Emerging Markets

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What is the outlook for investing in Emerging Markets ex-China?

At present, a combination of tactical tailwinds, structural headwinds and execution options lead us to maintain a market weight exposure to EM. In the medium term, we expect to see strategic opportunities (particularly in India), including private allocations, as we develop our network within the space.

At a very high level, any peak in developed market monetary tightening would likely remove an important support for the US Dollar. US dollar strength typically acts as a headwind for emerging market equities (EM), Exhibit 1.

Exhibit 1

EM equities tend to outperform in weakening US Dollar environments

Scenario (Data 2000 - present)	Average EM outperformance v DM (YoY %)
US Dollar Index YoY >10%	-10%
US Dollar Index YoY >5%	-3%
US Dollar Index YoY <-5%	12%
US Dollar Index YoY <-10%	16%

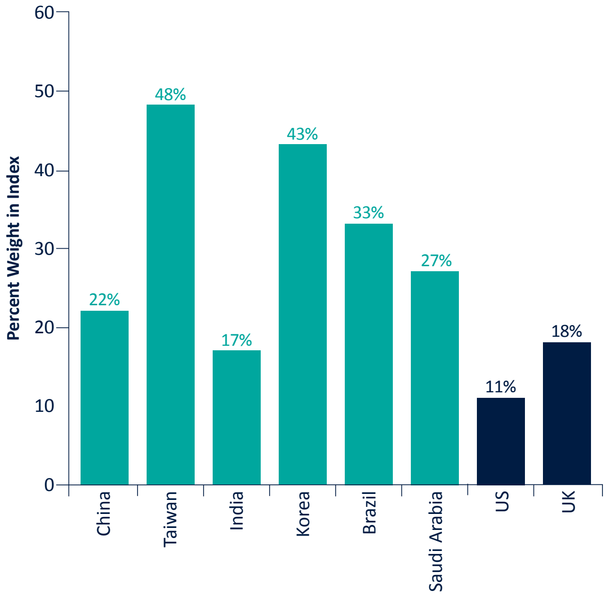
Source: *Bloomberg*

However, given the paradigm shifts outlined earlier, past history may be less representative of future performance. China, the main driver of EM equity performance, faces clear structural issues (which are discussed further in our China section). China's reopening post-Covid should benefit broader EM through regional trade, tourism, and commodity demand but targeted passive investment options are somewhat constrained.

Accessing specific countries via ETFs is inhibited by either a proliferation of poor governance or high levels of stock concentration and idiosyncratic risk (Exhibit 2, be it in semiconductors in Taiwan and Korea, or basic materials and energy in Brazil. In those regions where corporate governance is a concern and local relationships are a significant asset, we will only be comfortable investing in conjunction with specialist managers with deep regional knowledge. Outside of China, the only large EM market that we currently deem to be sufficiently diversified alongside of having a wealth of active management opportunities is India. As we discuss in further detail below, we believe there are many attractive features of the Indian market, but it is not clear that these are best accessed through public markets given valuations at present.

Exhibit 2

% weight of top 2 stocks in index



Source: *Bloomberg*

This leads us to conclude that maintaining market weight exposure to EM via broad passive instruments is the most appropriate stance as we reduce our China overweight. We continue to explore and build upon the menu of active managers we have available in EM as well as assessing the potential for future private allocations to India and other countries in Southeast Asia. Private allocations could facilitate more direct access to companies that are exposed to the strong underlying growth trends in the region.

India: What is the long-term outlook for investment?

