Global Emerging Markets Equity

Outlook

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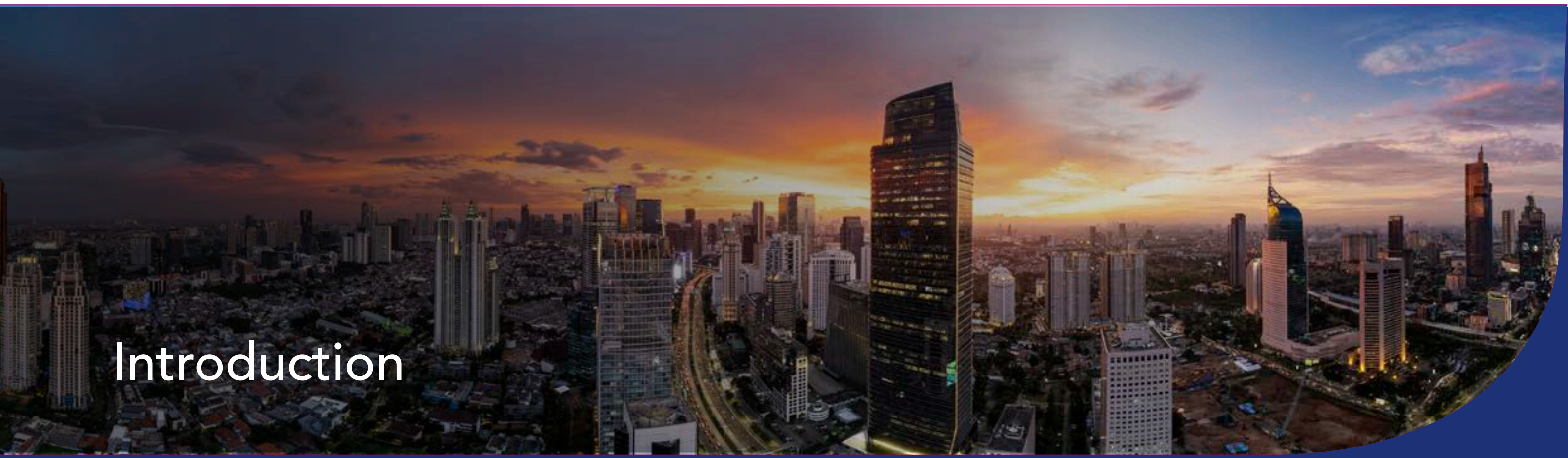

Introduction

There's never a dull moment in emerging markets (EM). We have seen various noteworthy developments in EM this year that merit discussion in this report. Moreover, as we will outline, they have reinforced our view about the prospects for EM over the medium- and long-term. The asset class has solid foundations and we see a range of tangible additional drivers of future growth.

There have been a number of elections in key emerging economies this year and, as a result, we anticipate a flurry of positive policy activity in the coming months and years that should provide a supportive backdrop for many emerging market companies.

We expect this to translate into investor returns in the form of earnings, dividends, and buy-backs; as well as freeing up capital that companies can re-invest in growth and margin-accretive projects.

> **In almost all cases, the new EM administrations remain committed to fiscal prudence and implementing reforms.**

In addition, improving corporate governance standards in key emerging markets should help solidify those returns, and ensure that retail and institutional shareholders remain interested and invested. Flows into EM are an equally important driver of performance.

Despite the fact that many EM policymakers have done an excellent job, and that the direction of most emerging economies is largely positive, EM as an asset class continues to underperform developed markets. The MSCI EM Index has returned 5.7% YTD to end-July compared with 12.7% for the MSCI World[1].

To understand what's in store for EM for the rest of 2024 and beyond, we first need to look at significant recent developments.

1) Elections in key EM countries

Elections have concluded in important emerging economies this year (including India, Indonesia, Mexico and South Africa). In almost all cases, the new administrations remain committed to fiscal prudence and implementing reforms.

While we await information from the new Mexican government about its judicial overhaul, and look forward to hearing about the incoming Indonesian government's spending priorities, we remain generally positive about emerging economies' fiscal discipline. In India, we expect Prime Minister Narendra Modi's incremental reforms and focus on infrastructure creation to continue following his re-election, while in South Africa, we expect an acceleration in planned reforms.

