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GLOBAL EQUITY

Investment Management
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Emerging Markets Equity 2024: Markets Diverge as a New Cycle Unfolds

In addition to providing an attractive valuation environment, we believe emerging markets (EMs) are the most efficient way to access some of the world's most powerful secular themes: India's emerging middle class, surging demand for artificial intelligence, and the near-shoring of supply chains.

December 2023

Portfolio Manager
Todd McClone, CFA, Partner

EM Equity | Markets Diverge as a New Cycle Unfolds

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PORTFOLIO MANAGER, EM EQUITIES

EMs have regained their footing in 2023, but the recovery from October 2022 lows has been anything but uniform across individual markets. As a new EM cycle unfolds, we expect that the heterogeneous dynamics and secular themes that have driven performance in 2023 will continue to shape market behavior in 2024. Among these trends are the divergent trajectories of China and India, surging demand for AI-related hardware, and the reshaping of global supply chains.

Favorable Macro, Valuation Backdrop Despite Monetary Headwinds

Macroeconomic fundamentals are improving throughout most of the EM universe, and EM central bankers are eager to transition to a more accommodative monetary policy now that inflation concerns have faded. Their ability to stimulate, however, was constrained for much of 2023 by a surprisingly resilient U.S. economy, which produced higher interest rates and a stronger U.S. dollar. Outside of Brazil and Chile, EM central banks have shied away from cutting rates to avoid collateral damage from the resulting devaluation of their local currencies.

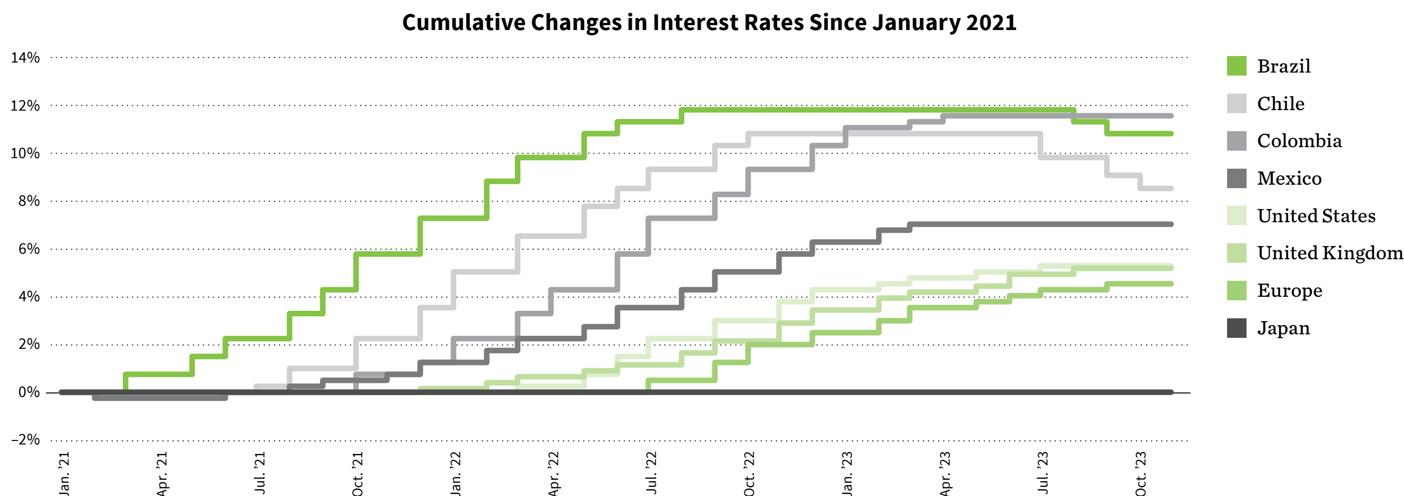
In the coming months, we believe flows into EM markets will be determined by the extent to which the U.S. economic expansion continues. Although a higher-for-longer interest rate scenario in the United States would create a more challenging environment for EM equities, the recent decline in U.S. inflation and a softening U.S. dollar suggest that a more constructive backdrop for EMs is developing.

In any case, relative valuations in EMs appear attractive, and we believe EMs remain the prime avenue to tap into many of the world's most potent secular trends. Looking beyond the initial recovery phase, where deep value and highly cyclical names have historically and predictably led the way, we believe a rotation toward quality growth is likely to be the next chapter of the story.

EXHIBIT 1

EM Central Bankers Have Adopted a Wait-and-See-Approach

Accommodative monetary regimes in emerging markets are unlikely to begin until there are more obvious signals that the U.S. economy is softening.



Sources: Bloomberg and William Blair, as of October 31, 2023.

