Global Emerging Markets Equity

Outlook

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Summary of GEMs Equity team views

Overall macro assumptions

We believe the overall investment environment has changed, with moderate economic growth likely over the medium term.

While inflation will moderate, it is unlikely to stay at a lower level unless sticky supply-side constraints are resolved.

We believe interest rates are unlikely to return to ultra-low levels. As a result, the cost of capital is likely to remain higher (relative to recent history). Higher borrowing costs will have an impact on credit-led growth, and the cyclical boost to the global economy will suffer to some extent. However, select emerging economies in Latin America and Eastern Europe will likely pursue a favourable monetary policy to boost economic activity and asset valuations. Central banks in Brazil, Chile and Poland have already started the rate-cutting cycle.

Style implications

High valuations were the main issue for growth stocks, and the market expectation has adjusted. However, high leverage and moderate growth prospects will be an issue for value and cyclical stocks, and the market has not fully adjusted its expectations. As a result, the team believes the recent outperformance of value stocks compared to growth is unsustainable.

While select areas within the value/cyclical space remain interesting, the team believes that focusing on structural drivers will likely provide a longer runway for growth (and value creation) in an otherwise growth-starved world. As a result, the team remains biased toward growth and quality while being selective on value, in line with the Strategy's history since inception.

The team does not believe in taking major one-way country bets; hence, the portfolio is geographically diversified and can benefit better from the emerging world order.

The market remains macro-dependent: monetary policy by the US Federal Reserve, the possibility of a US recession, and likely policy support in China, remain key factors. As a result, bottom-up fundamentals and structural drivers are mainly taking a back seat, offering a chance to bottom-up stock pickers to invest in areas that are being neglected.

China

The team remains constructive over China's medium- to long-term prospects as its economy transitions from a resource-driven and debt-based model to a higher value-added/sustainable growth model. While the associated deleveraging (in the property sector) and the transition are likely to be painful in the near term, it is a step in the right direction to improve the quality of the economy's growth drivers. Investors should not ignore China as it is a strategically critical global economy with a sizeable middle-class population (with substantial savings), and leadership in advanced technologies such as electric vehicles (EVs), batteries, solar, and wind power. The economy is progressing rapidly in industrial automation, robotics, biotechnology, and semiconductor manufacturing.

GEMs Equity positioning

At Federated Hermes Global Emerging Markets Equity, we are prioritising underlying fundamentals and medium- to long-term drivers for our investees and ensuring that the portfolio earnings (23% earnings per share [EPS] compound annual growth rate [CAGR] 2023-25) outgrow the benchmark (17% EPS CAGR) over the medium- to long-term without compromising on quality (i.e., a high return on equity of 14% vs. 11% for the benchmark[1] with very low leverage) and trading at very attractive valuations. The portfolio trades at c.13x 2024 price-to-earnings ratio (P/E) and c.11x 2025 (P/E)[2].

[1] Benchmark is the MSCI Emerging Markets Index.

[2] Source: Bloomberg as at October 2023.

An evolving economic environment

In the aftermath of the Covid-19 pandemic, a number of significant events have shifted the market's preference away from growth and quality stocks and towards cyclical and value. More recently, driven by the spectre of a possible US recession, priority has shifted to higher-yielding assets as investors look for signs of economic stabilisation, the direction of monetary policy, and how the macro situation in China might play out (particularly in the context of wider emerging markets).