2) South Korea's Value-Up programme

South Korean President Yoon Suk Yeol and the country's regulators are firmly behind the government's new 'Corporate Value-Up Programme' which aims to reduce the so-called 'Korea discount' that sees local companies trade at lower price-to-earnings multiples than global peers. The programme mirrors similar reforms undertaken in Japan. While the road will be long and bumpy, it represents a good start. South Korean companies are beginning to modify their shareholder return plans – in the form of buy-backs and cancellation of treasury shares – and in some cases proceeding with asset monetisation, as well as overseas listings to facilitate price discovery for the overall group. More needs to be done to eliminate the Korea discount, but the Value-Up programme represents a step in the right direction.

[1] Bloomberg as at August 20 (January 1 to July 31 2024) on US dollar basis.

3) China bids to stabilise property sector and reform SOEs

The Beijing government remains focused on stabilising the country's crisis-hit property sector. Unlike its huge stimulus package in 2008, China is taking a more measured approach to minimise the damage, and is seeking to ensure that speculation does not return in the real estate market.

The government and the People's Bank of China are providing liquidity support measures to solvent developers and selectively buying inventory. A few provinces have loosened property buying restrictions for first- or second-time buyers. However, there has been no credit-fuelled splurge as in the past, where debt was hurled everywhere to boost GDP, without any concern for the sustainability of this growth or subsequent returns.

Beijing now seeks economic growth of about 5% per annum and has been looking to support higher value-added sectors and tech self-sufficiency. Technology investment has focused on enhancing productivity in an increasingly unproductive world.

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4) Brazil: balancing spending with fiscal prudence

While there have been concerns about President Luiz Inácio Lula da Silva's spending plans, Brazil's finance and economy ministers have, thus far, been able to curb spending and keep Brazil's debt-to-GDP ratio under control. Going forward, the market expectation is that this fiscal oversight should limit inflation expectations and allow the Central Bank of Brazil to cut rates further.

5) Commodities: benign pricing environment

As the Chinese economy slowly rebounds, demand for commodities will pick up. In addition, there is growing global recognition that many of the key commodities required for electrification and the drive towards net zero are in short supply, in particular copper and aluminium.

Moreover, the rise in demand for hybrid vehicles is likely to encourage demand for platinum group metals (PGMs) given the crucial role they play in catalytic converters. Energy demand remains reasonably strong, especially for liquified natural gas (LNG) as evidenced in long-term supply contracts.

Section 2: Emerging economy resilience

Over the last three years as developed markets (DM) grappled with rising inflation, many emerging economies were already on a more stable footing – as evidenced by lower inflation vs. DM (in aggregate). Many emerging economies have also experienced limited impact from the US Federal Reserve's rate hiking cycle and the recent 'higher for longer' phenomenon.

During a period that saw the fallout from Covid-19, supply chain distortions, the Russia-Ukraine conflict, soaring prices and rocketing rates, no emerging economy defaulted on its debt and no EM bank required a bailout or significant support. One reason is the measures EM policymakers put in place following the infamous 'taper tantrum' of 2013. Another other reason is that many EM countries are much more resilient on a domestic level.

