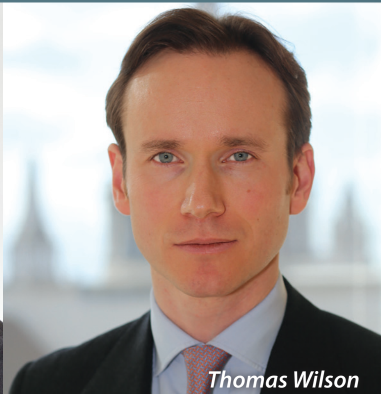
The 2022 Emerging Markets Roundtable

Seizing Alpha Opportunities

Amit Goel


Thomas Wilson

Todd McClone

Fujia Liu

For active managers, emerging markets provide a lot of opportunity to generate alpha, says Amit Goel, Portfolio Manager of the Fidelity Emerging Markets Focus Strategy.

During the *Benefits and Pensions Monitor* roundtable discussion on emerging markets with Thomas Wilson, Head of Emerging Market Equities at Schroders; Todd McClone, Partner and Portfolio Manager of Emerging Market Equities at William Blair; and Fujia Liu, Senior Equity Product Strategist at E Fund Management Co., Ltd., he said while they are called emerging markets, they are a very diverse set of countries and regions that are at different points of evolution in their history. This dispersion provides opportunities to generate alpha out of active management.

This makes them, said Wilson, "very strongly" an active play. "There is substantial performance dispersion in emerging markets at the country level, at the sector level, and, obviously, at the stock level. And you can take advantage of the volatility and market inefficiencies. So it's a big diverse space and you can make money from being active."

McClone said things can change quickly. "It's important to look at last year when China and Brazil were some of the worst performing markets. This year, whereas the rest of the world is going to be tightening monetary policy, China is easing its respective monetary policy cycle albeit at a slowing pace but easing, nonetheless. With Brazil, people are starting to anticipate a peak in inflation and interest rates. You need to take these things into account and be aware of where countries are and what their monetary policy is," he said.

One of the attractions of emerging markets for institutional investors is diversification. But even here there is dispersion, said Liu. More recently, the EM diversification benefit is less pronounced as it becomes more correlated with developed markets.

"However, China's correlation with developed markets is very low. Using the daily return from the past two years, the correlation among major China equity indices are approximately 0.2 with the S&P 500 index, 0.3 with MSCI Europe index, and 0.6 with MSCI emerging market (EM) index.

So having active investment in the Chinese market still provides a "lot of diversification benefits," she said.

> YOU CAN'T DECOUPLE EMERGING MARKETS COMPLETELY FROM DEVELOPED MARKETS. WHETHER YOU TALK ABOUT INDIA OR CHINA, HOW DEVELOPED MARKETS ARE DOING IS A VERY IMPORTANT ELEMENT FOR THESE COUNTRIES - Goel

What explains the wide gap today between emerging and developed equity markets?

McClone: Over the last 10 years or so, EM growth has probably been a little bit disappointing. Quantitative easing (QE) in the developed markets really supported equity valuations and growth. In EMs, QE hasn't been an option

That's now starting to end. EMs are coming out of the pandemic now much stronger and growth is starting to pick up on its own. But we've lagged quite a bit because we haven't had the option of the monetary and fiscal policy support we saw in developed markets.

Wilson: Clearly policy has been an issue which supported valuations. U.S. returns, for example, have accelerated upwards while EMs have been relatively stagnant. And that drove a derating from a price/

book standpoint. If you see an inflection in the relative return-on-equity for EM versus the U.S., you could see a period of better performance and the multiple or rating gap closing up a bit.

Goel: A lot of the differential between developed and emerging markets is structural. When we value companies on price-to-earnings or price-to-book, the key determinants are return on equity and the sustainability of that return. Since the great financial crisis, developed market differential in return-on-equity versus emerging markets has been widening.

It's a classic growth versus quality versus value phenomena where – in loose monetary conditions – you will always see valuations of high-quality companies going up while low-quality companies continue to degrade.

Liu: From an investment perspective, however, China should be considered as a separate mandate. It has a lower correlation with developed markets and the correlation is not that high with the EM index.

In addition, Chinese equities are under-represented in the EM Index. China A-Shares currently only account for approximately five per cent of the EM Index. But as the world's second largest economy and consumer market, as well as the world's major manufacturing powerhouse, China is well ahead of other EMs and presents idiosyncratic attributes.

The China A-Shares market also offer significant alpha where in-depth, on-the-ground research is key to finding the best opportunities. With its long-term strategy to open up, China's market is increasing accessible to international investors. I believe that global investors should look at China separately from other countries in emerging markets.

Speculation is that a recession may be coming for developed markets. Will this spill over to emerging markets?

Goel: You can't decouple emerging markets completely from developed markets. Whether you talk about India or China, how developed markets are doing is a very important element for these countries.

Without predicting whether we are going into a recessionary period or not, the monetary condition of emerging markets today is much better than what they have been in historical "taper tantrums." Inflation is a bigger developed market problem and is significantly higher than what you see in parts of emerging markets, especially north Asia, where inflation continues to remain low single digit. So you're talking about real interest rates being significantly better in emerging markets versus developed markets and this better monetary condition, as well as better government balance sheets and terms of trades, reduces the taper tantrum impact in emerging markets.