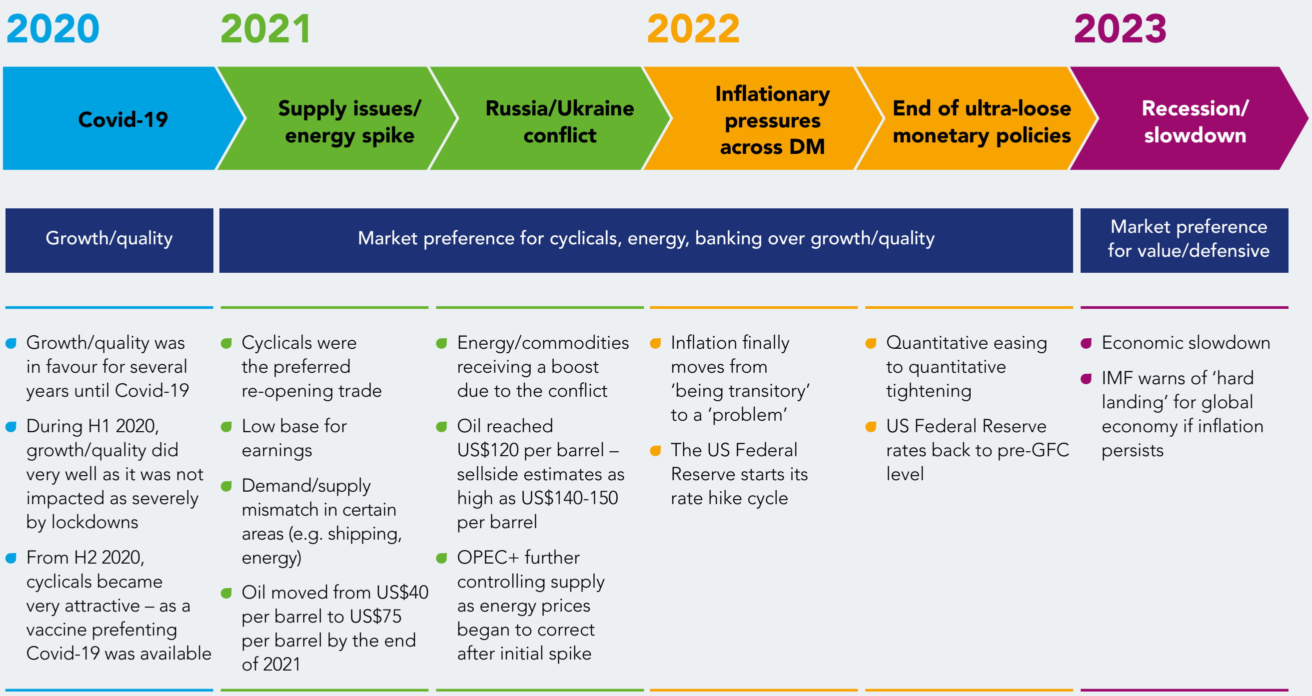
Uncertainty around these issues has led global investors – and some domestic investors – to steer away from deploying additional capital into the equity markets unless the direction of travel is clear (exceptions include India in emerging markets [EM] and artificial intelligence [AI] in developed markets [DM]).

Rapidly shifting investor preferences and a lack of conviction over the future direction of travel has created distortions and led to a general shift away from investment approaches based on fundamentals. Such behaviour can be observed in China today (11x P/E for 14% earnings per share [EPS] compound annual growth rate [CAGR] 23-25[3]) vs. India (21x P/E for 17% EPS CAGR 23-25[4]). While India does not have the same geopolitical or debt challenges as China, the market has become highly pessimistic about the world's second-largest economy and pricing reflects this subdued investor sentiment.

In addition, we also observe how a preference to profit from short-term trades has become a dominant theme in the market over a more long-term approach to investments. There has been a rapid shift from growth to value to income/yield over the last two and a half years. It suggests that the market has limited focus on sustainable long-term structural trends; with many investors opting instead for near-term opportunities created by changing macroeconomic factors.

A preference to profit from short-term trades has become a dominant theme in the market over a more long-term approach to investments.

Figure 1: Shifting investor preferences

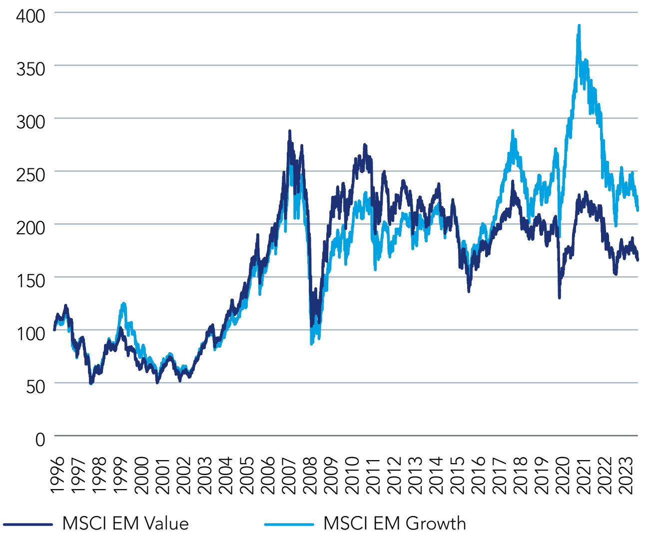


Source: Federated Hermes.

