Global Emerging Markets Equity

Riding the megatrends

Outlook 2025

Kunjal Gala,
Head of Global Emerging Markets

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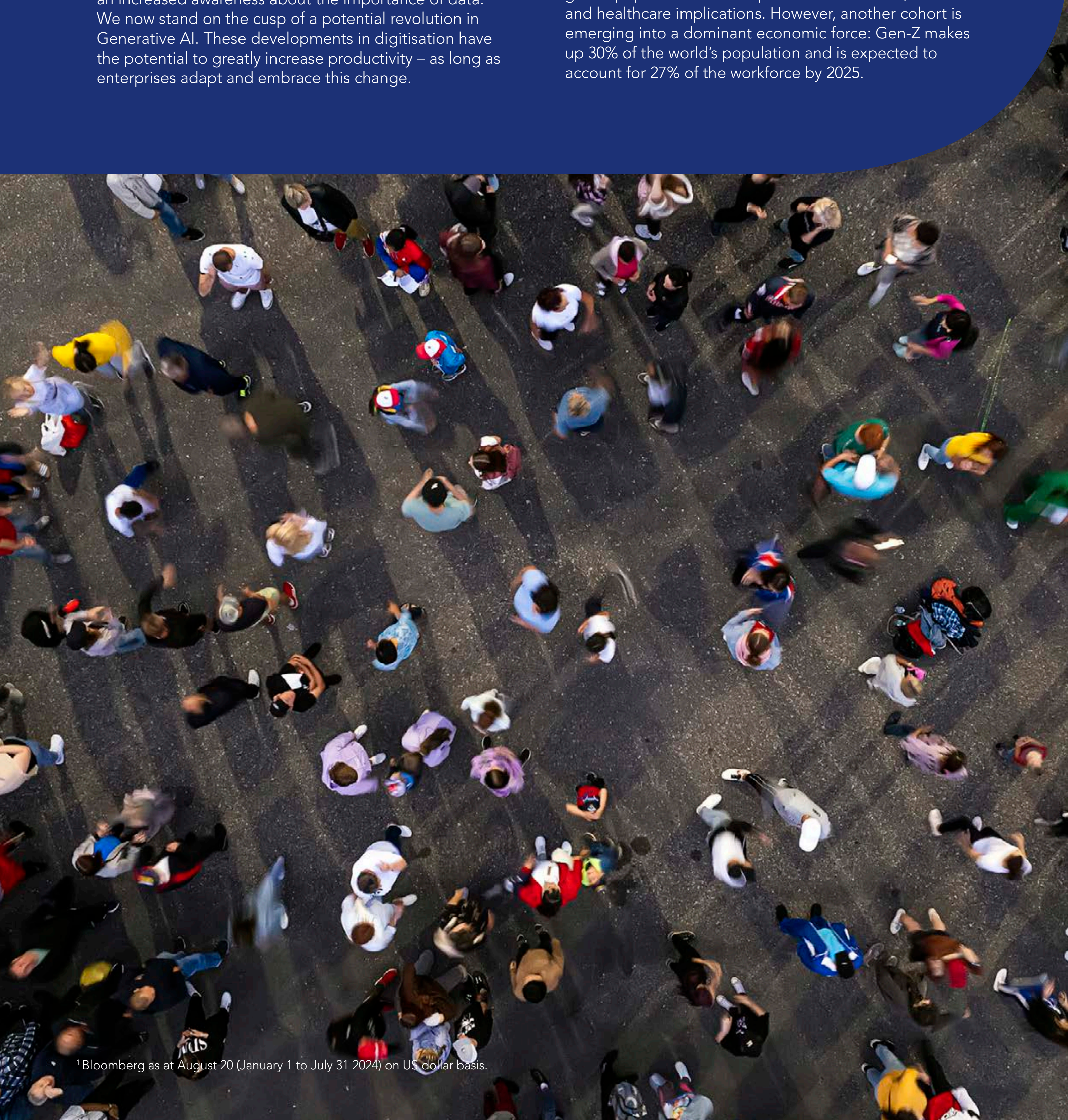
We believe three megatrends – digitisation, climate change, and demographics – will drive change in the global economy and business landscape for years to come. In this report we outline how we have invested in companies that we expect to benefit from this transformation

- The last few years have seen advancements in microchip technology, a rollout of cloud computing capabilities, and an increased awareness about the importance of data. We now stand on the cusp of a potential revolution in Generative AI. These developments in digitisation have the potential to greatly increase productivity – as long as enterprises adapt and embrace this change.
- The application of climate science to investment strategies has not yet become mainstream. However, the scientific evidence is increasingly hard to ignore. Insurers endured the third most expensive year for natural catastrophe losses in 2024 (US$140bn) because of climate change. We believe that climate change is an essential consideration to bear in mind when assessing the trajectory of the world, as it will significantly impact individuals, communities, and businesses.
- The share of the population aged 60 years and over will increase to 1.4 billion in 2030, according to the WHO. This figure is forecast to reach 2.1 billion by 2050. The ageing global population throws up a number of social, economic and healthcare implications. However, another cohort is emerging into a dominant economic force: Gen-Z makes up 30% of the world's population and is expected to account for 27% of the workforce by 2025.



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

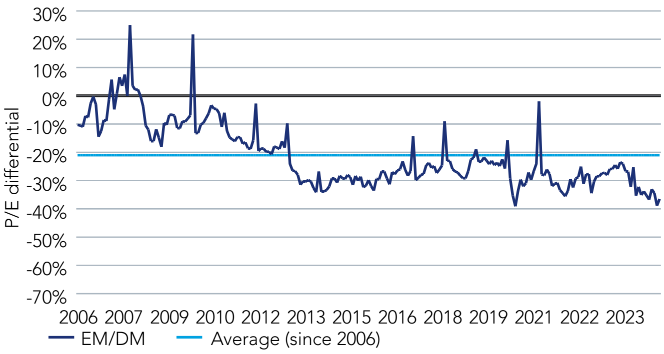
Introduction

2024 recap and thoughts for 2025

Emerging Market (EM) equities posted positive gains in 2024, returning 7.5% over the year, narrowing from 9.8% in 2023, helped by a late rally in Chinese equities, coupled with strong results from Taiwan and India[1].

EM significantly underperformed developed markets (DM), which returned 18.7% for the year, while US exceptionalism was sustained for another year. As a result, EM's discount to DM has widened[2].

Figure 1: EM/DM price-to-earnings differential



Source: Bloomberg as at February 2025.

Figure 2: EM/DM price-to-book differential

Source: Bloomberg as at February 2025.

Past performance is not a reliable indicator of future performance.

While EM equities had a positive year overall, returns from a number of leading EM countries diverged over the course of 2024 as a result of country-specific situations:

- The rebound of Chinese equities vs. EM ex-China
- Contrasting returns of Taiwan, Malaysia, and the UAE vs. Brazil, Mexico, and South Korea

[1] Bloomberg as at January 2025.
[2] Ibid.

China vs. EM ex-China

For the first time in more than three years, Chinese equities (+19.67%)[3] outperformed EM ex-China (+3.56%) despite the all-important tech sector making up about 30% of the EM ex-China index[4].

The returns of EM ex-China have suffered primarily because of country-specific issues in South Korea, Brazil, and Mexico.

Chinese equities initially rallied in September after Beijing announced sweeping stimulus measures to tackle the underlying weakness in the Chinese economy; including its misfiring property sector, debt-laden local governments and poor consumer confidence.

However, the re-election of US President Donald Trump in November, dampened market sentiment towards China and led investors to opt for high-yielding state-owned enterprises (SOEs), such as Chinese banks. Financials in China rallied almost 40% last year[5], driving the majority of returns for China in 2024, alongside the Communication Services sector.

