GLOBAL EMERGING MARKETS

MARTIN CURRIE
A Franklin Templeton Company

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For institutional, professional and wholesale investors only

2023 OUTLOOK

Despite a difficult 2022, we remain focused and optimistic about the long-term outlook. 2023 has the potential to see emerging markets decouple from their developed market peers and outperform.

Overview

With developed markets struggling under the burden of inflation levels not seen in decades and recessionary risks increasing, emerging markets equities look well placed in 2023.

As has been the case for much of the last decade China is key to the emerging markets equity outlook. The tight fiscal and monetary policy employed throughout the pandemic, combined with the Zero Covid policy has led to subdued growth and lower confidence in Chinese equities. This has also impacted the perception of the broader emerging markets asset class. Now as 2022 draws to a close, China is finally making the clear policy shift the market had been hoping for with the recent relaxation of certain Covid policies and definitive support for the troubled property sector. China is now in an interesting place, in sharp contrast to many developed markets, with easing policy and the potential for a significant economic rebound as Covid restrictions finally ease.

The divergence of economic cycles is likely to attract investors back to emerging markets. Despite the gloomy global economic environment, emerging market equities look poised to spring to life in 2023.

2022 was a market where we saw some divergent growth in emerging markets. Due to positive impacts from structural factors and policies, both Brazil and India were both strong. Brazil was one of the earliest markets to hike rates and its monetary policy is set to ease over the coming year. India continues to deliver the strongest growth amongst the large economies, fuelled by strong domestic demand. However, not all is rosy in emerging markets. We see some earnings pressure from technology-focused stocks in countries like Korea and Taiwan. Technology supply chains are entering a period of de-stocking, but much of that has already been discounted into their share prices.

In 2022, share prices have responded to what have been significant changes in investment conditions at both country and sector levels. We will enter 2023 with emerging market stocks trading on close to 10x price-to-earnings ratios, well below the average of the past decade. This reflects expectations of slowing global growth as the effects of higher interest rates start to weigh on consumption. Corporate earnings growth is likely to be lower overall in 2023, following a strong recovery from the Covid pandemic in 2021 and 2022, as the commodity boom seen this year is unlikely to be repeated.

Reflecting this, our portfolio positioning has remained broadly unchanged. We continue to find attractive investment opportunities across a broad range of countries and industries. Because our investment horizon focuses on the longer term, we remain excited by the powerful combination of technology adoption, urbanisation and services sector growth that is evident in emerging markets. We expect our highly selective, stock-focused approach will prosper through accessing companies with a high return on equity that operate in structurally growing industries.

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Key expectations for 2023

- Emerging markets are in a favourable position to lead global equities, currently trading at a discount to their developed market peers[1]. We will continue to find attractive investment opportunities across a broad range of sectors and industries as we remain focused on long term investment horizon.
- China will continue to be a key determinant of emerging market returns, given its prominence in the region, and we can see a path towards recovery in domestic growth enhanced by further relaxation of Covid policies.
- Microeconomic and Macroeconomic factors will both be important. We expect our investment companies and our key sector exposures to benefit from above-market earnings momentum.
  - Our most overweight sectors also offer strong earnings potential with forecasts sitting at 10-20% EPS growth for information technology, +20% for consumer discretionary and +15% for financials.[2]
- As highlighted below in Table 1, inflation remains relatively benign in emerging markets which gives central banks more optionality. Monetary policy is likely to be divergent across regions. emerging markets economies have the opportunity to decouple from G7.

Table 1: Country CPI YoY

	Emerging Markets					Developed Markets				
	China	India	Korea	Saudi	Taiwan	Hong Kong	Japan	US	Germany	UK
CPI YoY	2.7	6.0	5.9	2.9	2.9	2.7	2.9	8.3	8.5	8.7

Source FactSet at 5 December 2022. CPI data is YoY on a quarter end basis so presented numbers are for latest completed period, Q3 2022 to end September 2022.