[3] Source: Bloomberg as at October 2023 – the valuation and growth estimates are for the MSCI China Index. EPS CAGR 2023-2025 based on consensus estimates.
[4] Source: Ibid.

EM growth vs. value – a long-term perspective

Figure 2: MSCI Emerging Markets Growth Index vs. MSCI Emerging Markets Value



*Rebased to 100

Past performance is not a reliable indicator of future returns.

Source: Bloomberg as at October 2023.

The years that led up to the global financial crisis (GFC) in 2008-09, were extremely supportive for value stocks in emerging markets. Global gross domestic product (GDP) was expanding at 4-5% per annum, particularly after the dot-com crash in 2000 (the US federal funds rate increased from 1% in 2004 to more than 5% in 2006[5]).

During this period, credit expanded and there was a boom in leveraged activities, particularly in the western world. Commodities and energy investments did well.

In the aftermath of the GFC, value stocks proved particularly attractive on the back of huge stimulus spending led by the Chinese government. However, by 2012, global GDP struggled to grow much beyond 3% and the performance of value stocks disappointed.

The underperformance of value stocks vs. growth was exacerbated further during the Covid-19 crisis as global GDP growth declined by 3.4%[6]. In response, sweeping government stimulus around the world propelled a rebound in global GDP growth (5.8% in 2021) helping value stocks to overperform growth[7].

In light of these trends, we can summarise that for value to outperform growth it needs:

- A benign global GDP growth environment (c.4-5%)
- Rising interest rates or record levels of fiscal stimulus

Investors should not look at valuations in isolation, but look at them in the context of global growth prospects, interest rates, government fiscal spending, and leverage on the balance sheet.

The post Covid-19 rally was always likely to be a 12-18 month phenomenon because the 2021 global GDP growth rate of 5.8% was unlikely to sustain. And while global GDP growth did moderate to around 3% in 2022, the world economy struggled with the fallout from the Russia-Ukraine conflict which pushed oil prices above US$100 a barrel and exacerbated global inflationary pressures. In addition, several supply constraints emerged as a fallout from the imbalances caused by the pandemic:

- **A shortage of shipping/logistics capacity resulting in elevated freight rates;**
- **A shortage of microchips which curtailed automobile production;**
- **A shortage in manpower availability leading to large wage hikes, fuelling inflation.**

These factors led to a surge in interest rates around the world, and pushed the US federal funds rate above 5%.

Value has done well (vs. growth) primarily on the back of the performance of the energy sector – the MCSI EM Energy Sector Index (+7.7% from January 2021 to October 2023) – compared to the MSCI Emerging Markets Value Index (-9.5%) and the MSCI Emerging Markets Growth Index (-33.3%) over the same period[8].

Growth sectors, in particular, have been hit by rising interest rates – and the resultant de-rating and unwinding of excess valuation during Covid-19.

In addition, the specific issues within the Chinese economy further accelerated the de-rating of several growth sectors (for example, internet retail).

The sharp pull back of growth vs. value is largely behind us. Growth is trading at 17x PE for 2024 vs. value at 9x. While growth is still almost twice as expensive vs. value, it is also expected to grow at almost twice the rate of value sectors over 2023-2025 (23.5% vs. 13.8%) with approx. 300bps better ROE and approx. 54% lower leverage[9].

We believe that investors should not look at valuations in isolation, but look at them in the context of global growth prospects, interest rates, government fiscal spending, and leverage on the balance sheet.

[5] Bloomberg as at October 2023.
[6] Ibid.
[7] Ibid.
[8] Bloomberg as at October 2023. EPS CAGR 2023 to 2025 based on consensus estimates.
[9] Ibid.