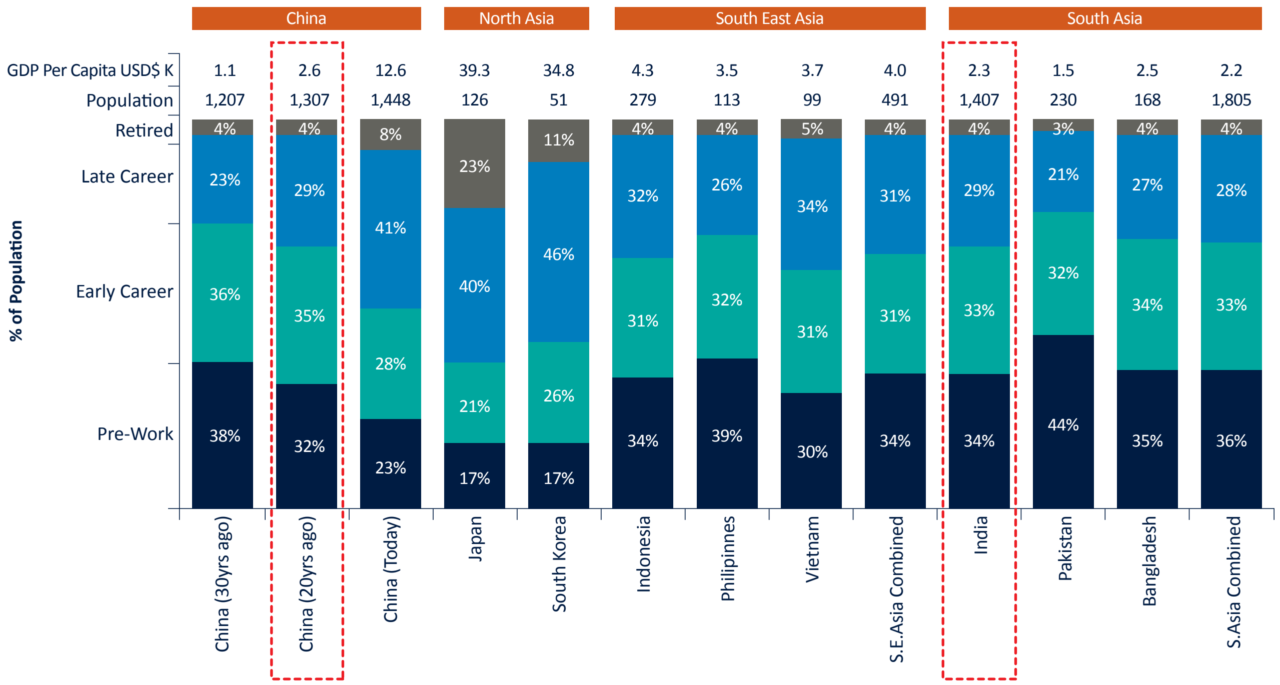
The Indian economy has a structural growth advantage over others in EM, thanks to demographics, government initiatives and trends in international supply chains. Private allocations may offer the best access to this growth, but questionable corporate governance standards mean it is essential to find investment partners with deep local knowledge and strong due diligence credentials.

Experts estimate that the impact of demographics, government policies and investment will mean that real GDP growth in India will average +6.5% over the coming decade compared to just c. +4% in China.[34] Morgan Stanley estimate that India will be the 3rd largest economy in the world by 2027 with its GDP forecast to double over the next 10yrs. This superior growth is primarily based on demographics and government policies designed to entice capital investment into the economy. India's population is young and not expected to peak until 2064 with a median age of just 27yrs. The population in China, by contrast, has already begun to contract with a median age close to 40 years.[35] India's population mix and GDP per capita closely resemble the demographic mix observed in China 20 years ago (Exhibit 3). Income levels are also growing at a rapid rate and the proportion of the population classified as middle class has risen from 14% a decade ago to 31% at present. It is expected to rise to 63% by 2047.[36] This would represent a significant change in the industrial mix of the Indian economy and its consumption patterns. In order to facilitate this transition, a major logistics upgrade is required akin to what occurred in China over the course of the last two decades.

The government believe that a programme centred on attracting capital via tax cuts, incentives for manufacturing and infrastructure development will drive a revival in the corporate CAPEX cycle. They expect this will be aided by the trend in international supply chain diversification away from China. The government is allocating 20% of its fiscal budget towards capital investment in 2023, the highest amount in over a decade.[37] This is a strategy which has been enabled by reform of the tax system in