Conversely, discretionary sectors have lagged the returns of the broader Chinese market. Even so, they still outperformed EM ex-China as they benefited from strong electric vehicle (EV) sales, a rebound in key e-commerce companies, smartphone subsidies, and a buoyant tourism industry.

We remain confident that Chinese policymakers have enough tools at their disposal to address the structural issues in the economy.

The main challenge remains stabilising the country's ailing property sector and officials have indicated that they are willing to do 'whatever it takes' to achieve this.

Setting aside the threat of US tariffs, the key factor that will determine the prospects for China's economy in 2025 and beyond is domestic policy.

We are optimistic that Beijing will seek to use the current geopolitical uncertainty – following Trump's return to the White House – to re-orient China's economy towards domestic consumption and high-end manufacturing.

We have a portfolio of quality companies listed in China and Hong Kong that we believe are well placed to succeed in the future. Despite the near-term drag on performance – caused by fewer SOEs and no banks in the portfolio – we retain our conviction.

We remain confident that Chinese policymakers have enough tools at their disposal to address the structural issues in the economy.

EM ex-China: leaders vs. laggards

As noted earlier, the technology sector accounts for approx. 30% of the EM ex-China index. Taiwan has benefited from the global boom in artificial intelligence (AI), with Taiwan Semiconductor Manufacturing Company (TSMC) delivering an impressive 71%[6] return in 2024; as well as helping to support a wider ecosystem – of microchip packagers, server assemblers, and liquid-cooling technology providers – in Taiwan.

Few markets in EM ex-China can match Taiwan's performance; Malaysia, the UAE, and Turkey all performed well (with approx.18-20% returns each). The surge in demand for data centres – on the back of the AI boom – was a factor behind Malaysia's performance, and a buoyant property market helped the UAE.

In contrast to the high-performing markets (Taiwan, Malaysia and the UAE), the Brazilian, Mexican and South Korean markets declined by 25-35% in 2024, mainly because of country-specific issues.

Brazil has been hamstrung by fiscal concerns over the spending plans of President Luiz Inácio Lula da Silva's government, as well as uncertainty over the direction of monetary policy.

Mexico was dragged down by the political fallout from Claudia Sheinbaum's landslide victory in the country's general election in June, and, later in the year, concerns about the threat of tariffs following Trump's victory in the US.

[3] https://www.msci.com/documents/10199/255599/msci-china-index.pdf
[4] https://www.msci.com/documents/10199/68ba6e15-672b-4b05-8140-6df3412ac472
[5] Bloomberg
[6] Bloomberg

South Korea, meanwhile, suffered from self-inflicted problems. Samsung Electronics' high bandwidth memory (HBM) chips struggled to pass tests for use in Nvidia's AI processors; and in December, President Yoon Suk Yeol's ill-fated attempt to impose martial law plunged the country into a political crisis.

Market favourite India posted decent returns in 2024 (approx. 11%). Nonetheless, a number of factors led to a repricing of Indian equities in the second half of the year: weak corporate earnings, a slowdown in urban consumption and the prospect of slower and shallower rate cuts in 2025 because of stickier-than-expected inflation.

Over the last few years, EM ex-China has emerged as an alternative to the EM asset class because of China's economic woes and subsequent underperformance. But the tables may have part-turned in 2024 following China's H2 stimulus blitz.

2025 could prove a crucial year for EM ex-China. Will Brazilian policymakers be able to get the country's fiscal deficit under control? Will Mexico strike a trade pact with the Trump administration? Will India's growth accelerate (justifying the market's lofty valuations)? Will the AI boom continue to help Taiwan outperform? And will Samsung solve its issues and fully enter the Nvidia supply chain?

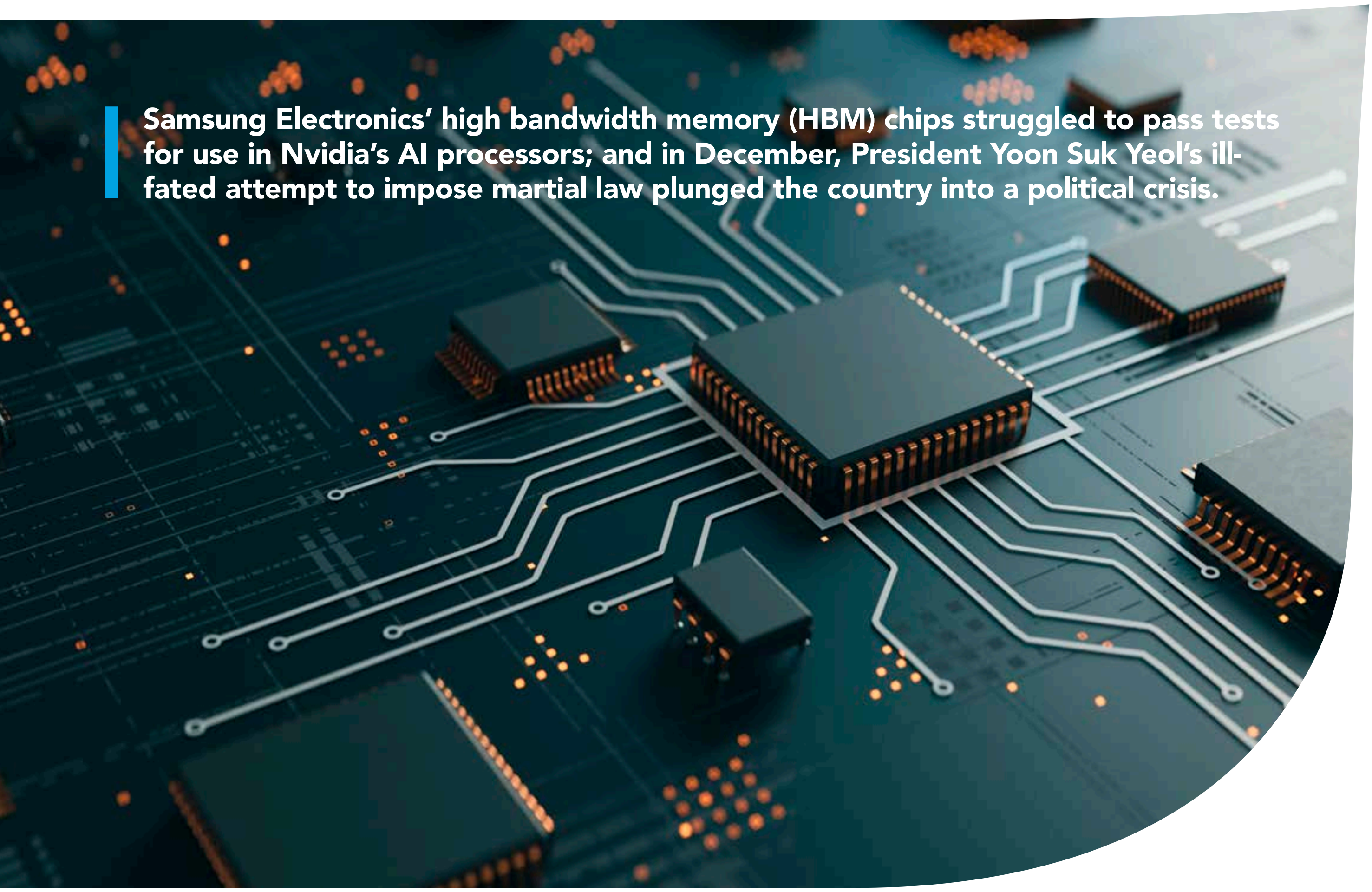
None of these challenges are insurmountable. But a lot needs to happen this year in order for individual markets in EM ex-China to re-rate.

In the case of India and Taiwan, valuations are already at more than one standard deviation above the mean (over a long-term timeline) so the margin of safety is limited. (A similar observation can be made for US equity markets and the so-called 'Magnificent Seven' – but that is for a separate discussion.)