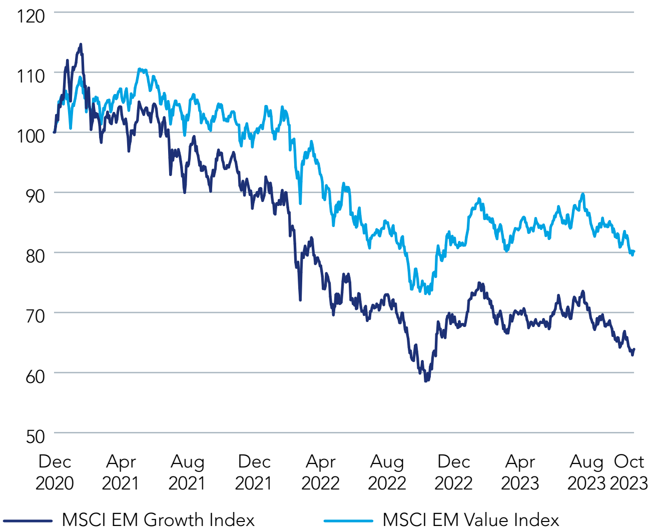
From end-2020 to October 2023 EM growth has underperformed EM value by

23.8%

In most instances, the indicators are flashing 'red': global growth is c.3% (1.5% in developed markets); interest rates are at pre-GFC levels (5%); fiscal spending power is limited as governments around the world grapple with rising interest payment burdens; small and medium-sized enterprises (SMEs) are struggling with rising borrowing costs; and large corporates are beginning to see the impact of higher interest rates as refinancing activity (from end-2023 onwards through to 2025) squeezes growth prospects[10].

While neither growth nor value has delivered a positive absolute return post-Covid-19, emerging market (EM) growth has underperformed EM value by a staggering 23.8% from end-2020 to October 2023[11] because of the trends outlined in the previous section.

Figure 3: EM growth vs. EM value indices (since January 2021)



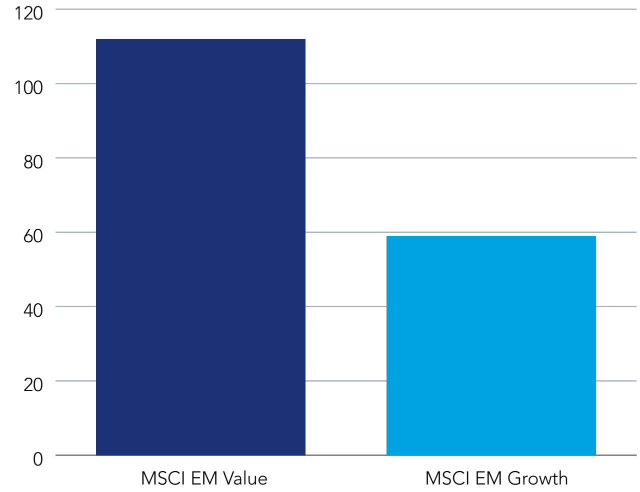
*Rebased to 100

Past performance is not a reliable indicator of future returns.

Source: Bloomberg as at October 2023

EM value's outperformance comes despite the fact that it carries almost twice the amount of leverage compared to EM growth[12].

Figure 4: Total debt-to-equity (EM value vs. EM growth)



Source: Bloomberg as at October 2023

In the face of rising costs of capital, there is a reduction in operating profits available for distribution to shareholders; and higher interest payments have an impact on companies' ability to invest in the business.

As a result, leveraged companies will likely suffer from limited funds for future growth initiatives.

While investors have rightly penalised growth companies trading at excessive valuations, we believe that many investors have not yet considered this fundamental balance sheet/cash flow issue within the value space. As companies look to refinance their credit lines in the coming quarters and years, the full impact of rising borrowing costs is likely to be felt.

The near-term outperformance of value compared to growth has been primarily driven by the market expectation of stable earnings for specific value sectors, contrasting with a mid-single-digit decline for growth sectors in 2023. However, the market seems to overlook the medium-term growth prospect at +23.5% vs. 13.8% for value sectors EPS CAGR 23-25[13]. On a price/earnings-to-growth (PEG) basis, EM growth is in-line compared to value. On a risk-adjusted basis, EM value has a greater scope for disappointment in light of the abovementioned leverage issue.

As companies look to refinance their credit lines in the coming quarters and years, the full impact of rising borrowing costs is likely to be felt.