34 Morgan Stanley
35 UN Population Division
36 UN Population Division
37 Bloomberg

Exhibit 3
India's demographics closely resemble those of China 20yrs ago



Source: *World Bank*

recent years with tax revenues that have jumped +34% in the last year and nearly tripled in the last 10yrs.[38] Spending on physical infrastructure has risen to 8T Rupees from just 1T Rupees 9 years previously and the government has successfully rolled out a huge digital infrastructure system known as "India stack" which includes a payments system and a digital identification system.[39] On initial inspection, the programme seems to be working. Tata, India's 5th largest listed corporate, intends to invest $18B annually out to 2027, a figure which would make it India's largest investor.[40] The three largest areas of investment will be directed towards energy transition, technology (particularly semiconductor packaging) and digital consumption. International companies are also investing. The Economist reports that Apple exported more than $2.5B worth of iPhones from India in 2022 nearly twice the previous year's figure. Foxconn, Apple's largest supplier, has been attracted by the ample supply of labour (at a 50% lower cost than China) and the significant tax incentives offered by the Modi administration. A key question is whether this investment cycle will be different to the last cycle which lasted from 2003-2011. That cycle was driven almost entirely by debt financing and ended in a protracted deleveraging process for Indian financials which are a key driver of performance in listed equity markets. The opportunity set outside of listed equity markets has increased significantly in recent years. Bain Capital reported that both the number and average size of venture capital deals in India have doubled in the last two years leaving the market four times as large as it was in 2020.[41]

While a growing private opportunity set looks attractive, there should be a high hurdle for assessing opportunities given the significant issues with corporate governance. Investment in India is not without its structural challenges. There is a history of poor governance practices that have left investors exposed even in the very recent past. Byju, once India's most valuable start-up, is now in the process of cutting its headcount after being accused of inappropriate accounting practices in recent months,[42] a charge they deny. The Economist has reported that several other high-profile start-ups also stand accused of fraud or at the very least overly aggressive accounting assumptions. These issues also extend to listed equities. In late January 2023 Hindenburg Research, an infamous activist short seller, released a report in which they alleged that Adani Group, the third largest conglomerate in India, had engaged in stock manipulation and accountancy fraud.[43] Adani have denied the allegations calling the report "malicious", "selective" and "baseless". The World Economic Competitiveness Forum cited corruption as the single most problematic factor for doing business in India. Outside of this, there are complex societal and business issues to be addressed. The female labour force participation rate stands at just 9% (vs. 46% in the US). With the Modi government religious tensions are never far from the surface either and Muslim participation in the labour force is just 7% despite representing over 14% of the overall population. Experts highlight that these are factors that will limit potential growth relative to current expectations if they are not properly addressed. All of this leads us to conclude that while India presents strong opportunities for outperformance over the long term it is essential to find investment partners with deep local knowledge and strong due diligence credentials.

Can India continue to outperform in the near term? The outperformance of listed Indian equities is unlikely to continue in the near term given the headwinds from valuations and China reopening. The IMF is forecasting an annualised growth rate of c. +6.4% over the next two years in India, comparing favourably to +4.1% for broader emerging economies and +1.3% for developed economies. Analysts are pricing in EPS growth at +15% in 2023 and +14% in 2024 compared to just +3% and +12% for the broader MSCI Asia ex Japan Index . Despite this backdrop most experts believe that listed Indian equities are unlikely to experience a third consecutive year of outperformance versus broader EM equities. First, domestic growth is expected to slow marginally as a result of a fading reopening growth boost (6.1% vs 6.8%). Second, the reopening of China is expected to disproportionately benefit north Asian economies on a relative basis and has the potential to impact India in a negative manner via higher energy costs. Interest rates will also likely have to rise further to contend with persistent core inflation.

38 Bloomberg
39 Bloomberg
40 The Economist
41 Bain Capital
42 The Economist
43 https://www.ft.com/content/aa626668-5b7f-4697-9ef0-ba9b2bff5155