Performance Highlights from 2023

Spurred by the optimism surrounding the reopening of China's economy, EMs were able to find solid ground in early 2023, following a 20-month bear market in which the MSCI EM Index fell 41.7% peak to trough. However, the China revival story did not play out as anticipated. Down 9.01% year to date through November 30, China has been severely challenged by greater-than-expected COVID-related effects, including higher unemployment, psychological damage across the consumer base and the corporate sector, weakness in the property sector, and deteriorating relations with the United States.

Although China failed to meaningfully reignite global growth, formidable bull markets developed elsewhere. India—a country we continue to overweight in our portfolios—emerged as a standout performer in 2023, with year-to-date gains of 11.75% through November 30. Indian industrials and financials have been particularly strong, bolstered by a robust capex cycle, solid gross domestic product (GDP) growth, and favorable demographics.

Elsewhere in Asia, the surge in demand for all things AI has been a significant boon for Korea (up 15.52% year to date through November 30) and Taiwan (up 23.81%), both of which play pivotal roles in the global AI hardware supply chain.

Mexico has also thrived in the current landscape, posting gains of 28.73% year-to-date through November 30. The country has become the poster child for the COVID-related reshoring theme, which has been amplified by rising geopolitical tensions between the United States and China and the war in Ukraine.

South Africa—a country we have minimal exposure to—is down 4.7% year to date through November 30 and has suffered from rampant corruption and flagging infrastructure. The poor conditions are underscored by the scandal in the state utility Eskom, which has led to rolling brownouts across the country and crippled the economy.

Divergent Paths in Dominant EMs

Together, China and India comprise 44% of the MSCI EM Investable Market Index (IMI). The stark differences between the two markets are becoming increasingly pronounced, and although much of the pessimism around China is currently reflected in valuations, we continue to have a more constructive view of Indian stocks.

From a leverage perspective, India's economic health is considerably more robust than China's: non-financial corporate debt to GDP is 51% in India, compared with 165% in China, and household debt to GDP is 19% in India and 65% in China.

On a fundamental level, India's demographics, politics, transparent monetary policy, and alignment with the West stand in contrast to China's, which we believe should continue to support the momentum of India's stock market. China's market, on the other hand, is becoming more difficult to navigate due to an increasingly prohibitive and unpredictable regulatory environment. In our view, an increasing portion of the MSCI China Index are companies with asymmetric risk profiles. If one excludes from the index companies that fall under the Common Prosperity umbrella, which are subject to potential regulatory pressure, state-owned enterprises (SOEs), and technology companies the United States has attempted to limit access to critical U.S. technology, what remains is a relatively small subset of the index that we consider to be viable investments.

In the aftermath of China's Draconian and protracted COVID-related lockdowns, Chairman Xi has conspicuously prioritized politics over economics, and little has been done to repair the long-lasting psychological damage inflicted on the population. Consumers have been reluctant to spend, and businesses have hesitated to invest.

Property-sector problems have been an intensifying concern, highlighted by the high-profile failures of Evergrande and Country Garden. At the time of this writing, 25 of the largest 50 residential property developers in China are currently in default. Many families have paid for new residential units, whether outright or in installments, that are likely to never reach completion, further damaging confidence in the property market. Given that real estate represents the largest portion of household wealth for most

of the population, falling property values have produced a negative wealth effect. It will be challenging for the economy to gain momentum until pressures on property prices dissipate.

China's latest round of stimulus hasn't been nearly sizable enough to reignite confidence in the household and business sectors. Furthermore, the opacity of monetary and fiscal policy has created uncertainty in the minds of investors around the economic outlook. What is clear is that the magnitude of the impact of China's total social financing (general lending activity into the economy) has been diminishing each successive round of easing the country has implemented since 2008, which we believe can be explained by already elevated debt levels and Xi's increasing reluctance to promote consumerism. An unexpected rescue of the property market or an outsized stimulus package would surely curtail the bleeding, but so far all announcements have fallen short of expectations and initial bouts of investor enthusiasm have been short-lived. In any case, the long-term fundamentals in India appear considerably more promising.