For Brazil, Mexico and South Korea, investor expectations are relatively low, therefore, any improvement in the market outlook will likely result in a positive reaction.

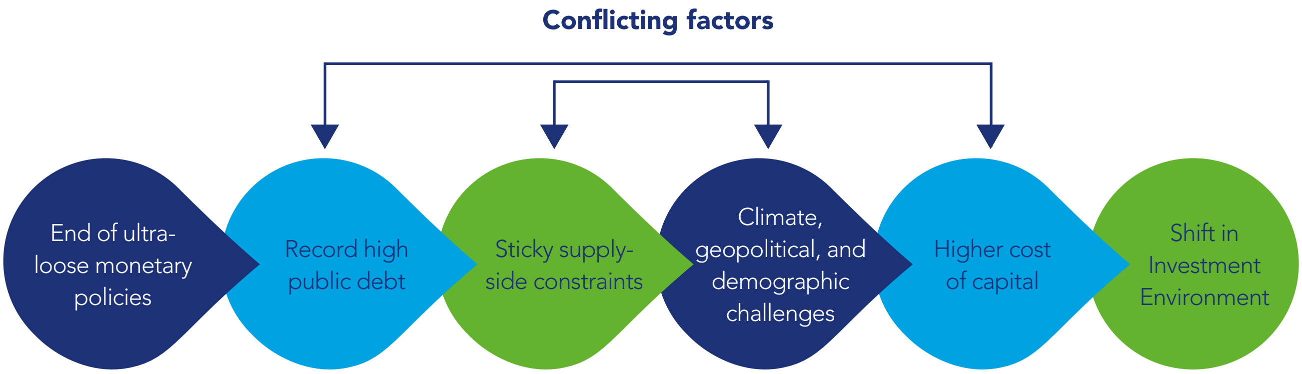
We remain cautious about slowing growth and high valuations in India, and the predominance of AI-related stocks in Taiwan. We, therefore, hold an underweight position in India and Taiwan. On the flip side, we have sought out long-term opportunities in Brazil, Mexico, South Korea, and China, and this is reflected in our overweight to these countries.

Our holdings in South Korea might typically be categorised as 'value' stock picks – but our preference for quality and growth at a reasonable price remains central to our approach in all other markets.



Global macro

The last few years have seen a more volatile macroeconomic backdrop – amid inflationary pressures, the end of loose monetary policies and supply chain disruptions – and we have applied a framework to evaluate the impact the global macro picture might have on the investment environment.



We had expected interest rates to remain 'higher for longer' and that various structural constraints would limit global growth. However, we have been surprised that US growth has sustained so strongly, which may be partly explained by increased fiscal expenditure (leading to widening government deficits).

We remain concerned that, at some point, the higher cost of capital, coupled with already high public debt, will act as a brake on credit- or debt-fuelled growth.

We continue to expect growth will be squeezed – unless the rollout of AI technology unleashes a massive productivity boom.

While AI remains promising, we still need to see sufficient evidence that it will positively transform enterprise workflows at scale, while at the same time not destabilising the existing jobs market.

We are paying close attention to the regulatory landscape around AI, as well as technological constraints that might limit the full potential of AI, at least in the near term.

In addition to AI, there is optimism among investors about President Trump's return to the White House and how his economic and foreign policy might impact the US economy. The market consensus seems to be that the benefits of deregulation and tax cuts will outweigh any price rises from the implementation of tariffs.

Yet for the rest of the world, the market is pricing in a more negative outlook, and this can be seen in currency fluctuations, as well as bond and equity market volatility.

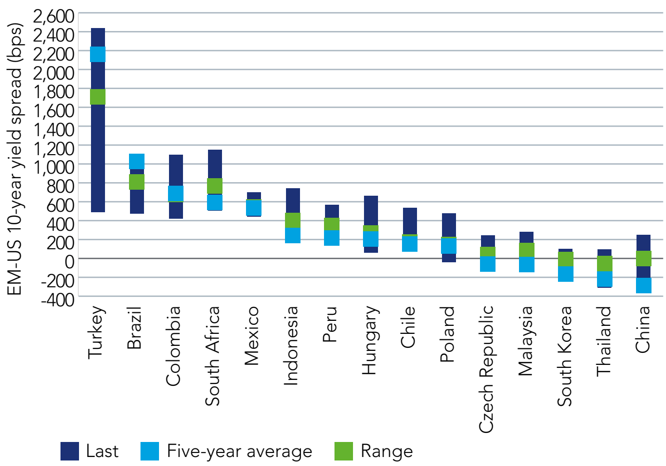
The shifts underway in US fiscal and monetary policy have complicated the outlook for emerging markets. While Chinese sovereign bond yields have dropped considerably for domestic reasons (and are below the US); rising US Treasury yields are limiting the ability of EM central banks to cut rates.

The market was particularly hopeful that the Reserve Bank of India would cut rates in 2025, reversing its less accommodative stance. But with US government bond yields nudging 5% and oil prices around US$80 a barrel, it might be difficult for India's central bank to meaningfully loosen policy.

Similarly, the Central Bank of Brazil looks set to continue tightening policy because of fiscal slippage. It's unlikely to change tack when US Treasury yields are so high.

As illustrated in Figure 3, the EM-US bond yield spread is at the lower end of the last five-year average in most countries (except for Brazil, Colombia, and Mexico)[7].

Figure 3: EM-US 10-year yield differentials



Source: Bloomberg as at 6 February 2025.

Past performance is not a reliable indicator of future performance.

[7] Bloomberg

Investors will be monitoring the implications of the new US administration's policies carefully. At the time of writing, tariffs on Mexico and Canada had been implemented then rescinded, while a suggested tariff of 10% on all goods exported from China to the US had been met with retaliatory tariffs from Beijing. We expect many countries to seek to work with the US on mutually beneficial trade deals.

In terms of EM, Mexico has pledged to shrink its trade deficit with China and boost domestic manufacturing[8] to appease the US; while China is shifting its focus towards the so-called 'global south'[9] to compensate for the loss of US markets for its products.

Beyond this point, we see very little value in trying to pre-empt US government policy as most emerging economies have idiosyncratic drivers that can help mitigate any adverse shifts in global trade.

Country	Drivers
China	Domestic consumption stimulus Resolution of the property sector crisis Solving local government funding issues to kick-start pending projects
South Korea	Stabilisation of domestic politics Focus on 'Corporate Value-Up' programme Rebound in Samsung Electronics' HBM business
Taiwan	Irreplaceable in advanced foundry and broader microchip ecosystem
ASEAN[10]	Steady development of manufacturing Tourism in Thailand, Indonesia, and Malaysia Growth in e-commerce, fintech and digital services due to high smartphone penetration and tech-savvy population
India	Driven mainly by consumption and services Government focus on manufacturing Revival of government capex spending
Middle East	Stable oil prices Ongoing diversification of the region's economies resulting in high levels of investment spend
Turkey	Stabilising/declining inflation The prospect of rate cuts
South Africa	Improving business confidence under the new coalition government
Mexico	A high level of informality in the economy offers a long runway for growth Role in near-shoring for US manufacturing
Brazil	Managing fiscal expectations Potential for better agricultural produce in 2025 (due to La Niña)

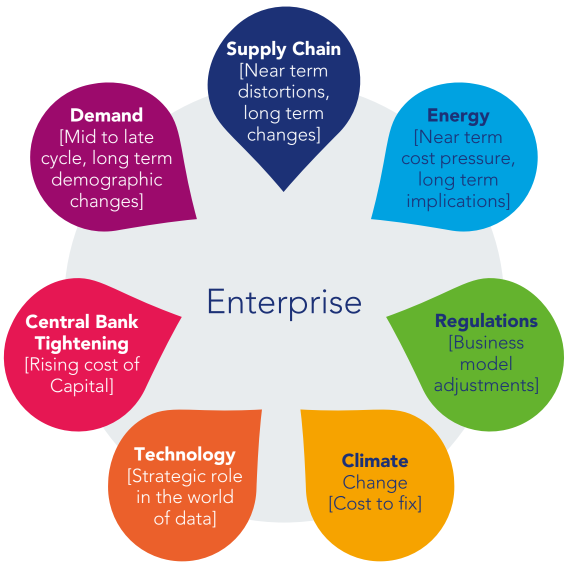
Source: Federated Hermes.

