GLOBAL EMERGING MARKETS

MARTIN CURRIE

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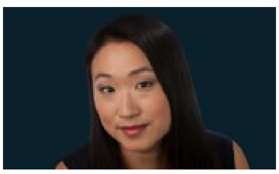
For institutional, professional and wholesale investors only

HEADWINDS AND TAILWINDS: WHO STANDS TO BENEFIT FROM THE NEW INVESTMENT LANDSCAPE?

Recent market events have shaken us all and, although the long-term investment outlook for emerging market equities remains positive, we thought it pertinent to revise our outlook in the shorter term. Against the backdrop of new developments and ongoing trends, we highlight some of the sectors we think will face headwinds and those which may benefit from tailwinds in this new environment.

Alastair Reynolds

Portfolio Manager



Susan Gim

Investment Client Portfolio Manager

How has the investment landscape changed?

Since releasing our *Global Emerging Markets Outlook 2022* earlier this year, the asset class has experienced a multitude of events. In light of these developments, we thought it prudent to update our outlook and provide some insights as to which sectors may face headwinds or, indeed, stand to benefit from the market environment as it is today.

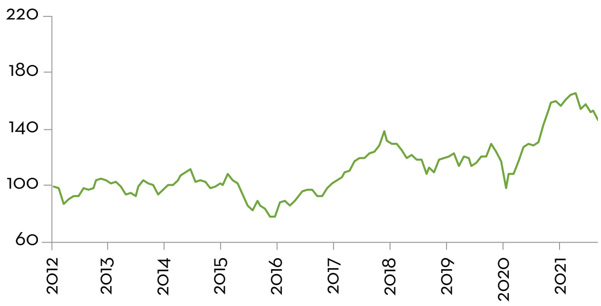
In 2022, we have seen the continuation of a global style rotation away from growth stocks, towards value. In particular, the value stocks which have benefitted most strongly from this change in sentiment have been typically low quality, cheaper tranches. We already highlighted in our January Outlook that emerging market equities have been trading at or near all-time lows relative to developed market equities. The style rotation and broad equity market downturn has pushed emerging market valuations even lower. The market's valuation has deviated meaningfully from individual company fundamentals but this does present an opportunity; while the underlying fundamentals remain strong, the long-term investment case remains intact and the valuation gap may be even more attractive than the start of the year.

Figure 1. Relative Price/Book MSCI Emerging Markets vs MSCI World

Source: FactSet to 31 March 2022. Price/Book ratio period is the next 12 months.

The macro environment is not dissimilar to the start of the year, with rising interest rates, inflation and the management of Covid-19 ongoing themes. We have continued to see additional proposed domestic regulation in China and a broad slowdown of that market impacting equity performance. As a key constituent of the asset class this has naturally driven the MSCI Emerging Markets Index lower too. Uncertainty and negative sentiment in this market was further fuelled by pressure being placed by the US regulator on Chinese companies to disclose audited financial statements or risk being forced to de-list – another continuing dialogue since last year. Read about it in more detail in our *recent note*.

Figure 2. Price performance of MSCI Emerging Markets over 10 years



Source: MSCI to 31 March 2022.

Russia's conflict with Ukraine has also played a central role during the period, initially sparking volatility and market uncertainty as tensions rose, followed by sanctions and illiquidity upon Russia's invasion at the end of February. As markets came to terms with the trading suspensions, sanctions and broad market volatility, further concerns arose over supply chain disruption risk, particularly in the energy and commodities sectors due to Russia being a key producer and exporter.

Given these changes, we wanted to highlight some sectors and industries which might stand to benefit from these developments and those which may find these conditions more challenging.

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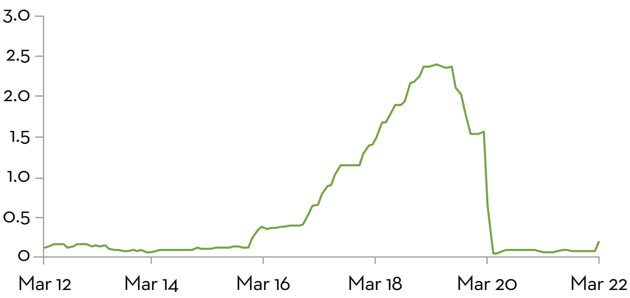
Headwind or tailwind – who stands to benefit?