[10] World Economic Outlook, October 2023: Navigating Global Divergences (imf.org).
[11] Source: Bloomberg as at October 2023 – comparing MSCI EM Growth vs. MSCI EM Value Index.
[12] Source: Bloomberg as at October 2023 – comparing the total debt to equity ratio for MSCI EM Value and Growth indices.
[13] Source: Bloomberg as at October 2023. Comparing the EPS CAGR of MSCI EM Value and Growth indices for 2023-2025 estimates.

GEMs Equity approach in a shifting investment environment

During 2020, the GEMs team observed that several value sectors had de-rated significantly because of the uncertainty caused by lockdowns and other Covid-19 restrictions. By Q3 2020, the team had made a few adjustments, adding value/cyclicals to the portfolio. However, one key difference was how the team perceived value vs. the wider market. The market generally considers anything trading at cheap/low multiples as value. In contrast, the GEMs team's investment philosophy has always considered the reversion to mean theory as unhelpful (i.e., buy a stock at 0.5x price to book and sell at 0.8x price to book) because timing of entry and exit trades can carry significant risks.

As a result, we are happy to invest in high-quality cyclicals where we see clear evidence that we are close to the bottom of their cycle and their valuations provide us with a healthy margin of safety. These are companies with barriers to entry, good management, and high returns.

For the last two and a half years, the team has added several cyclical/value names to the portfolio, including a mining equipment company, a copper mining group, an aluminium producer, a key player in the LNG transport business, several banks across EM, a petrochemical and an electric vehicle (EV) battery materials producer.

We invest in high-quality cyclicals where we see clear evidence that we are close to the bottom of their cycle and their valuations provide us with a healthy margin of safety.

More recently, the team has added several quality compounders to the portfolio, including an Asian stock exchange business, leading car manufacturers in India and China, a hospital operator in India, and a leading property service company in China.

While value/cyclicals were added, the team held the view that it would not shift entirely out of growth and quality and limit the value component to those companies that were temporarily trading at lower multiples – as opposed to companies that are always cheap and to avoid value traps. The team also took the view that value was likely to be a 12-18-month trade as opposed to a structural shift away from growth/quality. This view was supported by the subsequent actions of global central banks – led by the US Federated Reserve and European Central Bank – which ended a decade of ultra-loose monetary policies, drawing a curtain on the era of cheap money.

Figure 5: GEMs Equity's response to a shifting investment environment

2020

- The portfolio benefitted from being already positioned in growth/ quality
- From July 2020 onwards, the fund bought a few cyclicals trading at attractive valuation
  - Mining equipment company
  - Mexican bank

2021

Added the following cyclical/value names

- Asian shipping group
- SOE bank India
- Memory player
- Mexican airport
- Copper miner
- Chinese appliance maker
- South Korean petrochemical and battery maker
- Aluminium producer
- Bank in Chile

2022

- Added the following companies linked to the energy sector:
  - Supplier of LNG carrier membrane
  - Bank in Qatar
  - Bank in Abu Dhabi
- Added the following cyclical/value names:
  - Brazilian bank/infrastructure holding company
  - Asian SME lending company
- Our exposure to financials grew to more than 300bps overweight by the end of 2022 – as a key beneficiary of rising interest rates

2023

- Added stable compounders and some defensive exposure
  - Industrial automation China
  - IT services India
  - Hospital operator India
  - Four-wheel Original equipment manufacturer (OEM) India
  - Four-wheel EV OEM China
  - Stock Exchange HK
- Adding value in China
  - Property services, China