2022's pain, 2023's gain

Investor confidence has been negatively impacted over the past 18 months by price inflation, rising interest rates, and heightened geopolitical risk. While this has led to a significant sell off in many of the world's financial markets, outcomes within emerging markets have been more varied. Countries and sectors with positive exposure to rising commodity prices and rising interest rates have fared well both in terms of earnings delivery and share price performance. Inversely, commodity importing countries have disappointed.

In the second half of 2022, growth expectations in the technology sector have come under pressure due to an anticipated slowdown in global demand. Concerns have heightened around inflationary pressures impacting consumer demand and this has weighed on equity performance. During this period, we also saw expectations surrounding Chinese domestic growth dampen in response to ongoing Covid lockdowns and declining activity in the property sector. However, more recently there has been some more positive news flow out of China. Several government measures have been announced to support the property sector as well as some relaxation of Covid related restrictions.

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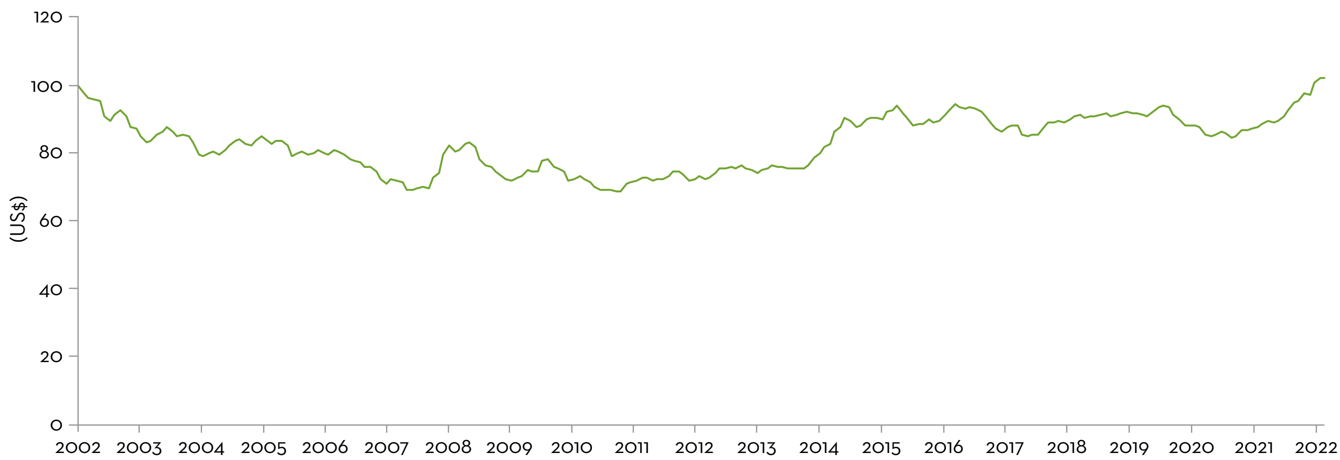
[1]See figure 5, showing MSCI Emerging Market index relative to the MSCI World Index looking at price-to-earnings using next-twelve-months forecasted earnings, MSCI Emerging Market Index is trading below the 20Y average.

[2]Source: FactSet as at 22 November 2022. Earnings per share growth – consensus for 2022.

Impact of the US Dollar

The strong US dollar had a dominating impact on global markets, and this has been seen in emerging markets performance as well.

Figure 1: US$ currency performance



Source: FactSet, at 5 December 2022. US$ performance shown by USD Major Currencies Fed Index.

For the key emerging markets and non-US markets, returns in US dollars have been negatively impacted by currency translation effects, as demonstrated in Table 2.

Some emerging market currencies have been more resilient – down ~5% compared to their developed nations where depreciation against the dollar has been almost double that[3].

We expect the strong dollar backdrop to alleviate in 2023. Emerging markets have a better inflation outlook, and most of the currency depreciation experienced year to date reflects market expectations of higher terminal rates in the US and the developing world.