Financials

Under a backdrop of higher interest rates in the US and several emerging market economies, we see positive implications from the top down as well as bottom up for financials.

Typically, we observe higher rates impacting financial stocks through higher revenues from loan and investment books. Financials are the strongest performing sector year-to-date in MSCI emerging markets.

Figure 3. Monthly Federal Funds Effective Rate in the US (%)



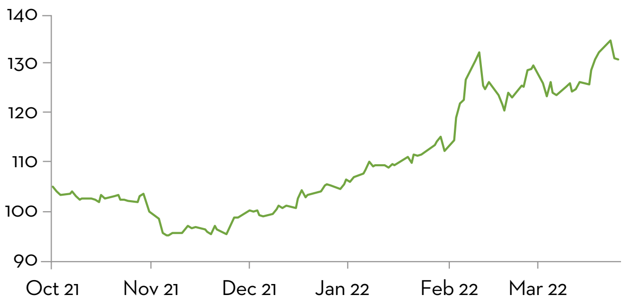
Source: Statista and St. Louis Fed (fred.stlouisfed.org), April 2022.

Latin American stocks, particularly in 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 and the East, as well as from investors' diversification efforts.

The increase in oil prices and US rates has been supportive of Middle Eastern equities this year too – further compounded by the style rotation which has favoured value-oriented stocks over quality growth stocks.

Figure 4. Bloomberg Commodity Index price level

The index saw a sharp rise at the beginning of the Russia-Ukraine conflict and has maintained high, yet volatile, levels since.



Bloomberg, to 26 April 2022.

Commodity-rich countries and sectors

In the shorter-term, the impact on commodity markets from the Russia-Ukraine conflict has already shown that the equity markets in commodity-rich or commodity-producing countries have experienced broad-based strength. On top of this, with the developments in Russia and China, there have been increased asset flows as investors have sought to diversify across their emerging market exposure. We anticipate that this will continue at least in the short term as the conflict continues without resolution and sanctions persist.

Green energy companies

Companies whose products and services support the green energy transition may stand to benefit in the medium term as well as the long term. The supply chain concerns around commodities such as fossil fuels, metals and agricultural products, for which Russia is a key global producer and exporter, have led to volatility and price increases. Read more on the topic in our note on *Supply Chain Disruption*. In particular, the impact on fossil fuels may provide momentum to accelerate the global theme of transitioning to cleaner forms of energy.

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And who is likely to be more challenged?

Industrials

Companies with rising input costs have been hit by profit-taking. Specifically, companies that use commodity inputs such as aluminium, steel and petrochemical products have (and are likely to continue to) face an uphill struggle.

Information Technology

There has been broad-based weakness in this sector as concerns build about higher-than-normal inventory levels in the smartphone supply chain. However, not all companies face the same level of risk and, despite the issues facing the industry as a whole, some have reported stronger-than-expected results and guidance with a particular emphasis on pricing power and supply stability.

Consumer sectors

As several Asian countries continue to tackle Covid-19 outbreaks and new variants, particularly China which has implemented a 'zero Covid' policy, local lockdowns will persist in causing disruption to businesses. This may heavily impact the consumer sector as factory-workers and other employees are physically restricted from continuing to work.

New economy stocks are also facing continued headwinds in the short term due to the regular proposals for regulation in China which have increased negative sentiment for the industry as a whole. While we believe the long-term investment case for these companies remains intact, there may be further difficulty for them in the near-term.

What next?

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. The market valuation deviating meaningfully from individual company fundamentals increases the attractiveness of emerging markets relative to developed markets in the near and long term. However, given regulatory pressures, human conflict and an ever-evolving macro environment, it is clear that a focus on strong ESG characteristics will be crucial in determining those companies who can stay ahead of the curve in the long run.