Figure 1: Key emerging economies exhibit resilient macro backdrops

	FX reserves US$bn	Import Cover in months	Current Account (% of GDP)	Inflation (CPI YoY%)	Short Term Foreign Debt as % of GDP	Short Term Foreign Debt as % of FX Reserves	Real Policy Rate	Spread local 10-year yield vs. US 10-year
ASIA (average)	**666**	**11.1**	**2.4**	**2.5**	**11.1**	**39.2**	**1.64**	**-0.04**
China	3,201	16.2	1.3	0.6	7.9	44.1	3.8	-2.1
South Korea	389	7.5	3.1	2.6	7.6	36.2	0.9	-1.1
Taiwan	573	20.8	13.6	2.1	24.0	32.2	-0.1	-2.7
India	654	12.4	-0.8	4.8	2.9	15.6	1.7	2.6
Indonesia	122	7.2	-0.7	2.9	2.9	32.3	3.4	2.8
Malaysia	104	4.9	2.5	2.5	25.4	97.7	0.5	-0.5
Thailand	200	9.8	2.3	0.8	15.2	39.0	1.7	-1.7
Philippines	88	10.2	-2.4	3.55	3.3	16.5	3.0	2.4
LATAM (average)	**196**	**9.9**	**-2.1**	**4.1**	**4.9**	**35.6**	**5.00**	**5.16**
Brazil	323	17.4	-1.7	4	4.0	27.0	6.5	7.9
Mexico	220	4.8	-0.9	4.5	3.4	27.3	6.5	5.6
Chile	46	7.7	-3.6	3.75	7.2	52.6	2.0	1.9
EMEA (average)	**80**	**4.5**	**-1.3**	**22.3**	**11.7**	**146.5**	**-0.92**	**9.88**
South Africa	46	5.9	-2.0	5	8.4	69.4	3.3	6.9
Poland	135	5.5	0.6	3.75	10.5	63.1	2.0	1.4
Turkey	59	2.2	-2.4	58	16.3	306.9	-8.0	21.4

Source: Bloomberg as at July 2024. Based on expected CPI for 2024.

In light of the recent developments outlined above – elections, reforms, fiscal consolidation, corporate governance improvements, a focus on higher value-added sectors and a benign commodity environment – we remain confident about the outlook for EM for the rest of 2024.

At this point, it's worth pointing out various additional factors that we believe will further reduce economic vulnerability across EM.

Economic reforms in South Africa and Turkey

South Africa and Turkey represent two sizable EM economies that have underperformed over the last decade or so on the back of poor policy decisions by their respective governments.

However, we have been encouraged by the Turkish government's change in direction following President Recep Tayyip Erdoğan's re-election last year, which has led to the reintroduction of orthodox economic policies – it should result in the Turkish lira strengthening and put an end to hyperinflation.

In South Africa, meanwhile, the African National Congress (ANC) lost its majority in May's general election for the first time in the post-apartheid era. The ANC – whose kleptocratic and incompetent rule has caused far-reaching economic damage – has been forced into a coalition government with centrist opposition groups. We anticipate this change could lead to a period of improved governance, which could help make South Africa an attractive long-term investment destination once again.

Commodities starting to outperform on a secular basis

It's widely accepted that commodity markets are 'super-cyclical' by nature, and tend to go through extended periods of boom and bust.

If we step back and look at the big picture – over the last 100 years – we can see a number of commodity super-cycles. The pattern has typically seen seven-to-10-year commodity upcycles followed by 10-to-20-year downcycles.

The last downcycle began around 2011, which suggests we are roughly 13 years from the previous peak. It is hard to accurately predict when next upcycle will occur, but it's clear that certain commodities are likely to be in structural undersupply over the next five to 10 years.

A number of counties in the EM benchmark[2] are significant commodity exporters, including Indonesia, Brazil, Peru, Chile, South Africa and Saudi Arabia.

These economies stand to benefit from periods of higher commodity prices – which should strengthen domestic currencies, increase consumer spending, grow government revenues, expand investment, accelerate GDP growth, and boost stock values.

The Middle East's economic diversification

Saudi Arabia, Qatar and the UAE are in the process of investing their vast oil wealth in diversifying their economies – it means that 'non-hydrocarbon' GDP is likely to grow much faster than 'hydrocarbon' GDP over the next decade. It represents another trend that should pique the interest of long-term investors in the region.

[2] The MSCI Emerging Markets Index.

Section 3: The forces driving the global economy and EM positioning

Beyond 2024, we will now consider the main forces that we expect to continue to drive emerging economies over the medium to long term. We will also discuss the crucial question of earnings and return on equity (ROE).