Table 2: MSCI Country index returns in local currency and US$ returns

	Stock market returns in local currency	FX change	FX% of total	Total return in US$
South Korea	(19.8)	(12.1)	37.9%	(31.8)
Taiwan	(17.7)	(11.0)	38.3%	(28.7)
China	(19.8)	(12.1)	37.9%	(31.8)
Saudi Arabia	(1.8)	(0.2)	9%	(2.0)
South Africa	1.9	(8.2)		(6.3)
India	4.7	(8.8)		(4.1)
Brazil	7.4	4.5	38%	12.0
France	(6.2)	(8.5)	58%	(14.7)
Germany	(10.5)	(8.5)	45%	(19.0)
Japan	(5.6)	(18.7)	77%	(24.2)
United Kingdom	2.7	(11.3)	132%	(8.6)
United States	(15.2)			(15.2)

Source Bloomberg at 11 December 2022. Data shows relevant MSCI index country returns year-to-date in local currency and US$.

[3]Source: Reuters as at 9 December 2022. Looking at MSCI EM currency index (US$) and G10 countries currency compared to USD used as comparison, data year-to-date as at 6 December 2022.

Impact of commodities

Commodities outperformed during 2022 and as such commodity linked countries also outperformed.

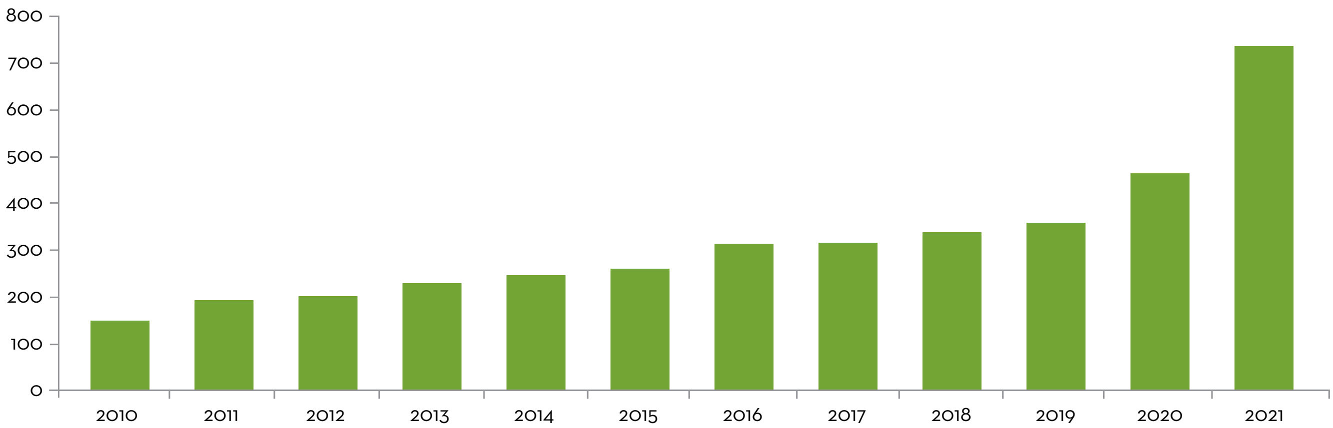
Figure 2: Bloomberg Commodity Index price level

Source: FactSet as 5 December 2022. Bloomberg Commodity Index price level.

The impact on commodity markets from the Russia-Ukraine conflict demonstrated that the equity markets in commodity-rich or commodity producing countries experienced a boost to performance.

Brazil made broad based gains this year, with energy and mining companies leading the way. As a commodity-rich region, it stands to benefit from the supply chain disruption in Russia, as well as from investors' diversification efforts. Brazil is one of the largest producers of soybeans, corn, sugarcane, and coffee. The country has seen significant growth in agricultural value and is now the world's 3rd largest agricultural producer behind the US and EU[4].