Our investment philosophy (in a complex business environment)

The last few years have seen supply chain fragmentation, trade tensions, rapid digitisation and military conflicts in Ukraine and the Middle East – creating a more complex business environment for many companies.

We have established a framework for evaluating the environment in which businesses operate, and concluded that quality companies are better at handling this tricky and complex backdrop.

Quality companies seldom rely on debt for operations or growth, have better margins and returns, and generally compound earnings steadily over extended periods.



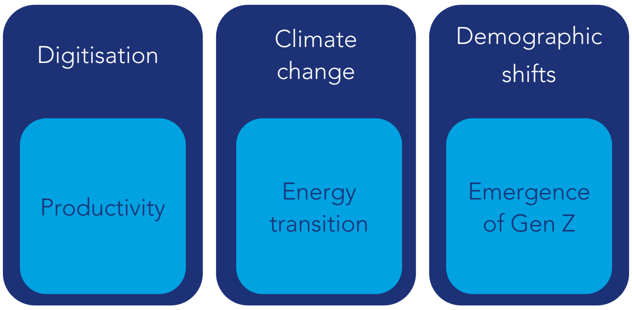
8 Mexico pledges to shrink trade deficit with China in nod to Donald Trump
9 According to UN Trade and Development (UNCTAD), the Global South broadly comprises Africa, Latin America and the Caribbean, Asia (excluding Israel, Japan, and South Korea), and Oceania (excluding Australia and New Zealand).
10 The Association of Southeast Asian Nations (ASEAN) is a political and economic union of 10 states in Southeast Asia: Brunei, Cambodia, Indonesia, Laos, Malaysia, Myanmar, Philippines, Singapore, Thailand, Vietnam.

We continue to believe and have conviction in quality/growth companies with structural drivers trading at reasonable valuations. Returns in the future will be driven by the valuation we pay today and the growth delivered by the business over the coming years. Given the complex global macro backdrop and rising bond yields, it is prudent to assume that richly valued stocks will face a significant de-rating if growth falters – as we see in India now. Hence, we prefer owning quality/growth companies trading at a reasonable valuation and margin of safety.

Trajectory of the world – beyond macro

In the previous section, we provided a flavour of how we invest. In the following sections, we discuss where we invest our clients' (and our) capital.

To help illustrate our approach, we will first discuss three significant global shifts and outline how their implications influence our bottom-up approach to stock picking.



Shift One: digitisation and productivity

We have written extensively about how technology has become secular. In this note, we focus on how rapid developments in digitisation have the potential to greatly increase productivity – as long as enterprises adapt and embrace this change.

The last few years have seen advancements in microchip technology, a rollout of cloud computing capabilities, and an increased awareness about the importance of data. We now stand on the cusp of a potential revolution in Generative AI (GenAI).

GenAI enables machines to interact with people on an unprecedented level, helping to potentially address a multitude of tasks with speed and precision.

The development of GenAI has been possible because of advanced microchip manufacturing; innovations in advanced packaging[11] technologies – including high bandwidth memory (HBM) – and the development of software solutions that integrate Gen AI technology.

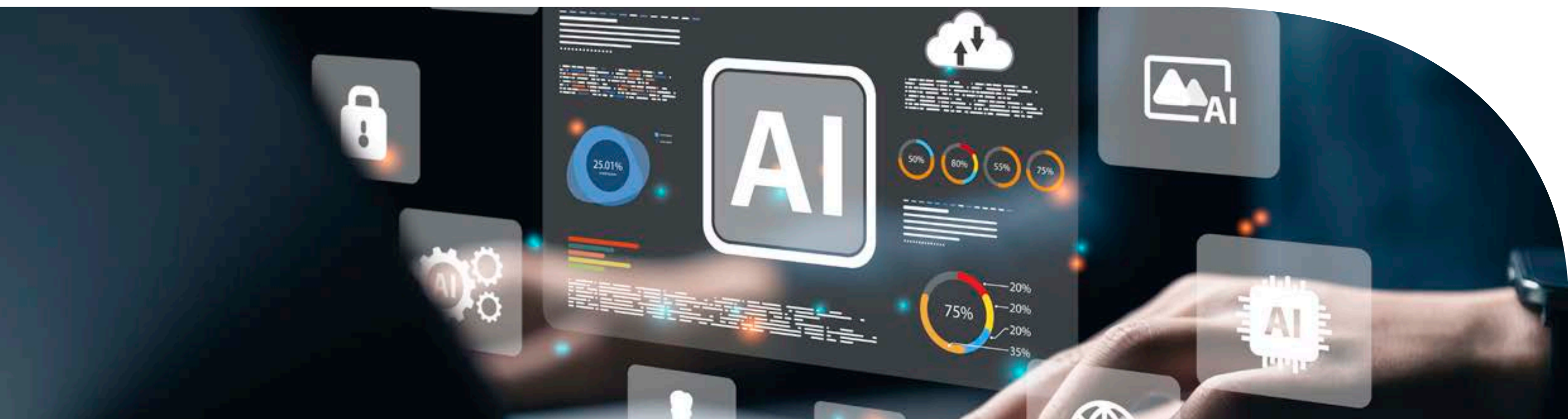
In December, Google updated a list of more than 300 real-world use cases of GenAI[12]. Many utilise 'AI agents' that can plan and carry out tasks on behalf of a user, which could help companies to improve productivity, automate processes and enhance customer experience, among other areas.

The use of GenAI is not limited to the US or developed markets. A number of our portfolio companies have been developing dynamic applications using GenAI in advertising, videos and enterprise software – and even, potentially, humanoids (robotics).

A recent survey by CB Insights[13] found that while GenAI is the leading technology priority for corporate strategy teams in 2025, only 32% of strategy leaders surveyed reported GenAI was being actively deployed at their organisations.

However, most survey participants said their organisations *were* deploying mature technologies (such as AI [non-generative], data management, cybersecurity, and cloud computing). It confirms our belief that such technologies are equally important – and will potentially form the building blocks for future GenAI deployment.

To understand the role of technology in boosting productivity, we need to look at the current state of productivity growth. According to a recent study by McKinsey[14], productivity growth in advanced economies has declined to less than 1% (post-GFC). In recent years, productivity growth in emerging economies has also been falling, towards the levels seen in advanced economies.



[11] Advanced packaging is the aggregation and interconnection of components before traditional integrated circuit packaging where a single die is packaged. Advanced packaging allows multiple devices, including electrical, mechanical, or semiconductor devices, to be merged and packaged as a single electronic device.
[12] Real-world gen AI use cases from the world's leading organizations | Google Cloud Blog
[13] Here's how leading strategy teams are successfully driving generative AI adoption in their organizations - CB Insights Research
[14] https://www.mckinsey.com/mgi/our-research/investing-in-productivity-growth

Figure 4: Productivity growth across all global regions (post-GFC[15])

High growth — Low growth

	Lane/Region	1997-2002	2002-07	GFC	2012-2016	2016-2022
Advanced	Advanced Asia	2.4	2.1		1.5	1.2
	North America	2.6	1.9		0.6	1.2
	Western Europe	1.5	1.1		0.6	0.5
Fast lane	China	5.9	10.9		6.9	6.6
	India	3.4	7.7		6.9	3.1
	Central Europe	5.0	4.8		1.5	2.9
Middle lane	Eastern Europe	4.4	7.0		0.9	1.7
	Emerging Asia	0.5	3.8		3.4	2.9
Slow lane	Latin America & Caribbean	-0.1	2.2		0.6	0
	Middle East & North Africa	0	2.5		1.7	1.5
	Sub-Saharan Africa	1.6	2.7		0.7	-0.1

Source: McKinsey & Company

This decline in productivity growth can be attributed to a number of factors, including: lower capital deployment, the 'de-globalisation' of international trade, the slow progress of institutional reforms, and unfavourable demographic trends.