Force	Comment	Emerging Economies
Growth	Developed economies will struggle to accelerate growth due to a combination of ageing populations, a rising debt-servicing burden, lack of productivity, a reduced ability of governments to spend on infrastructure and innovation and, in certain instances, a shift in economic models away from globalisation.	EM GDP will continue to grow over 3.5-4.0%[3] and select emerging economies will grow over 4-4.5% annually[4], benefitting from positive demographics and a benign investment cycle.
Supply Chains	While US President Joe Biden's administration has made some progress in re-establishing the US in critical technology manufacturing industries, overall, emerging economies will continue to dominate global supply chains due to the availability of qualified workforces, improving infrastructure, incentive schemes, and in certain cases, large and growing domestic markets that make manufacturing more economically feasible.	China remains a dominant force in global supply chains[5] due to its impressive infrastructure and supply chain ecosystem build-out. India is emerging as a credible regional player. Mexico has become the most cost competitive nearshoring option for the US[6]. Taiwan and South Korea have cemented their positions as critical players in global technology supply chains.
Technology	Technology continues to drive large parts of the global economy and the trend is irreversible. We see significant improvements in technology, initially driven by digital, data, and cloud technologies. With 5G and AI, we have entered a new dimension. Success or otherwise of economies and companies will depend not only on production of technology but also the effective use of technology.	Most of the enabling technologies in microchip manufacturing, hardware, and software development are concentrated in EM (Taiwan, South Korea, China, and India). In addition, emerging economies such as China and India have significant data advantages due to the size of their populations. Many emerging economies are taking steps to localise data technology within their borders, supporting the creation of local data centre and software industries.
Leverage	Many governments' addiction to debt is a well-known fact globally. Governments borrow to spend and meet their public service obligations. Arguably, all was well until the recent interest rate hikes hit the global economy. As a result, government debt is being scrutinised by the market because increasingly large sums will be required just to service existing obligations. In the absence of meaningful GDP growth, tax receipts are unlikely to rescue the fiscal situation, thus forcing governments to prioritise their spending. We anticipate that, as a result, outlay on productivity-boosting measures such as infrastructure, and innovation will suffer as interest payments and other essential public services (e.g. health, pensions) are prioritised.	EM government debt to GDP is moderate compared to DM, allowing governments in EM to spend on infrastructure and other growth-boosting measures. We are witnessing a renewed focus on lowering fiscal imbalances in EM – a stark contrast with the situation in DM. (Witness, for example, US government borrowing which is the equivalent of 6% of GDP[7].)
Politics	Undue government interference in the private sector has been in a concern in many emerging economies in the past. However, politics in many parts of the Western world have a taken a populist turn, which has led to uncertainty and volatility. The recent parliamentary election in France is a case in point and the on-going electoral drama in the US continues to create surprises.	As discussed in the points above, the majority of recent election outcomes in emerging economies have been positive and, crucially, lend much-needed stability in an increasingly unstable global political environment.
Climate	The risks related to climate change have moved to the top of the agenda in many emerging economies. Politicians meet regularly to craft policy responses to the climate crisis. However, meaningful action on the ground remains inadequate.	Most emerging economies need to accelerate plans to decarbonise and reduce future dependence on coal. The country with the most dynamic growth in renewable energy is China. It commissioned as much solar PV in 2023 as the entire world did in 2022, while additional wind power installations rose 66% year-on-year. The role that biofuels can play in tackling climate change gained prominence in 2023. Emerging economies, led by Brazil and India, are expected to drive 70% of global demand for biofuels over the next five years. The development of biofuels suggests they could replace diesel in many sectors and even find a potential use in air travel [8]. A key point to emphasise is that the majority of the renewable energy and electrification supply chain is concentrated in emerging markets, specifically in China[9]. Therefore, as the world moves towards ambitious net-zero targets, various emerging economies stand to benefit because of their technological and scale advantages in renewables.

[3] Bloomberg – Economists' forecasts for 2024-26.
[4] Includes emerging economies such as China, India, Indonesia, Malaysia, and Philippines.
[5] CEPR: China is the world's sole manufacturing superpower: A line sketch of the rise, dated January 17, 2024. https://cepr.org/voxeu/columns/china-worlds-sole-manufacturing-superpower-line-sketch-rise.
[6] BCG: Harnessing the Tectonic Shifts in Global Manufacturing dated September 21, 2023. https://www.bcg.com/publications/2023/harnessing-tectonic-global-shift-in-manufacturing.
[7] Source: Bloomberg, Q2 2024.
[8] IEA: Massive expansion of renewable power opens door to achieving global tripling goal set at COP28 dated, January 11, 2024. https://www.iea.org/news/massive-expansion-of-renewable-power-opens-door-to-achieving-global-tripling-goal-set-at-cop28.
[9] LSE: China's role in accelerating the global energy transition through green supply chains and trade dated, February 21, 2024. https://www.lse.ac.uk/granthaminstitute/publication/chinas-role-in-accelerating-the-global-energy-transition-through-green-supply-chains-and-trade/.