Figure 3: Agricultural production value in Brazil from 2010-2021 (in billion Brazilian reals)



Source: Statista as 14 December 2022.

The increase in oil prices and US rates has also been beneficial to the Middle East region. Over the course of 2022, the Middle East increased as a proportion of the emerging markets index by 24.4%[5]. Although still volatile and above previous levels, commodity prices have pulled back, as has the oil price. This volatility can be seen in the performance of the Middle East regions, where stocks that have their performance more closely tied to these factors have a more dominant position.

[4]Source: USDA as at 14 December 2022. Article is "Brazil's Momentum as a Global Agricultural Supplier Faces Headwinds".

[5]Source: FactSet as at 8 December 2022. Data compares the % weight of the 4 Middle Eastern countries in the MSCI Emerging Markets index (Kuwait, Qatar, Saudi Arabia and United Arab Emirates) as at 31 December 2021 and 8 December 2022.

2023: time for a renaissance in emerging markets?

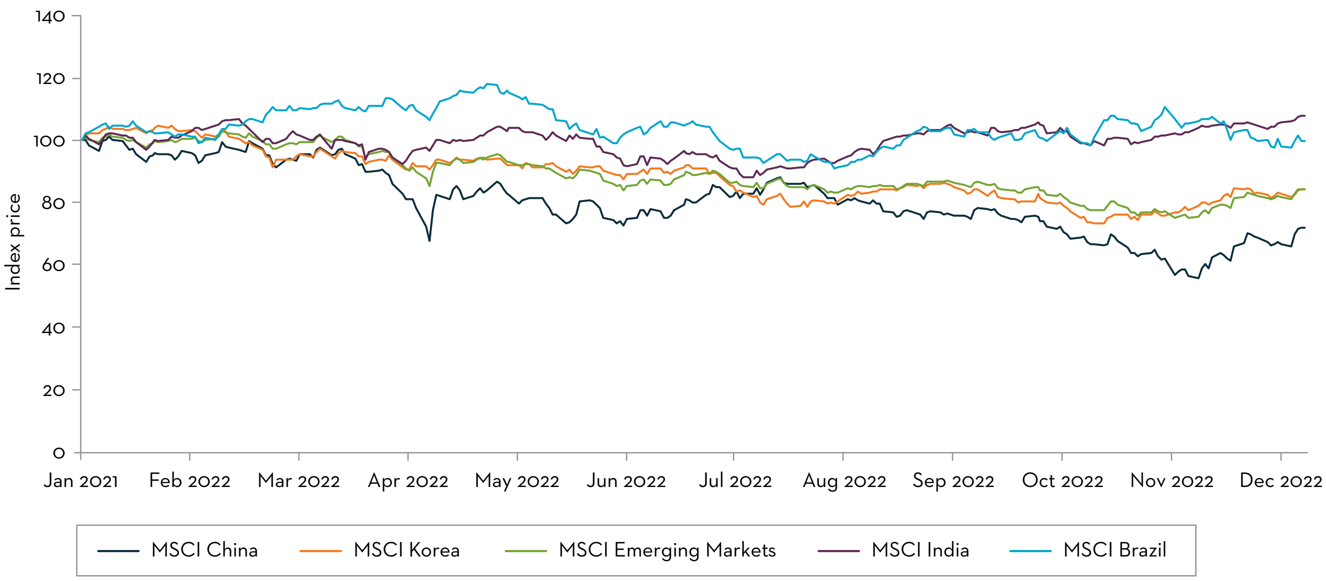
We continue to be excited by the long term opportunities in emerging markets

Despite a wide variance in individual performance, share prices have responded rationally to what have been significant changes in investment conditions at both a country and sector level. Reflecting this, our portfolio positioning has remained broadly unchanged. We are confident that the long-term investment case for emerging markets remains strong and we retain high conviction in our portfolio holdings. The market consistently undervalues high quality, sustainable growth companies and despite the current style rotation we believe that in the long term, investing in these companies will yield results.