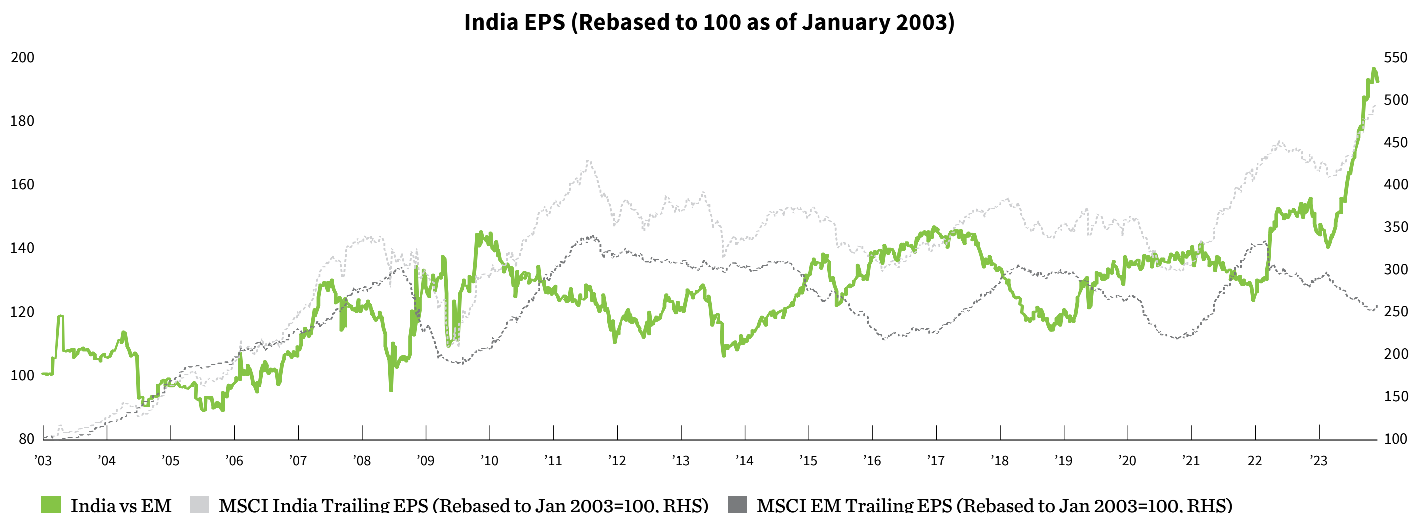
With a share of global GDP growth approaching 20%, India is one of the strongest markets in the emerging world, and we believe its story continues to improve. As a matter of fact, the country has surpassed Taiwan and Korea to become the second-largest component of the MSCI EM Index. Inflation has cooled, interest rates are no longer rising, GDP growth is robust, and both public and private sector capex appear to be entering an upcycle. The first leg of India's multidecade growth story—characterized by an emerging consumer—has evolved to "version 2.0," centered on building out housing and critical infrastructure. India's residential real estate market is booming, and we expect decades of growth given the massive demand and short supply of housing. The country has announced a $35 billion railway expansion plan, substantial investments in power infrastructure, 220 new airports by 2025, and numerous other initiatives that support our positive stance on midcap industrials.

Along with industrials, we maintain our positive outlook for the Indian financial sector. Since 2005, Indian banks have quietly but significantly outperformed the MSCI AC

EXHIBIT 2

India's Long-Term Earnings Outperformance Has Accelerated

Demographics and a positive capex cycle could continue to fuel impressive earnings growth in India.



Sources: Datastream, MSCI, IBES, Morgan Stanley Research, and William Blair, as of November 29, 2023. EPS refers to earings per share.

World Banks Index, and there are reasons for continued optimism. Penetration rates for financial products are trending higher and remain very low relative to the rest of the world on an absolute basis. The population is under-levered and beginning to increase borrowing to finance home purchases. Per capita income recently exceeded the $2,000 threshold—in our opinion, a key signal that demand for durable goods of all varieties is poised to inflect higher.

Although India is trading at a premium to the EM universe, we believe valuations are justified by impressive levels of earnings per share (EPS) growth, driven by the powerful tailwinds in the financial and industrial sectors.

Beyond India, Select Bull Markets May Have More Room to Run

Beyond India, we are seeing opportunities in several other markets.

A Virtuous Cycle Unfolding in Mexico

The poster child of the global reshoring story, Mexico has been one of the strongest performing equity markets of the past three years. Its low labor costs and the growing consensus in the United States to bring supply chains closer to home—catalyzed by COVID-19 and spurred on by geopolitical tensions—has created a powerful trend of factories being relocated from China to Mexico. In fact, Mexico recently surpassed China as the No. 1 exporter to the United States, according to Bloomberg, with U.S. exports increasing from $385 billion in 2021 to $455 billion in 2022.

> "Korea and Taiwan are the main beneficiaries of the growing demand for all things AI."
>
> **Todd McClone, CFA, Partner**

Social Reforms Unleashing Potential in Saudi Arabia

A newcomer to the MSCI EM Index, Saudi Arabia is already approaching the size of Brazil in the index. A 2023 survey by *Ipsos* suggested 91% of Saudi Arabians believe the country is heading in the right direction, the highest percentage of any country in the world. The Saudi government, supported by the sovereign wealth fund, the PIF, is steering the country's transition from oil into other industries. The Vision 2030 plan encompasses $3.1 trillion in investments to help drive that transition. A flurry of capital markets activity is on the horizon, with approximately 50 initial public offerings (IPOs) planned for the next 12 to 18 months. In addition, Saudi Arabia is benefiting from growth tailwinds stemming from social structural changes: women can now drive, they are spending more, and they are also entering the workforce in large numbers. Despite the positive momentum in the country, about half of active global equity market funds (largely U.S. based) don't own a single Saudi Arabian stock, and more 90% are underweight the country, according to FactSet and Morgan Stanley Research as of June 30, 2023. We see some of the most attractive opportunities in Saudi's small- and mid-cap equities.