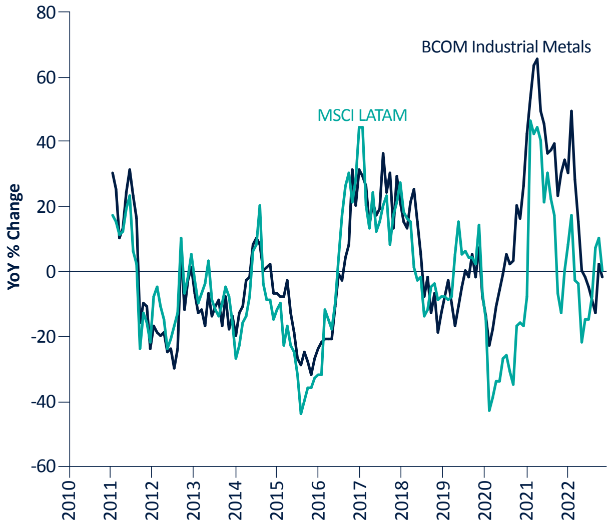
Perhaps the most pertinent factor for many investors is valuation. The MSCI India currently trades on 22x 2023 earnings, 30% above its long-term historical average and an 80% premium to the rest of the EM space. This would suggest that the superior earnings growth is well established in current market pricing. The PEG ratio for Indian equities is 1.4x compared to just 0.4x for Korea and 0.7x for China. The MSCI India has annualised returns of +10.6% in USD terms over the last three years compared to just -1% for the broader MSCI EM Index.[44] This has meant that the weight of Indian equities within the EM index has risen from 8% to 16% since October 2020 whereas the weight of Chinese equities has fallen from 43% to just 28% over the same period. While valuation and performance are not good timing indicators, they do suggest some mean reversion is an elevated probability in the near term.

LATAM:[46] Will slowing globalisation provide a structural benefit?

Near/friend-shoring is expected to marginally benefit LATAM equities but institutionalised protectionism and a lack of domestic investment are structural impediments to meaningful outperformance. LATAM is expected to benefit from the trend towards near/friend-shoring which should lead to significant FDI inflows as capital repositions away from China. Structural tightness in commodity markets should also provide a benefit given the importance of metals/mining and resource extraction to these economies with Mexico exposed to the oil and gas sector and the larger south American economies exposed to the green metals/battery materials sectors. For context, 72% of total exports from LATAM are linked to commodities compared to just 25% in Asia.[47] Exhibit 4 illustrates that industrial metal returns tend to be the key return driver for LATAM equities.

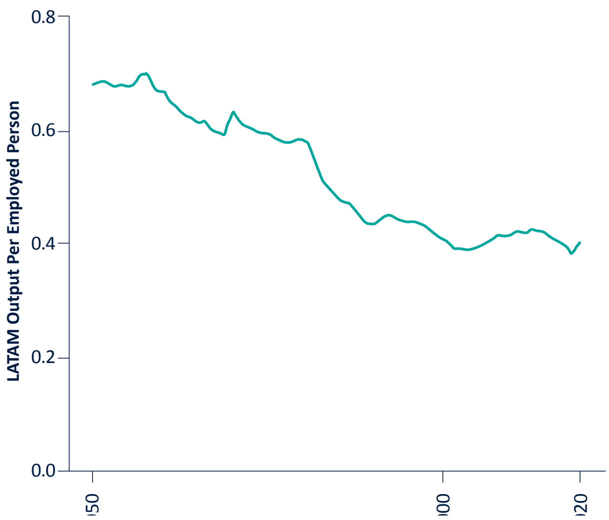
The Economist notes that the corporate landscape in LATAM is dominated by established family-run conglomerates and a mass of small unproductive firms. Roughly half of the region's labour force works in the informal economy. Almost all of the growth in the region has been driven by population growth with productivity remaining stagnant at best, Exhibit 5. Productivity per employee is roughly one quarter of what it is in the US and experts suggest that the root cause of this is protectionism.[48] While trade tariffs were slashed during the 1990s there is a raft of non-tariff barriers and regulation that protect established firms and unions. William Maloney of the World Bank notes that "the protection of incumbent firms means they get away with poor management, a lack of innovation and a lack of investment". Brazil, for example, the largest LATAM economy, ranks 124 out of 190 in the World Bank's Ease of Doing Business rankings. Each of these factors have contributed to an overdependence on commodity exports as the lack of investment and geographical constraints mean that high/mid-tier manufacturing has limited scope for growth.