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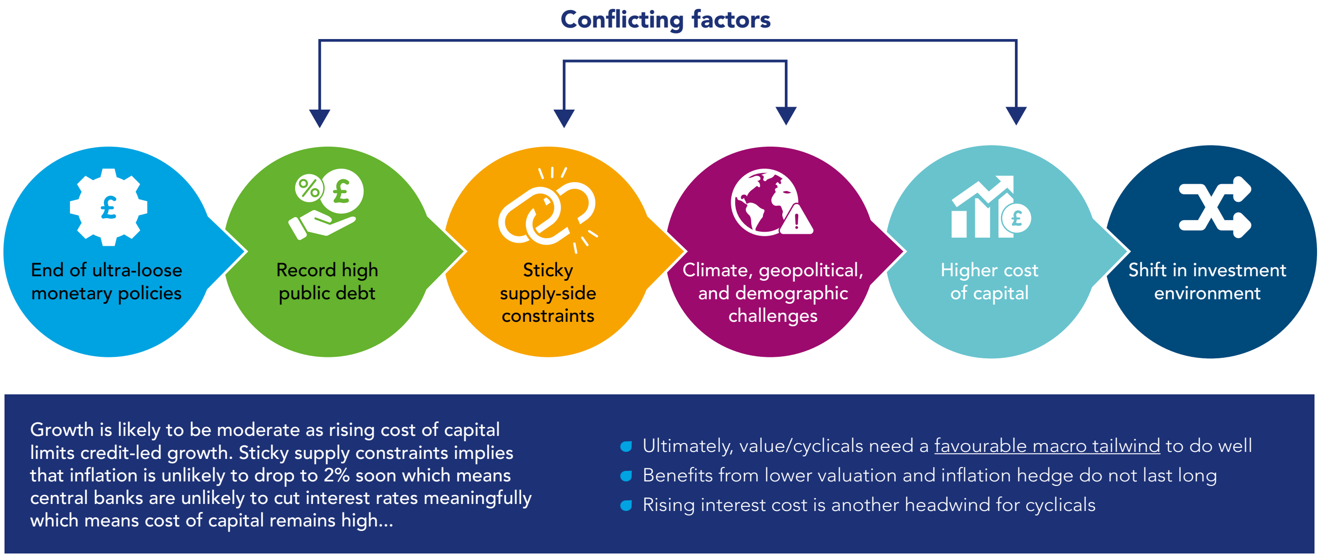
Source: Federated Hermes.

Figure 6: Conflicting factors



Source: Federated Hermes

Value/cyclicals require favourable macro tailwinds to outperform. The tailwinds enjoyed by such sectors in the aftermath of Covid-19 was unprecedented. Value benefitted from a shallow earnings base because of severely curtailed economic activity in 2020. The macro tailwinds were maintained by demand-supply imbalances in several cyclical and commodity-linked sectors as demand staged a sharp 'V-shaped' recovery while supplies took time to adjust. The shipping industry is a perfect example of such an imbalance. Due to a shortage of container shipping capacity, shipping companies enjoyed benign pricing and, in several instances, earned super-normal profits in 2021[14]. These profits were almost equal to those made in the previous 10 years[15].

Similarly, oil prices benefitted from a sharp rebound in travel demand, with the OPEC+ cartel[16] effectively controlling supplies, resulting in an almost doubling of oil prices from Covid-19 lows. The Russia-Ukraine conflict further exacerbated the energy security issues.

The oil price has since corrected as demand conditions have normalised – any rebounds in price are largely driven by the supply constraints initiated by OPEC+ rather than any fundamental surge in global demand.

The team considered these abnormal moves in several value and cyclical sectors. It did not feel comfortable chasing these opportunities as there was limited confidence in the sustainability of the earnings momentum.

Beyond the post-Covid-19 boost, the Russia-Ukraine conflict, and the end of the cheap money era, the GEMs team has focused on conflicting factors that remain unresolved by global policymakers.

These conflicts include:

- **How governments will invest in the economy at a time when the cost of capital is higher.** *(Many governments have high debt borrowings and must pay higher borrowing costs).*
- **Ongoing sticky supply-side constraints that politicians have yet to address.** *(The scope of climate, geopolitical, and demographic challenges suggest many supply-side issues are structural.)*

As a result, inflation is unlikely to remain subdued (once it moderates to a lower level), and monetary policy is unlikely to revert to ultra-low interest rates.

This shift in economic reality implies slower growth around the world in the coming years. There are significant structural challenges that need to resolved. Unfortunately, we do not see the market focusing on these challenges yet. Investors remain primarily focused on the near-term macro concerns such as US Federal Reserve policy, the possibility of a recession in the US, and the potential for significant government stimulus in China.

[14] Bloomberg as at December 2022.
[15] Ibid.
[16] OPEC+ is a group that comprises the 13 member countries of Organisation of the Petroleum Exporting Countries (OPEC) and other oil-producing countries.

Long-term opportunities in EM

Predicting macro events and policymaker responses is challenging and, beyond a point, an unhelpful exercise. Rather than spend precious time and energy second-guessing policymakers, the team has identified several interesting long-term shifts the portfolio is exposed to. These are not six- to nine-month trades, but approximately three- to five-year-plus opportunities, where the team is not betting or speculating on macro direction or certain policy action to occur.