Surprisingly, productivity growth has not picked up in recent years despite the aforementioned technological advancements. It could prove to be something of a 'lagged impact' as advancements in microchip technology, and the proliferation of cloud computing and digital channels become widespread.

The rollout of digitisation at the enterprise level has been gradual, and as a result its benefits on productivity have been slow to trickle through. In contrast, consumers in much of the world have adopted digital technology quickly as part of their daily lives. As a result, there is a lot of hope that the impact of GenAI on productivity growth will be more meaningful – particularly given the speed at which innovative use cases are being developed.

GenAI has the potential to add US$2.6tn to US$4.4tn in value annually to the global economy across 63 use cases, according to a study by McKinsey[16].

According to the research, about 75% of the value that GenAI use cases could deliver falls across four areas: customer operations, marketing and sales, software engineering, and R&D – providing a significant boost to overall productivity growth[17].

A significant caveat is that workers will need to learn new skills or change occupations altogether and policymakers and businesses may have to navigate workers' expectations carefully.

There are many ways to benefit from the growing use of AI. We have seen the meteoric rise of Nvidia, TSMC, and many other US and Asian businesses in the semiconductor and cloud computing businesses. Nonetheless, we believe that at some point, the growth in the capex/build-out phase will slow down because enterprise adoption of GenAI is still in its early stages, and as with every new technological development, the hype cycle follows a typical trajectory.

According to Gartner[18], GenAI is over the 'peak of inflated expectations'[19] as the business focus shifts from excitement around foundation models to use cases that drive ROI. As a result, our investments not only include GPUs (TSMC), servers (Wiwynn), liquid cooling (Lotes), power management (Delta), networking (Accton) and advanced packaging equipment (ASMPT), but we are increasingly focusing on use-cases and adoption of GenAI. Hence, we have invested in Infosys, a leading IT services and software development business, and Cyient, a leading engineering and R&D service provider, focusing on companies adopting GenAI within our portfolio.

We believe that over the medium- to long-term, an equally large value opportunity will be captured by enterprises that successfully implement GenAI in their business processes, generating new revenue sources and/or running their operations efficiently, helping improve profitability and earnings.

In addition to GenAI use cases in enterprise software and processes, we believe that GenAI will drive the development of the next generation of humanoid robots. Integration of GenAI will help industrial robots become flexible and learn from past experiences. We have invested in Shenzhen Inovance, China's leading industrial automation company. In addition, we have an investment in Sinbon, a Taiwanese supplier of cables (integrated, sensor, high-speed data) and PCB assembly solutions for humanoid robotics.

[15] GFC refers to the global financial crisis – a period of extreme stress in global financial markets and banking systems between mid-2007 and early 2009.
[16] Economic potential of generative AI | McKinsey.
[17] Generative AI could enable labour productivity growth of 0.1 to 0.6% annually through 2040, depending on the rate of technology adoption and redeployment of worker time into other activities. Combining generative AI with all other technologies, work automation could add 0.5 to 3.4 percentage points annually to productivity growth, according to McKinsey.
[18] Gartner 2024 Hype Cycle for Emerging Technologies Highlights Developer Productivity, Total Experience, AI and Security.
[19] https://www.bmc.com/blogs/hype-cycle-peak-of-inflated-expectations/

Shift two: climate change and the energy transition

We now move from technology and its role in improving productivity to our next topic – climate change.

Along with technology and demographics, we believe that climate change is an essential consideration to bear in mind when assessing the trajectory of the world, as it will significantly impact individuals, communities, and businesses[20].

In *The Greatest Balancing Act* (2019), David Attenborough and Christine Lagarde state: "We cannot hope to sustain life without taking care of nature". Attenborough and Lagarde connect a thriving global economy, and long-term human development, with a stable climate and a sustainable environment.

From an EM perspective, thriving economies are central to lifting millions out of poverty and driving social development. As the planet gets warmer, there is a risk that rising sea levels could damage coastal regions and make other areas uninhabitable. In addition to food and water security implications, the displacement of millions of people could lead to mass migration and spark political unrest.

For most investors, the perception might be that climate risk is immaterial or beyond a reasonable investment time horizon. Therefore, the application of climate science to investment strategies has not yet become mainstream.

However, the scientific evidence is increasingly hard to ignore. The recent wildfires in Los Angeles provide a reminder of the devastation that natural disasters can cause. While the role climate change plays in causing natural disasters is debated[21], as long-term investors, we see an obvious need to evaluate the risks – both physical and transition.

Moreover, the physical risks associated with climate change – such as rising sea levels and warmer temperatures – present greater potential threats to emerging economies. Not all EM countries have the financial capacity to address frequent and large-scale devastation. In addition, physical and transition risk may make certain business models obsolete or unviable – requiring investment in new technologies, innovation, and operational adjustments, to enable resilience and business continuity.

Hence, we believe the financial risk to companies and the markets will be meaningful. However, so far, despite US$1.3tn in direct damage (or 0.2% of world GDP on average per year) from climate disasters over the past decade, the average impact on the equity market is relatively modest at approx. 2% for banking stocks and 1% for the whole market, according to the IMF[22].

The IMF observed that of the 350 large climatic disasters over the past 50 years, in only 10% of the cases, the impact on the aggregate market has been greater than 14%. The effects of climate disasters vary by region. For instance, in 2005, US GDP was hit by approx. 1% in the aftermath of Hurricane Katrina, but the event did not destabilise the US stock market. In comparison, the 2011 floods in Thailand caused a 30% drop in the domestic stock market over a 40-day period.

The general lack of concern about climate change in equity markets is surprising. According to research by Munich Re[23], insurers endured the third most expensive year for natural catastrophe losses in 2024 (US$140bn) because of climate change.

Overall, economic losses from natural disasters worldwide reached US$320bn in 2024, compared to US$268bn in 2023 when adjusted for inflation[24].

The world is getting hotter leading to increasingly severe hurricanes, thunderstorms and floods, Munich Re warns.

Close to half of all homes in the US (44.8%), are at risk of severe or extreme damage from environmental upheaval, according to real estate portal Realtor.com. Almost US$22tn in residential real estate is at risk from flooding, wind damage, wildfires, and extreme heat[25].

The knock-on impact could destabilise the housing market, play havoc with prices, and drive up insurance costs, according to economists.

We are also concerned that climate-related natural disasters and their aftermath – including rebuilding, modification and compensation – could prove costly and inflationary, adding to pressure on already-stretched US government public finances.

We can draw a number of conclusions:

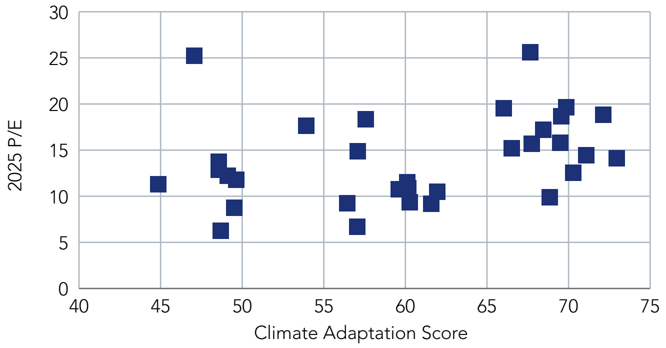
1) Equity markets view the risks of climate change as 'non-recurring', especially in countries that have the fiscal capacity to respond swiftly to natural disasters.