Divergent country performance and emerging markets valuation

As discussed, during 2022 the impact of foreign currency and disparate moves in commodities has resulted in a wide range of performance amongst the various countries within the emerging markets space.

Figure 4: MSCI index price performance over the last 12 months



Source: FactSet as at 5 December 2022. Data shows indexed price performance since 1 January 2022.

The current valuations of emerging market economies are wide ranging as shown below in Table 3, with markets such as India trading at near 22x forward multiples versus China trading at sub 10x.

Table 3: MSCI Country index valuations

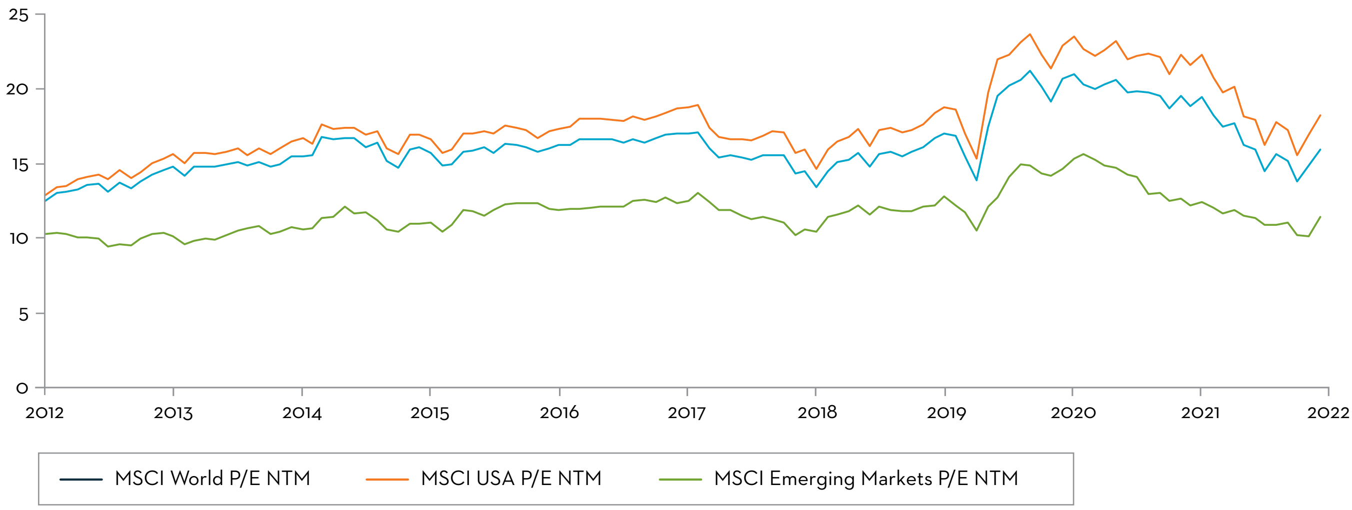
	NTM P/E				
	NTM P/E	5 yr avg	Rel to emerging markets	5 yr avg	Rel % gap to 5 yr avg
MSCI Brazil	6.9	14	0.7x	1.1x	(40%)
MSCI China	9.6	14	0.9x	1.1x	(17%)
MSCI India	21.7	18	2.1x	1.5x	41%
MSCI Korea	8.8	9	0.8x	0.7x	19%
MSCI Taiwan	10.4	14	1.0x	1.1x	(8%)
Saudi Arabia All Share	15.6	13	1.5x	1.0x	42%

Source: FactSet as at 1 December 2022.

Furthermore, emerging markets are trading at a significant discount to global equities as well

The valuation gap relative to developed markets is sizable, as can be seen in Figure 4, with the MSCI Emerging Markets index currently trading at a 27% discount to the MSCI World index[6].

Figure 5: Index Price-toEarnings ratios over last 10 years



Source: FactSet at 5 December 2022. Indexes shown are MSCI World, MSCI USA and MSCI Emerging Markets.