Instead, the shifts are structural regardless of interest rates, recession, or stimulus action. Of course, the investor sentiment towards these areas varies and is influenced by the macro situation. Nevertheless, the team believes that growth opportunity in these areas is substantial over a more extended period to mitigate any near-term change in market sentiment resulting in de-rating.

On the contrary, the team believes several attractive long-term opportunities are trading at desirable levels today due to investor perception and a pervasive focus on macro direction.

Figure 7: Country-specific opportunities and global themes

Source: Federated Hermes.

Investing in China

China is the world's second-largest economy, accounting for a third of the EM universe[17] and half of EM GDP[18]. China is a significant player in the global supply chain and a leader in critical areas such as renewable energy technologies, electric vehicle batteries, and mature chip production, and it is fast catching up in several other high-end areas such as biotech, automation, robotics, and artificial intelligence (AI).

China has a deep equity market with approximately 8,000 listed companies domiciled there. It is, therefore, not possible to ignore the market entirely. We can deviate from the benchmark[19] (within limits), but at the present time, we do not share the view held by many in the market that China is largely uninvestable.

To that end, we hold a contrarian view on China and have a small overweight. We review our top-down assumptions regularly and adjust our allocations accordingly. We have moved to an underweight on China in the past, and if conditions make us pessimistic, we will reduce our allocation to the country. However, at the present time, we see a favourable risk-reward situation in China.

> **We do not share the view held by many in the market that China is largely uninvestable.**

China is at a crucial junction with multiple challenges, including a geopolitical rivalry with the US, the fallout from the pandemic, and stresses in its property sector, to name a few. These are immensely difficult issues that will test the resolve of the Beijing leadership.

Beyond these challenges, the debt-fuelled growth model that underpinned the economy is now irrelevant, and historical valuations are, as a result, less meaningful.

Our focus is on how China is likely to evolve beyond the reopening of its economy following the end of Covid restrictions. We believe that, at best, China can sustainably achieve mid- to low single-digit real GDP growth, considering the constraints under which its economy operates.

A credible policy to stabilise the economy might help China outperform global indices in the short term. However, its long-term performance will depend on how successfully the leadership in Beijing manages the economy's transition.

> **It is clear that China's leadership understands that its historical addiction to leverage (debt) is not sustainable.**

The economic transition involves shifting away from a reliance on property and heavy resource orientation (A reliance on an ever-increasing supply of commodities and energy to produce goods) towards other more sustainable growth drivers – such as rising middle-class consumption, improving people's quality of life, and increasing focus on higher value-added activities – which will help the economy develop with more effective and productive capital allocation.

It is clear that China's leadership understands that its historical addiction to leverage (debt) is not sustainable and it is consciously moving away from the old growth model, curbing unnecessary speculation, particularly in the property and construction sector.

It has been reassuring to see no big stimulus announcement to boost the economy this year, and that the Communist Party has set conservative growth targets. In the coming years we believe we are likely to see significant economic reform. The China that emerges will be more economically conservative and sustainable. As a result, we expect internal financial risks in the future to be contained to a large extent, with China less vulnerable to external liquidity shocks as a result.

Along with the ongoing economic shifts, underneath the surface, the Chinese economy is undergoing a more profound and dynamic transformation that presents unique investment opportunities for long-term investors. In a global context, very few large economies can provide growth opportunities on the scale that China is likely to offer.

We believe focusing on the following themes will provide a long runway for growth:

- **Digitisation**
- **Renewable technologies and energy**
- **Biotechnology**
- **Financialisaton of savings**
- **Metaverse / AI**
- **Localisation of critical technologies**

While the opportunities in these sectors are likely to be meaningful, investors must avoid potential pitfalls (some of which are unique to China). Any sectors caught in the crosshairs of geopolitical tensions with the US – and at risk of the US Entity list – are representative of one such pitfall.

In addition, the team avoids companies in cyclical industries as these are typically loaded with excessive leverage and generate returns below their cost of capital. Over time, we believe such companies will likely find the transition to net zero challenging.

Although China has made commendable progress in multiple fields, there is potential for the economy to achieve more. However, progress in the future will depend on the pace of economic reforms and the further opening of the economy. Progress will heavily depend on how quickly the Chinese leadership can reform its state-owned enterprises (SOEs), making them competitive and relevant for the future.