2) Investors are generally sanguine about natural disasters in geographies with well-developed insurance industries, as the overall risks are distributed efficiently.

3) Despite the rising possibility of severe weather events and associated losses, current market valuations do not price any risk from climate hazards.

[20] What are the impacts of climate change? | Grantham Institute – Climate Change and the Environment | Imperial College London
[21] Climate Change Did Not Cause the LA Fires - by Emily Yoffe
[22] Equity Investors Must Pay More Attention to Climate Change Physical Risk
[23] Insured Losses From Natural Disasters Hit $140B as Climate Change 'Shows Its Claws'
[24] Insured Losses From Natural Disasters Hit $140B as Climate Change 'Shows Its Claws'
[25] Climate Risks Threaten Nearly Half of All Homes in the U.S.: What Buyers and Sellers Need To Know

Figure 5: P/E vs. climate adaption score



Overall Climate adaptation score
0-100 Score:
0=Highest climate risk
100=Lowest climate risk

The climate adaptation scores are taken from the University of Notre Dame Global Adaptation Initiative (ND-GAIN). The ND-GAIN Country Index assesses climate risk by combining a vulnerability and a readiness score. Further information can be found here: Source: https://gain.nd.edu/our-work/country-index/rankings/

Source: Federated Hermes/ND-GAIN Country Index/Bloomberg as at 21 January 2025.

Investors apparent lack of attention could become a significant source of market risk in the future, according to the IMF.

Many governments' fiscal space – allowing flexibility in their spending choices – is significantly lower than before the Covid-19 pandemic and bond market vigilantes have been expressing dissatisfaction over the fiscal trajectories of many economies.

In the face of rising debt costs and burdensome welfare spending, the fiscal situation is only set to deteriorate in the G7 and elsewhere.

The challenge of climate change requires an absolute reduction in greenhouse gas (GHG) emissions around the world and material improvements in energy efficiency.

Therefore, an energy transition is imperative, despite the divergence in opinion and policy approach among governments around the world.

Many governments now view 'energy security' as a priority. The digitisation of many countries' economies mean they will require vast amounts of energy to run data centres (to support the AI innovations which are central to future productivity growth).

While hydrocarbons will still have a vital role to play in meeting global energy needs many countries are shifting their models towards renewables, nuclear, hydrogen, and other low-carbon energy sources.

In the face of rising debt costs and burdensome welfare spending, the fiscal situation is only set to deteriorate in the G7 and elsewhere.

Many economies are using liquified natural gas (LNG) instead of coal in industrial applications. Meanwhile, the car industry is shifting towards hybrid and electric vehicles (EVs) in many parts of the world.

The energy transition is evidently underway, but countries will approach it differently.

Many countries will use LNG as a transition fuel[26] – to facilitate the move away from coal – as part of a longer-term shift towards renewable sources, for example. Such choices are dictated by the structure of countries' internal energy systems (or grids).

In the coming decades, we anticipate that power grids will become the most important part of a country's energy transition journey.

The modernisation of the grid represents the backbone of the energy transition[27], according to the Energy Transitions Commission (ETC), a leading climate think tank. The rationale behind this proposition is simple: clean electrification is the vital precursor to the maximum possible reduction in absolute GHG emissions – power grids, therefore, must play a central role in the energy transition.

But to meet the net-zero scenario set out by the Paris Agreement, the total size of power grids around the world must increase by more than 50% by 2050 – requiring US$22.5tn in investment, according to the ETC.

Despite widespread concerns about climate change, progress on the ground has been limited. Not all countries have set a 2050 deadline to achieve net zero. China, for example, aims for carbon neutrality by 2060 and India by 2070.

There is an 80% chance that the annual average global temperature will temporarily exceed 1.5 degrees Celsius above pre-industrial level for at least one of the next five years, according to the World Meteorological Organisation (WMO).

While this near-term warning does not suggest a permanent breach, it highlights the urgency of climate action.

We continue to see opportunities in companies that enable, facilitate or benefit from the climate transition in EM. As such, the portfolio is invested in:

- Grid developers or technology providers in EM (NARI in China, Power Grid in India, and WEG in Brazil).
- Press Metal Aluminium, one of the lowest-cost producers of aluminium, predominantly using hydropower (aluminium plays a key role in light-weighting – improving energy efficiency).
- Gaztransport & Technigaz, a leading provider of technology for LNG transportation (LNG is positioned as a transition fuel).
- VA Tech Wabag, a leading water treatment and desalination technology provider in India and the Middle East (adaptation to climate issues).

[26] How LNG is helping to deliver responsible energy security | World Economic Forum.
[27] Building Grids Faster: The backbone of the energy transition.

- Rumo and Localiza Rent A Car which are uniquely positioned to take advantage of Brazil's large biofuel sector and pro-biofuel policies to utilise lower-carbon biofuels in their vehicle fleets (biofuels are recognised by the IEA as a key medium-term decarbonisation solution for land transport; Brazil's biofuel sector is a world leader).

No analysis of the energy transition and green tech is complete without discussing the role of China. China dominates green manufacturing globally – in electric vehicles, lithium-ion batteries, and solar panels[28], according to the Grantham Research Institute on Climate Change and the Environment.

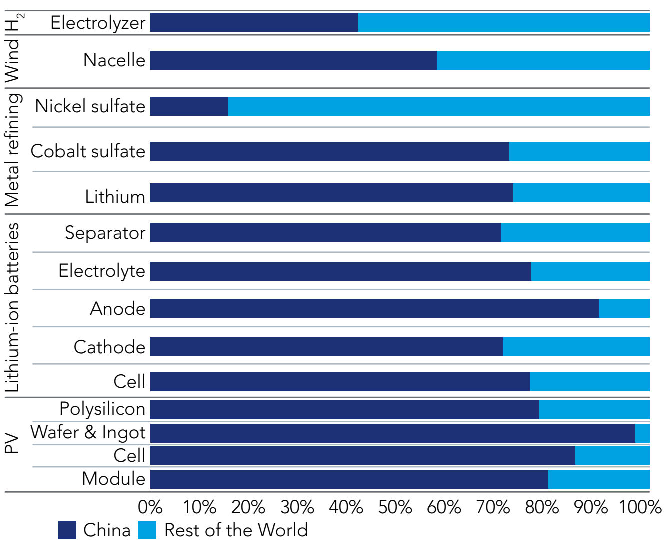
China is a global leader in many critical climate technologies, and the country's policymakers continue to prioritise the green transition.

The country's Belt and Road Initiative has given it a competitive advantage in the downstream processing of key materials – for end use in EV, batteries, solar, and wind power – and it has an indirect influence over the upstream mining of various critical minerals.

Various onshoring initiatives, meanwhile, are in the early stages of development and seek to capture further market share and diversify manufacturing capacity globally.

Overall, we expect China to continue to hold significant global leverage as the energy transition progresses towards net zero in the years ahead.

Figure 6: Clean energy manufacturing capacity by location



Notes: by factory location, PV, hydrogen and battery components epressed in MW, MWh, m² or tonnes. Nickel is the class-1 variety and lithium is in lithium carbonate equivalent. H_2 is hydrogen. Data as of October 2022, except electroysers which refer to a 2021 and nacelle data which are for 2020.

Source: BNEF.

From a risk management perspective, we maintain a very low level of portfolio emissions intensity relative to the benchmark (on a Scope 1, 2, and 3 basis) to mitigate any policy risk that might arise from higher emissions (for example, from the implementation of the EU Carbon Border Adjustment Mechanism[29]).

We believe every company has an obligation to protect the environment and respect the society in which it operates. Businesses that ignore their responsibility or act egregiously will eventually pay a heavy price – in the form of loss of reputation, loss of a social licence to operate, and ultimately, the loss of customers.