Looking at the current landscape, emerging markets are trading at a discount to their developed market peers. At an index level, as shown in Figure 5, emerging markets are trading below the 20-year average on a price-to-earnings ratio. We expect this to attractive relative valuation to close as the negative sentiment around emerging markets lessens and companies deliver on the expected earnings growth. Looking at the current forecasts for global growth, emerging markets are expected to grow at 3.7% vs developed markets at 1.1%[7].

Figure 6: Relative P/E

Source: FactSet at 5 December 2022. Price-to-earnings shown over 20 years using expected next twelve months earnings.

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[6]Source: Factset at 14 December 2022.

[7]Source: IMF World Economic Outlook: Countering The Cost-Of-Living Crisis October 2022, page 9. Data shown is for projected GDP growth.

Additionally, emerging market countries look to have the advantage over their developed market peers with monetary policy. Having gone through the period of dollar strength (as seen in Figure 1) we see the potential for this to reverse during 2023 as we see a pull back on rate hikes and the potential for rate cuts. Additionally in emerging markets, although likely to be divergent across regions, looking at countries such as Brazil where the interest rate cycle of increases is sitting almost a full year ahead of their developed market peers, the monetary policy position looks favourable for the year ahead.

Idiosyncratic India

During 2022, one of the best performing markets amongst emerging markets was India. Given the level of uncertainty investors have faced this year, India has been seen favourably as it continues to deliver growth and has shown itself to be a more defensive market. India's growth is predominantly linked to domestic demand and is less reliant on global growth drivers such as export/trade flows.

From a country perspective, during 2022 India was one of our strongest countries. Much of this performance came from stocks exposed to consumption trends, and we see positive signals for this to continue driven by strong consumer demand. The consumer sector companies we are exposed to, continues to benefit from the long term trend around formalisation, with market share moving away from the unregulated informal space and into the more tightly regulated formal space (licensed, tax paying businesses). The direction of travel in India is for increasingly tight regulation and formalisation, which benefits companies we have exposure to in the space which have strong governance practices and adherence to government legislation.

The Indian financial sector has also been a key area for us as well. Rising income levels are resulting in consumers entering new financial segments, while housing affordability combined with lower mortgage rates has resulted in more loan demand. Corporate India is also undergoing a renaissance with our banks seeing some of their strongest loan growth in decades.

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Continued (and renewed) case for China

China headlines this year were dominated by China's Dynamic Zero Covid Policy and the strengthening control of Xi Jinping in the Politburo Standing Committee. We believe that 2023 will show a movement towards more dynamic Covid policies and an increasing emphasis on technology leadership for Chinese companies.

Our investments in China are underexposed to key challenging areas: 1) Covid-linked consumption 2) Chinese real estate. Our exposures are aligned with structural growth trends, including:

Digitisation

Healthcare

Green energy

Financial inclusion

We are seeing growth rates that are very strong and significantly above the weakened GDP currently in force. We believe these companies have broad based, diversified pools of growth to source from and that their growth destinies are not intrinsically linked to general Chinese growth. We expect that high quality, sustainable growth companies will weather any short-term market pessimism, leading to long-term success in 2022 and beyond.

Looking beyond 2023

Looking at the longer-term picture, we remain excited by the powerful combination of technology adoption, urbanisation and services-sector growth that is evident in emerging markets. We expect our highly selective, stock-focused approach will prosper through accessing companies with a high return on equity, operating in structurally growing industries. Additionally, the current environment we are in with regulatory pressures, human conflict and an ever-evolving macro environment, continues to underline the importance of focusing on strong ESG characteristics and sustainable growth as a critical determinant of which companies will remain relevant and stay ahead of the curve in the long run.

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- This strategy may hold a limited number of investments. If one of these investments falls in value this can have a greater impact on the strategy's value than if it held a larger number of investments.
- Smaller companies may be riskier and their shares may be less liquid than larger companies, meaning that their share price may be more volatile.
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