Force	Comment	Emerging Economies
Commodities	The global economy is digitalising at pace; it will eventually electrify at pace too. Digitalisation and electrification are two megatrends that will continue to shape the world, particularly as policymakers look to tackle global warming and improve productivity. The development of these megatrends suggests we are entering a 'material world' of sharply increasing demand for certain commodities that are essential to digitalisation and electrification.	Emerging economies boast access to large reserves of critical minerals. China, for example, is a big exporter of rare-earth metals, South Africa is a major producer of platinum group metals, Chile and Peru have significant reserves of copper, and Indonesia is the largest producer of nickel in the world[10]. Policymakers in various emerging economies are taking proactive steps to ensure that the companies which benefit from access to their critical minerals also invest locally. Access to commodities will become increasingly important, and we will see positive implications for select emerging economies in the form of higher investment spending, which will boost GDP.

Based on the above analysis of the forces driving the global economy, it is obvious that emerging economies hold meaningful advantages. To benefit, they will need to capitalise on these advantages.

EM governments need to maintain focus on developing infrastructure, creating more high-quality jobs, and ensuring that the population at the bottom of the pyramid benefits from the 'trickle-down effect' as investment and growth rates accelerate.

It will not be easy and will require further reforms, prioritising spending on infrastructure over populist sops, overhauling state-owned enterprises (SOEs), and establishing top-tier corporate governance standards across the board.

Patchy or limited reform delivery in the past has meant that emerging markets have not historically delivered strong earnings. However, we can see evidence that this is beginning to change: SOEs are becoming less relevant, tech now makes up more than 25% of the index, and structural growth – in countries such as India – is on the rise.

The broad mix of countries and stocks in the EM index means that an active approach to investing remains the best way to identify the best-in-class companies that will benefit from the aforementioned megatrends, while at the same time ensuring quality, governance, and sustainability parameters are not sacrificed.

[10] WTO: High demand for energy-related critical minerals creates supply chain pressures dated, January 10, 2024. https://www.wto.org/english/blogs_e/data_blog_e/blog_dta_10jan24_e.htm#:~:text=Exports,all%20at%206%20per%20cent).

Section 4: conclusion

As outlined in this report, there have been multiple noteworthy developments in emerging markets this year – and they have reinforced our view that many of the economies in our investment universe are on solid foundations with credible drivers of future growth. The recent election results in India and Indonesia have been reassuring in terms of policy continuity, while the election outcome in South Africa has the potential to accelerate reforms in the country.

The landslide victory by the ruling Morena party in Mexico's election has created unease among investors, but it appears increasingly likely that the new government under President-elect Claudia Sheinbaum will take a pragmatic stance on the crunch issues. Meanwhile in South Korea, if the 'Corporate Value-Up Programme' is implemented effectively, it could provide a helpful tailwind for many South Korean companies and has potential to address the 'Korean discount'.