The last point about consumer preference is critical, particularly in the context of ongoing demographic shifts. While there is much discussion around ageing populations, investors should not lose sight of the emergence of Gen-Z – because, among other concerns, Gen-Z are known to care about the climate[30].

Shift three: demographic shifts and the emergence of Gen-Z

The third of our three significant shifts concerns demographics. The world's population is set to reach 9.7 billion in 2050 (from 7.7 billion today), according to the United Nations[31].

While the global population is urbanising, the overall population is also ageing. It has been well documented that countries such as India, Indonesia, and Egypt will enjoy a demographic dividend.

While the US should benefit from an increase in population, Europe and East Asia face the most significant demographic shifts towards an ageing population.

As average life expectancy increases, people are living longer. The share of the population aged 60 years and over will increase to 1.4 billion in 2030 (from 1 billion in 2020), according to the World Health Organisation (WHO)[32]. This figure is forecast to reach 2.1 billion by 2050.

The ageing global population throws up a number of social, economic and healthcare implications.

However, another cohort is emerging into a dominant economic force: Gen-Z makes up 30% of the world's population and is expected to account for 27% of the workforce by 2025, according to Zurich Insurance[33].

It is a generation that is digitally savvy and spends significant time navigating sites, apps and social media on their mobile phones.

[28] China's role in accelerating the global energy transition through green supply chains and trade - Grantham Research Institute on climate change and the environment.
[29] **The EU Carbon Border Adjustment Mechanism** is a carbon tariff on carbon intensive products, such as steel, cement and some electricity, imported to the European Union. Legislated as part of the European Green Deal, it takes effect in 2026, with reporting starting in 2023.
[30] Gen Z, worried about climate change, unified in holding politicians responsible: Poll - ABC News.
[31] Shifting Demographics | United Nations.
[32] Ageing and health.
[33] How is Gen Z changing the workplace? | Zurich Insurance.

Gen-Z is also idealistic with strong views around climate change, purpose and accountability, diversity and inclusion, and sustainability, according to McKinsey[30].

Businesses need to understand Gen-Z, both as consumers and as a workforce. Gen-Z has different perspectives compared to older generations: salaries and the career ladder is less important, while there is a greater emphasis on work flexibility, according to Zurich Insurance[31].

As consumers, Gen-Z has distinct habits[32]. They prefer access over ownership, experiences over luxury, superior user experiences, multi-channel shopping and a preference for brands with a strong sense of purpose.

In one McKinsey study[33], 73% of Gen-Z respondents said they sought to purchase products from companies they considered 'ethical'; and nine out of ten respondents said they believed it fell to companies to address environmental and social issues.

Gen-Z also claim they can tell when a brand is paying 'lip service', and not backing up diversity or sustainability claims with viable action.

87%

Gen Z consumers believe that companies have a responsibility to address environmental and social issues.

Demographics is a challenging topic. On the one hand, many regions of the world will have to grapple with the issues of an ageing population; and on the other hand address the emergence of Gen-Z, Gen Alpha and Gen Beta.

By 2035, the composition of the world's population will differ materially from today, creating compelling investment opportunities.

While we like the structural opportunity healthcare companies offer, we are also optimistic about the prospects of internet-focused businesses across emerging markets. We particularly like businesses operating in gaming and entertainment, e-commerce, recruitment, real estate, food delivery and q-commerce[34].

Because of their size and scale, we're drawn to Chinese internet players (Kanzhun, DiDi, KE Holdings) and Prosus (a subsidiary of Naspers) allowing us to access dynamic internet businesses in a variety of emerging economies.

Prosus has established a meaningful presence in India (via food delivery and q-commerce business Swiggy, digital payment solutions PayU, e-commerce start-up Meesho, and online jewellery seller Bluestone). Prosus has also acquired Latin America's leading online travel agency, Despegar.

We have exposure to Southeast Asia's digital industry via Grab, a leading super app, which provides everyday services like deliveries, mobility, and financial services. Among the internet businesses we own in China, we have exposure to Kanzhun which operates the Boss Zhipin app and is a leading mobile-native recruitment business. Kanzhun is unique in terms of its technology, which connects hiring managers to job seekers using AI technology.

We also have investment in the Chinese ride-hailing app DiDi, which also operates across Latin America, where it benefits from structural growth drivers and limited competition.

Federated Hermes GEMs Equity – investing for a transforming world

Despite the uncertain macroeconomic and geopolitical backdrop, we believe that the megatrends outlined in this report – digitisation, climate change, and demographics – stand to drive change in the global economy and business landscape for years to come.

As a result, we have opted to primarily invest in companies that we expect to benefit from this transformation, which we view as inevitable.

On the flip side, we have a lower preference for chasing momentum trades or investing solely for a dividend yield.

As bottom-up stock pickers, the last few years have presented a great opportunity to invest in quality companies at reasonable prices amid wider macroeconomic and geopolitical concerns. While we are not ignoring these concerns, beyond a point, we do not see much value in attempting to forecast macroeconomic trends – because multiple outcomes are possible.

Hence, our preference for quality/growth stocks, as highlighted previously.

[30] What is Gen Z? | McKinsey.
[31] How is Gen Z changing the workplace? | Zurich Insurance.
[32] What is Gen Z? | McKinsey
[33] 'True Gen': Generation Z and its implication for companies.
[34] Q-commerce, also referred to as quick commerce, is a type of e-commerce where emphasis is on quick deliveries, typically in less than an hour.

Nonetheless, it is important to note the following points:

1. **Emerging markets have now underperformed for almost 14 years:** Over the last 30 years, there have been two major periods of EM outperformance lasting five to 10 years. The first period was driven by the Washington consensus reform era (late-1980s to early 1990s) following a decade of crisis and economic instability. The second period was driven by a combination of reform to Asian economies in the aftermath of the 1997 Asian financial crisis, a commodity supercycle and China's supercharged GDP growth (2001-2010). Both periods coincided with phases of dollar weakness.

Figure 7: Periods of EM outperformance over the last few decades

Emerging markets vs. developed markets

Source: : Bloomberg as at 6 February 2025. MSCI EM divided by MSCI World (USD).

2. **US exceptionalism – how long will it last?** It is hard to call the end of US exceptionalism. Nonetheless, we believe long-term investors should consider these facts.

   a. **National debt:** The US had a national debt of US$36tn[35], and a fiscal deficit of US$1.83tn[36] in 2024. Over the last few decades, US government dependency on foreign lenders has increased from 23% in 1995 to 29% in 2023[37]. Total foreign holding of US debt is US$7.9tn (as of 2023).

   b. **Fiscal deficit:** A moderate fiscal deficit is not an issue if the gap is spent on productive areas. However, the US government spent 3% on education and training, 2% on environment, and 2% on transportation in 2024 – compared to 36% on welfare payments (social security/ income security/veterans benefits), 15% on defence, and 13% on net interest payments[38]. The rise of bond vigilantes globally suggests it's not going to be easy for the US government to continue such fiscal profligacy without any impact on US Treasury yields and interest rates.

   c. **Competing blocs:** The BRICS alliance now consists of 10 countries, including Saudia Arabia and Indonesia[39]. It represents almost half of the world's population and aspires to be an alternative to the G7. The group has discussed alternative currencies, global institutions and payment systems, albeit with limited progress thus far due to various internal differences. The Western order could face a serious challenge if the BRICS were to put these differences aside and agree on key policies.

   d. **Energy:** At present, the US has considerable energy security. But as climate-change-related natural disasters increase in economic and cost significance, the US will have to expedite its energy transition which could potentially challenge its hegemony in energy.

   e. **Domestic inequality:** Inequality in the US is on the rise and has widened over the past 40 years, increasing by more than 40% between 1980 and 2021, according to the US Department of Commerce[40]. Millions of people in the US are living in communities with few or dwindling economic opportunities,

3. **Emerging market reforms are back on the agenda:** A number of EM economies have embarked on ambitious reform programmes. India has stepped up its reform efforts since 2014; South Korea has introduced its Corporate Value-Up Programme to improve corporate governance; China has introduced SOE reforms; Turkey has shifted back to economic orthodoxy; and the coalition government in South Africa has improved business confidence.