EM: An Efficient Way to Play the Surge in AI Demand

Korea and Taiwan are the main beneficiaries of the growing demand for all things AI. Across all applications—cloud, automotive, consumer, PC, smartphone, etc.—AI semiconductor revenues are forecast by Morgan Stanley to increase 31% annually between 2023 and 2027.

We believe AI hardware-focused small- and mid-cap equities, almost all of which operate in Korea and Taiwan, are the purest way for investors to participate in this burgeoning market. Taiwan's mid-caps are critical to NVIDIA's supply chain, and Korea is well-positioned with its companies that exclusively design high-end DRAM memory cells, key components in AI chips.

Selectively Tapping into Secular Themes Across EM

Recent developments only reinforce the adage that EMs shouldn't be considered one big, homogeneous asset class. Monetary, economic, and political conditions vary widely from country to country, and despite the significant headwinds for EM's largest constituent, China, we believe compelling valuations and select bull markets support an optimistic outlook for well-constructed EM portfolios.

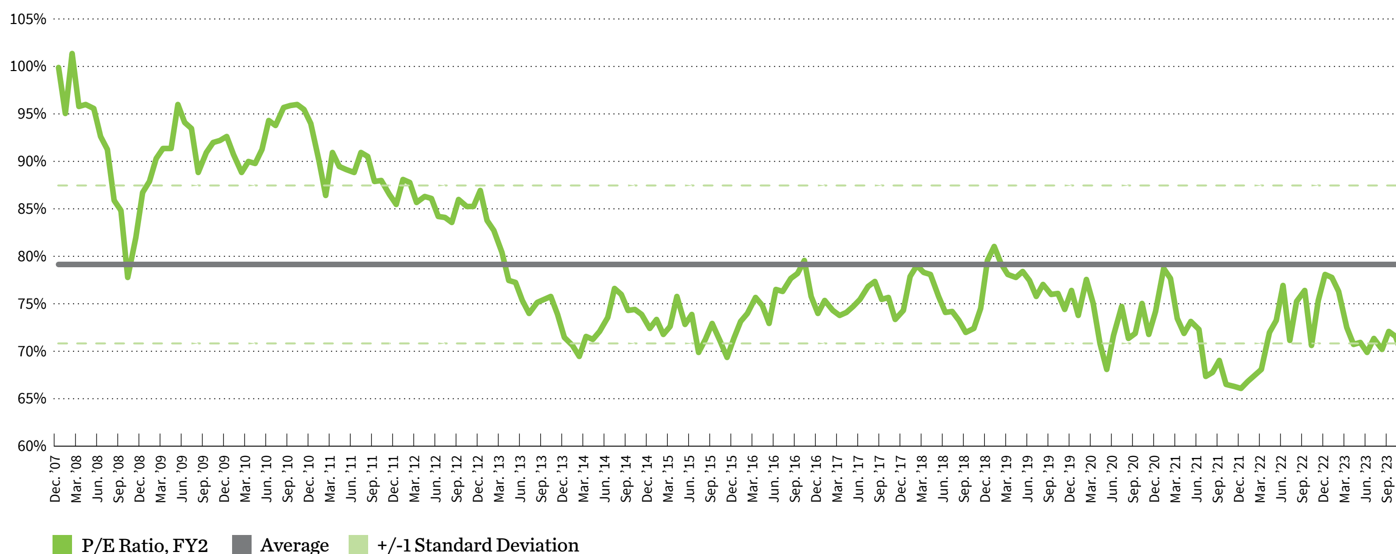
We believe EMs are the most efficient way to access some of the world's most powerful secular themes: India's emerging middle class, surging demand for artificial intelligence, and the near-shoring of supply chains. Now that the asset class's early recovery phase is in the rearview mirror, we think quality growth is poised to outperform. Within this backdrop, we believe stock selection and the ability to identify high-quality companies with strong management teams, sustainable competitive advantages, and strong balance sheets remain paramount.

EXHIBIT 3

Attractive Forward Price-to-Earnings Multiples

Despite improving fundamentals, relative EM valuations are currently around one standard deviation below the long-term average.

MSCI EM Index P/E Ratio FY2 Relative to MSCI World Index



Sources: Factset, MSCI, and William Blair, as of November 30, 2023.

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