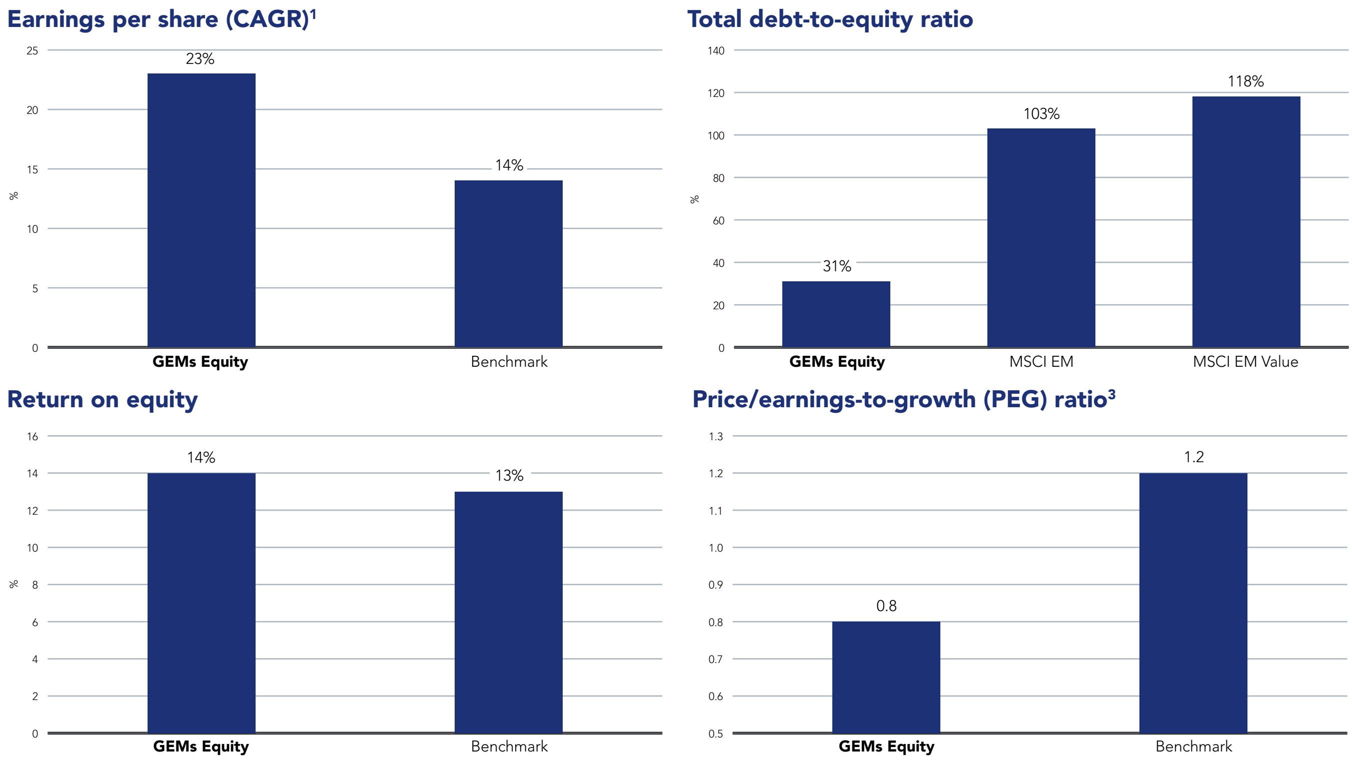
China continues to support the country's property sector, pursue SOE reform and is steadily moving towards a higher value-added economy; and it looks likely that Brazil will maintain fiscal prudence amid a benign outlook for key commodities.

Positive policy action in emerging economies should translate into a supportive environment for businesses and allow them to flourish. The GEMs Equity team prioritises investments in good quality companies with a proven ability to compound their value over a long time period. We seek companies with drivers that will help them grow structurally, with low levels of leverage and which trade at reasonable valuations.

We believe companies with these characteristics will be best placed to outperform in a world that may well see volatile and higher-for-longer interest rates, slower global growth, and further geopolitical uncertainty.

We look for: growth/quality, value with catalysts supported by a margin of safety

Figure 2: Portfolio offers better growth and quality at reasonable valuation



Past performance is not a reliable indicator of future results.

1 EPS CAGR based on 2023 to 2026 based on consensus estimates. Estimates cannot be guaranteed. 2 Index method applied on current portfolio to compute the P/E. 3 PEG: PEG calculated as 2023 P/E divided by EPS CAGR 2023-26. ROE, Total Debt/Equity are as per last available financials. Benchmark shown is the MSCI Emerging Markets (Net TR). Source: Bloomberg as of July 2024.

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Investments in emerging markets tend to be more volatile than those in mature markets and the value of an investment can move sharply down or up.

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