[17] MSCI EM Index.
[18] Bloomberg as at October 2023 (Growth figures between 2017 and 2022).
[19] Benchmark is the MSCI Emerging Markets Index.

We believe that a portfolio that avoids the pitfalls and focuses on the ongoing transformation of the Chinese economy will be well positioned to generate long-term value.

Globally, economies rarely cross the US$10,000 per capita income without reforms at an institutional level. On the back of its previous growth model, and a focus on exports, and infrastructure, China has already crossed this level. As some of these drivers unwind – including issues in the property sector and excessive leverage – China will have to quickly assemble new drivers to sustain income levels and ensure a higher quality of life for its people.

We note two significant drivers for China over the long term:

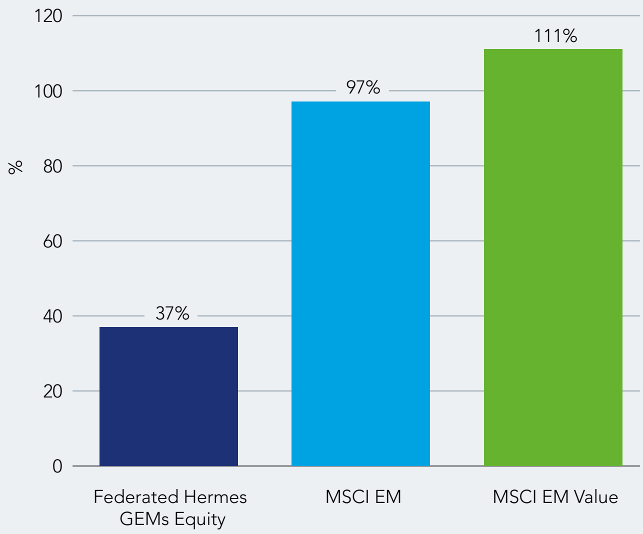
- China's leadership in renewable technologies is likely to enhance the country's status globally despite moves by the US and EU to reduce dependency on China.
- The rising penetration of enterprise digitisation, cloud computing, and robotics will continue to offer tailwinds to the economy from an efficiency and productivity perspective. China is increasingly localising critical areas of technology, which will enhance the scale of domestic businesses. A thriving ecosystem of such companies will help China move up the value chain, creating more higher-quality jobs.

We believe that a portfolio that avoids the pitfalls and focuses on the ongoing transformation of the Chinese economy will be well positioned to generate long-term value.

Figure 8: GEMs portfolio price-to-earnings (P/E) ratio and total debt-to-equity ratio

GEMs Equity: P/E ratio of current holdings over time
(index method applied on current portfolio to compute the P/E)

Comparison of total debt-to-equity ratio
(index method applied on current portfolio to compute the P/E)



Key highlights Updated for 2023-2025 estimates

- **GEMs portfolio:** 23% EPS CAGR[1], 14% ROE, PEG[2] = 0.72x
- **Benchmark:** 17% EPS CAGR[1], 11% ROE, PEG[2] = 0.77x
- The portfolio offers, c.40% better growth, c.303 bps better ROE, and c.-59% lower leverage

[1] EPS CAGR based on 2023 to 2025 based on consensus estimates. [2] PEG: PEG calculated as 2023e P/E divided by EPS CAGR 2023-25. ROE, total debt/equity are as peer last available financials.

Past performance is not a reliable indicator of future returns.

Source: Federated Hermes and Bloomberg as at October 2023.

Portfolio characteristics vs. benchmark

The team's focus is to try and anticipate medium- and long-term shifts and position the portfolio accordingly to future-proof the investments as much as possible. Hence, the portfolio was refreshed to ensure it was ready for the evolving investment environment.

As a result of the GEMs team's focus on structural growth opportunities, value with catalysts, and consideration of balance sheet risks in bottom-up stock picking, the portfolio displays attractive characteristics. It offers c.1.4x better growth and c.300bps better return on equity (quality) vs. the benchmark and trades at a reasonable growth-adjusted multiple (PEG) in line with the benchmark. There is no compromise on balance sheet quality, and the portfolio has c.60% lower leverage vs. the benchmark.

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