4. **China's policy pivot:** China's policy priorities have shifted to stabilising the property market, addressing local government debt, stimulating domestic consumption, recapitalising its banks, and supporting its equity markets. We expect policymakers to loosen its fiscal deficit target for 2025 to support the economy and address the risk of deflation.

5. **Vulnerability in EM:** We do not see underlying economic vulnerability[41] in any leading EM country (with the exception of ongoing fiscal concerns in Brazil). EM exporters face general currency depreciation risk from US tariffs (and the risk of FX reserves depleting if central banks decide to intervene).

We continue to monitor economic vulnerability, valuations and growth prospects to ensure the risk/reward positioning in our portfolio is appropriately considered.

It's worth reiterating that while our portfolio is geographically diversified – with investments in more than 18 countries worldwide – it is concentrated in a few sectors, highlighting our focus on tapping megatrends and investing in companies that can navigate the challenging macroeconomic backdrop.

[35] Understanding the National Debt | U.S. Treasury Fiscal Data.
[36] National Deficit | U.S. Treasury Fiscal Data.
[37] The Federal Government Has Borrowed Trillions. Who Owns All that Debt?
[38] Federal Spending | U.S. Treasury Fiscal Data.
[39] BRICS is an intergovernmental organization consisting of ten countries: Brazil, Russia, India, China, South Africa, Egypt, Ethiopia, Indonesia, Iran and the United Arab Emirates.
[40] Geographic Inequality on the Rise in the U.S. | U.S. Department of Commerce.
[41] Our vulnerability matrix considers macro risks evaluating numerous metrics such as – forex reserves, import cover, inflation, current account, fiscal deficit, short term foreign debt, real interest rates, and spread over US rates.

We provide a few examples below of companies in our portfolio that reflect our preference for investing in wider global trends:

Lotes (digitisation)

Lotes is headquartered in Taiwan and specialises in designing and manufacturing electronic interconnect and hardware components, including connectors, central processing unit (CPU) sockets, coolers and antennas. The company plays a critical role by supplying essential components for AI servers, such as universal quick disconnects (UQD) and graphics processing unit (GPU) sockets. These components are vital for the efficient operation and cooling of AI systems.

VA Tech Wabag (water treatment)

VA Tech is a key player in the Indian and Saudi Arabian water treatment industry. The company has capabilities across water and sewage treatment and desalination. India and the Middle East have water availability issues and Tech Wabag is well positioned to expand business and order flow.

Gedeon Richter (women's healthcare, central nervous systems)

Gedeon Richter is headquartered in Hungary and operates globally. The company covers many important therapeutic areas, including women's healthcare, central nervous systems, and cardiovascular health. Gedeon Richter discovered cariprazine, an antipsychotic medication used to treat schizophrenia and bipolar disorders. Cariprazine is sold under the brand name Vraylar.

Kanzhun (mobile-native online recruitment)

Kanzhun operates a popular mobile-native recruitment app in China called Boss Zhipin. With its AI-powered technology, the app can connect employers with the right job seekers, lowering recruitment expenses and enhancing the employer's user experience.

Shenzhen Inovance (industrial automation)

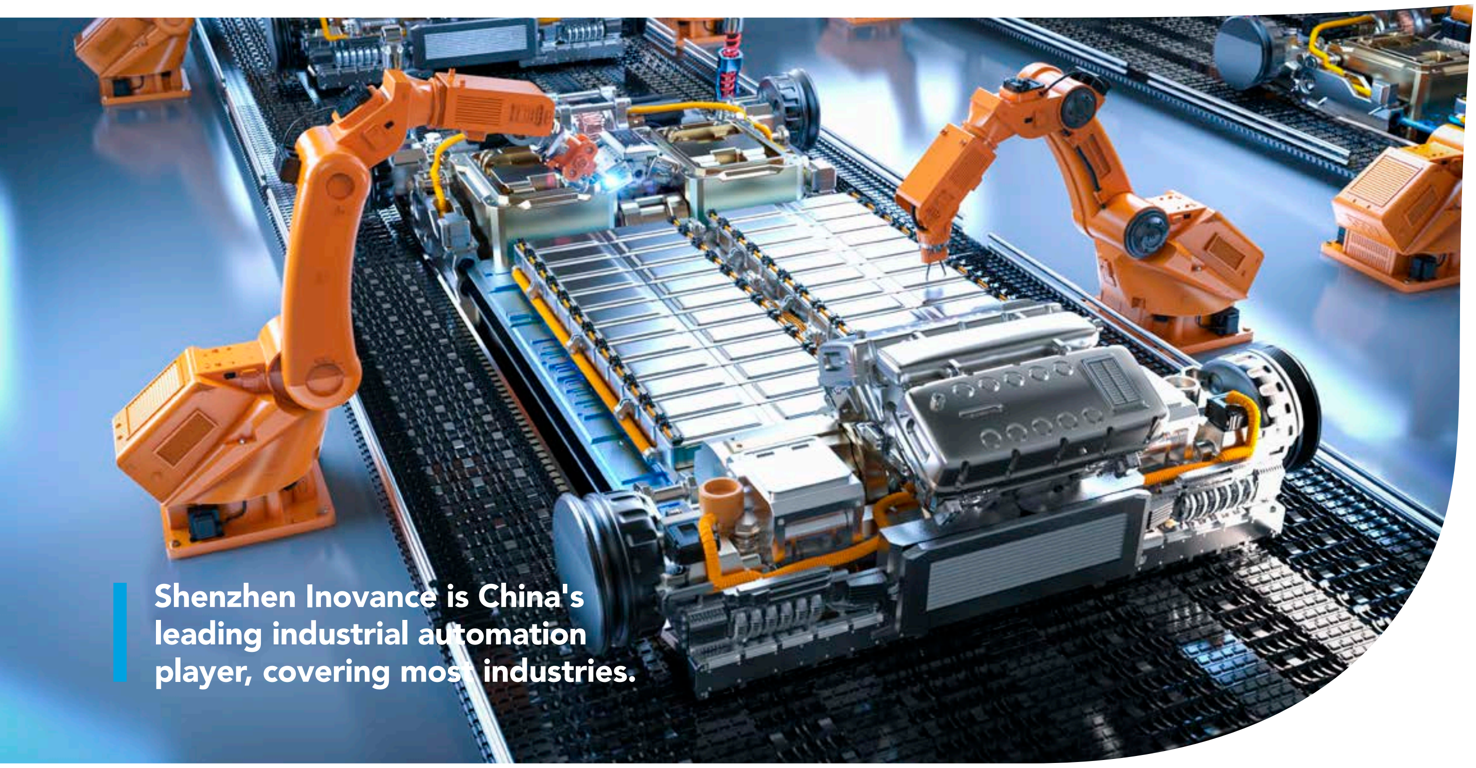
Shenzhen Inovance is China's leading industrial automation player, covering most industries. The company has benefited from the structural growth of EVs, solar, and batteries, and the increasing penetration of automation in traditional sectors.

Press Metal (aluminium)

Malaysia's Press Metal is a low-cost producer of aluminium. Manufacturing aluminium is extremely energy intensive, however, Press Metal's smelters are mainly reliant on hydropower, providing a sustainable low-cost energy source and giving the company a tremendous competitive advantage and a 'green premium'.

Banorte (digital banking)

Banorte is the second-largest bank in Mexico – with 12 million customers – and has benefitted from the steady formalisation of the Mexican economy. In 2024, Banorte launched a digital bank and plans to add 2.8 million new clients over the next five years.



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