Exhibit 4
LATAM equities tend to be highly correlated to the performance of base metals



Source: *Bloomberg*

Exhibit 5
Productivity has been stagnant at best in LATAM



Source: *The Economist*

44 Morgan Stanley
45 As at mid-February 2023
46 IMF definition of Latin America and the Caribbean
47 America's Quarterly
48 The Economist

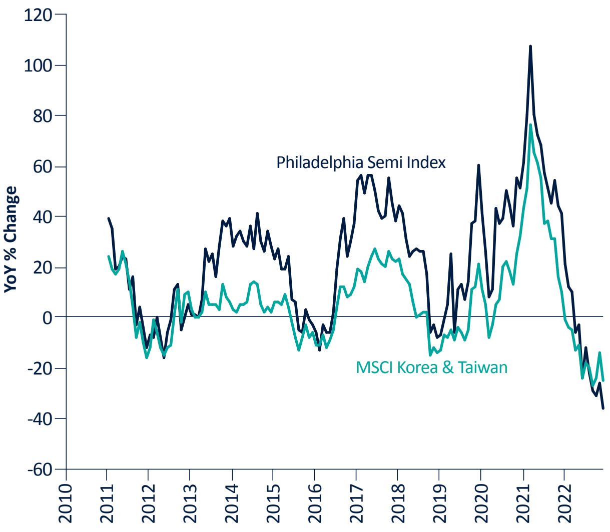
Are valuations attractive in LATAM? The MSCI LATAM Index trades on a forward P/E of 7.4x versus a long-term average of 14.4x meaning it trades -1.5 standard deviations below the historical average. This, however, is heavily influenced by a sharp rise in earnings expectations for 2023 (+36% versus Jan 2022) that are explicitly linked to the rise in energy and base metal prices. Price to book value may provide a more stable estimate of valuation and currently suggests that valuations are slightly below their long-term historical average.[49]

Korea & Taiwan: What is the long-term case for an allocation?

Both Korea and Taiwan stand to benefit from the structural growth trend in semiconductor usage. However, an allocation to a broader-based semiconductor vehicle could be preferable given the idiosyncratic risk in these countries' indices and the geopolitical risk associated with Taiwan in particular. From a structural perspective the economies of Korea and Taiwan are intrinsically linked to the semiconductor sector, Exhibit 6, with the sector representing roughly 40% of both indices. Semiconductors are expected to be an area of structural growth for the global economy as a result of the green energy transition (EVs, smart grids) and digitalisation trends (cloud, 5G, AI, data centres).

Exhibit 6

Korea/Taiwan equities tend to be highly correlated to the performance of semiconductors



Source: *Bloomberg*

There are however some key risks associated with an investment in these regions. First, the semiconductor cycle is currently in a slowdown phase. PCs and smartphones account for roughly 50% of chips sold globally (this is expected to drop to less than 35% by 2030) and data from Gartner research suggests that smartphone sales fell by -6% in 2022 and sales of PCs fell by -10%. New research suggests that key industrial customers for chip firms had inventories that were +40% above average as of late August 2022 with the spot cost of memory chips having dropped by -40% on a year-on-year basis.[50] The consensus among analysts is that inventory destocking may be completed by the end of H1 2023.[51] An end to rate hikes and a reopening of China would also assist in improving the outlook for the semiconductor cycle. Second, there is a high degree of idiosyncratic risk associated with an investment in Korea and Taiwan, with the two largest stocks accounting for >40% of each index, Exhibit 2. Finally, in Taiwan, there is geopolitical risk associated with the risk of China invading. All of this would suggest that if the structural growth story is attached to the semiconductor sector, as opposed to the specific regions, then investors may be better served with an allocation to the global semiconductor sector particularly if Korea and Taiwan introduce idiosyncratic and geopolitical risks.

Are valuations attractive in Korea/Taiwan? Korea/Taiwan offer attractive valuations, stand to benefit from China reopening and a potential bottom in the semiconductor cycle but stock specific risk makes any targeted allocation very challenging. Korea and Taiwan exhibit some of the lowest valuations in emerging markets both relative to their own histories and to other countries in EM. This is despite the fact that both indices have seen the largest negative revisions to 2023 EPS expectations over the course of the last year -40% and -18% respectively while the average revision for Brazil, India, Malaysia, South Africa and Saudi Arabia was just -3%. However, as discussed above, the key consideration for investment in the region remains the timing of the semiconductor cycle as well as the concentration of idiosyncratic risk within the index, both of which combine to make any potential allocation quite challenging.

49 As at mid-February 2023
50 The Economist
51 Bernstein

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