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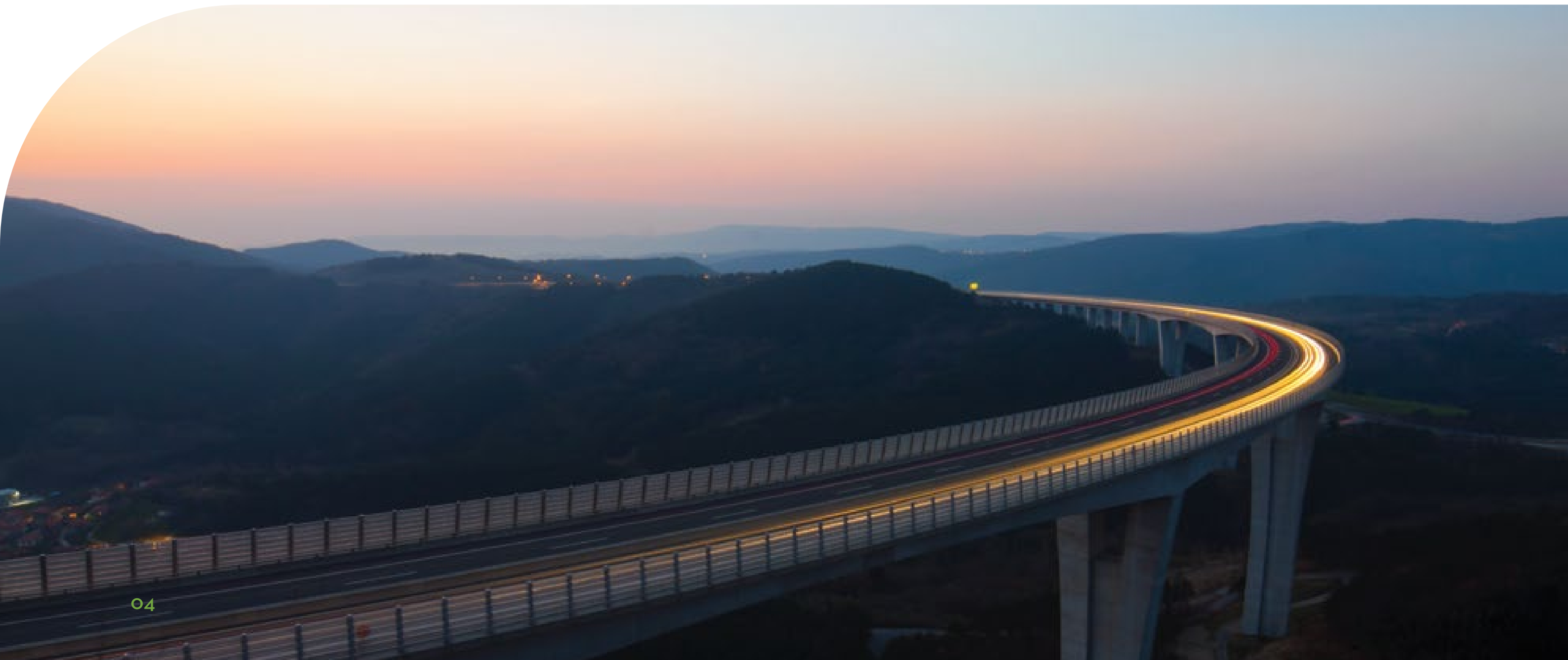

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- This strategy may hold a limited number of investments. If one of these investments falls in value this can have a greater impact on the strategy's value than if it held a larger number of investments.
- Smaller companies may be riskier and their shares may be less liquid than larger companies, meaning that their share price may be more volatile.
- Emerging markets or less developed countries may face more political, economic or structural challenges than developed countries. Accordingly, investment in emerging markets is generally characterised by higher levels of risk than investment in fully developed markets.
- The strategy may invest in derivatives [index futures and FX forwards] to obtain, increase or reduce exposure to underlying assets. The use of derivatives may result in greater fluctuations of returns due to the value of the derivative not moving in line with the underlying asset. Certain types of derivatives can be difficult to purchase or sell in certain market conditions

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