology leadership. Although valuations have de-rated somewhat, Taiwan continues to trade at one standard deviation above its history on P/B. • Geopolitical tensions with China are unlikely to go away. • Key risks are a larger-than-expected given the inventory correction in the global technology supply chain.
India	Overweight	• The rupee continues to depreciate 3-4% per annum vs. the US dollar and this is in line with long-term experience. At 7-8% real GDP growth and approx. 5% inflation (approx. 12-13% nominal growth), India is one of the fastest growing economies in the world, mitigating the currency depreciation risk. • Growth and productivity-boosting reforms continue and are necessary for job creation. • Political stability is strong, and the BJP is likely to win a third term in 2024, ensuring policy continuity over the medium term. • The economy has undergone structural changes in the form of a lower current account deficit compared to the prior crisis (helped by rising exports), higher FDI flows, and moderate inflation. As a result, the Indian economy now can tolerate higher oil prices ($120-130 a barrel). • Key risks include elevated absolute valuations vs. the rest of EM, especially China. Inflation so far has remained close to the Reserve Bank of India's upper limit. However, if inflation overshoots materially, the economy could be in trouble.
Indonesia	Overweight	• The government has been successful so far in maintaining a delicate balance between inflation, rate hikes, and the fiscal situation. • As a result of fiscal subsidies, consumer inflation is under control, limiting the quantum of rate hikes so far. • The economy is benefitting from commodity exports and is likely to grow approx. 5% in 2022. • Key risks include a sharper global slowdown that will impact the commodity trade, resulting in production cuts detrimental to the economy.
Qatar	Overweight	• Although Qatar's importance in global energy security has increased recently, valuations have corrected below long-term average levels. • A global slowdown will impact demand for energy, but the ongoing transition to lower emission energy production will benefit LNG over the medium term. • Geopolitically, Qatar is stable. The Biden administration has announced Qatar as a major non-NATO ally and recent frictions with Saudi Arabia appear to be at an end. • Key risks include a sharper global slowdown hurting energy prices. Another risk is that the European Union could side-step Qatar/LNG and increase its use of coal in the near term to avert an energy crisis. Over the medium term, the EU doubling down on renewable energy is an additional risk.

Country	Positioning	Comments
Turkey	Underweight	• Economic vulnerability remains high with uncontrolled inflation in the economy. • Unless tamed, inflation will hurt consumers and the economy. • The lira has been depreciating since the beginning of the year after significant relief in 4Q21 driven by the government's promise to protect local currency deposits from market fluctuations. • Rising oil and food prices will continue to be an issue while inflation is already running high in the economy. • Key risks include a sharper acceleration in inflation resulting in a deeper economic contraction, possibly resulting in social unrest.
South Africa	Neutral	• While recent economic data has been encouraging, sustaining the momentum will be vital for South Africa, where growth has been muted ever since the global financial crisis. • The economy has benefited from the resource crunch as South Africa is a significant producer of platinum group metals. • However, structural issues of high unemployment, inflation, and a weak external position will continue to impact growth potential. • The rand has held on well between ZAR14-16 to the dollar, but a global slowdown could impact demand for commodities and leave the currency vulnerable. • Valuations are cheap, with PE and PB both close to two standard deviations below their long-term level. • Key risks include acceleration in inflation along with a global slowdown.
Mexico	Overweight	• Inflation is rising in Mexico, and the central bank has acted with approx. 225bps hikes over the last three months. • Mexico is defensive in the Latin American context, with no significant vulnerabilities and a solid fiscal position. • Politics is stable, but there has not been significant structural reform to boost growth potential. Mexico remains a relatively informal economy and hence needs reform/job creation to improve conditions. • Proximity to the US, Biden's infrastructure plan, and nearshoring of supply chains are structural drivers for Mexico over the medium term. • Valuations are reasonable. • Key risks include a significant slowdown in the US economy. An improvement in economic conditions across the rest of Latin America will likely result in outflows from the Mexican market.
Brazil	Neutral	• The macro case for Brazil is quite complex with multiple moving parts – slow economic momentum despite a boost from high commodity prices, high inflation, a significantly hawkish central bank, and upcoming presidential elections. • As a result, it is no surprise that the market is one standard deviation below its long-term average. • While downside risks might be lower, Brazil needs to stabilise inflation, hence the current rate-tightening cycle. • Clarity on policies post-election will help, but it seems either candidate could be reasonable for Brazil's economy. • Key risks include a sharper uptick in inflation resulting in further rate hikes and an economic slowdown. Any adverse shift in either presidential candidate's approach could result in an overhang.
Chile	Overweight	• Chile is one of the cheapest markets in EM and is trading three standard deviations below its long-term PE. • While a near-term global slowdown will impact copper prices, the outlook for the Chilean economy is expected to deteriorate. However, the long-term outlook for copper is positive and will likely drive investments in the economy. • Politics is a risk with the new constitution likely to impact free markets, especially the mining industry. According to media reports, the vast majority of Chileans are unlikely to support the new constitution. • Key risks include a sharper slowdown in the global economy impacting copper prices. The new constitution, if accepted by Chileans, will be a significant overhang on the economy.

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