THE EXTERNAL ENVIRONMENT HAS BECOME MORE DIFFICULT FOR CHINA. TRADE HAS BEEN A KEY SUPPORT FOR GROWTH AND NOW THE EXTERNAL ENVIRONMENT IS WORSE SO TRADE IS LIKELY TO FALL GOING INTO THE SECOND HALF - Wilson

McClone: China is ahead of cycle being first out of pandemic and tightening at the end of 2020/2021. The U.S. is tightening. Europe's going to have a slowdown and people in developed markets are worried about overtightening and pushing economies into recession.

China is the opposite. As the first one out of the pandemic, it actually started easing monetary policy. Now they probably are a little bit too timid and that's why the market hasn't found its footing yet. Coming into an easing cycle, people are going to start expecting growth to improve in the next year.

However, emerging markets are not a homogeneous asset base. Countries are in different cycles, so investors can position themselves to be in countries where easing policy valuations can be supportive of growth and value, even if you're seeing decelerating growth in developed markets.

Wilson: If you just step back, global growth has been running hot due to excessive stimulus and the U.S. Fed, in our view, is very behind the curve. So you've got rates, you've got QT (quantitative tightening), and there are indications of a desire to effectively bring inflation back under control.

A look to China and, on a near-term basis, its zero-COVID policy is causing material economic disruption. You're not going to get much relief on the supply side anytime soon.

Obviously, Russia's invasion of Ukraine has put upward pressure on commodity prices, so you have a more stagflationary environment.

If they want to control inflation, you have to see a slowdown in activity and we would expect that to occur through the second half of this year into 2023. So you have a weaker environment for trade and you probably have a stronger dollar to act as an ongoing headwind for emerging markets. So yes, you do have the opportunity to be selective.

What sort of broader impact do you expect the Russia-Ukraine conflict to have on emerging market equities?

McClone: The biggest thing is just the boost in commodity prices. Agricultural commodity prices have gone up quite a bit and that's benefited some countries. It also creates food price issues with the lower end of the populations and we've seen that in some of the Middle East and Latin America markets where the food price inflation has really caused a lot of volatility and economic and social disruption

Oil and gas, we'll see what happens with that. With oil prices, in the past Russia has always been played for energy exposure, whether you have one energy company or even a consumer company that benefits just from Russian energy. We've been doing more in Saudi and in the Middle East (with further embargos against Russian oil) in general because they're the energy commodity beneficiaries of this whole situation with new sanctions.

I can't imagine any sanctions in the near term will come off Russia, probably as long as Putin is still in power and there is no change in government.

Goel: If you think about direct impact, Russia is a big exporter of a big basket of commodities – steel, oil and gas, sunflower oil, wheat, aluminum and so on. So you're seeing big price dislocations in these commodities which, in turn, has accelerated this inflation and rate movement. Before the invasion, we were talking about U.S. Fed rates of close to two per cent. Obviously, these expectations have moved up.

To me, the biggest long-term impact is on oil and gas. Russia is a net exporter of six million barrels of oil per day. Europe buys 40 per cent of its gas from Russia. That's a big dislocation because every commodity will find the price where demand will start getting hit.

But oil and gas has the lowest elasticity of price because the end consumer still gets subsidized in a lot of economies. India, China, and parts of Asia are net importers of oil. This will cause inflation to catch up in these economies. We've been talking about monetary conditions in emerging markets, but inflation becomes a big risk with high oil and gas prices in emerging markets.

How is China positioned to weather the impact?

Liu: In the short term, China has faced some volatility. But China has enough buffers to remain resilient. For example, U.S. Fed tightening likely won't deter China's policy of easing. Despite the Fed's hiking stance, China continues to ramp up its growth, with a GDP target of 5.5 per cent for 2022.

The policy cycle disparity between China and the U.S. will continue and China's growth is expected to recover, while overseas economies might be under pressure. In such an environment, external tightening could have a limited effect on Chinese equities.

China also has the world's second largest consumer market with a comprehensive industrial value chain and China now seeks to become more self-dependent, as stated in the 'Dual Circulation' development strategy.

Finally, geopolitical tension caused some capital outflows and put pressure on import prices. But China can defend itself against those external shocks. The supply-chain disruption might put pressure on key import prices, such as oil and agriculture products, but China's robust current account surplus and Forex reserve, as well as capital account controls, provide a buffer, along with domestic growth stability policies, to dampen the impact from external shocks.

We are positive on Chinese equities over a medium term. Valuations of Chinese equities have fallen below their long-term historical averages and are very attractive compared to peer markets. China's macro environment is stabilizing, helped by material financial deleveraging since 2017, and Chinese capital market reforms have improved the quality of listed companies, laying a solid foundation for a secular bull market. Finally, economic restructuring and upgrading has accelerated, while Chinese residents are now investing more in equities, which all underpin the positive market outlook in the long term.

LOOKING AT SECTORS WITHIN CHINA, YOU NEED TO SEE IF THEY ARE ON THE RIGHT SIDE OF REGULATION. THOSE ON THE WRONG SIDE OF REGULATION HAVE A MUCH HIGHER HURDLE RATE - McClone

Wilson: The external environment has become more difficult for China. Trade has been a key support for growth and now the external environment is worse so trade is likely to fall going into the second half anyway. China's zero-COVID policy was very good at controlling it. But now with a much more infectious variant – Omicron – you have materially more difficulty in controlling COVID. An increasing proportion of the population is in either full or partial lockdown and this is going to have a significant impact on consumption and on manufacturing. And it's very difficult for the government to reverse the existing policy theme because you could see potentially quite high fatalities. That might be a significant political problem.

The net of all this is you see some softening in global trade and you probably see China relinquish export market share.

McClone: China has become more complex in terms of how we invest on multiple fronts.

If you look back a couple years, the story was Alibaba and Tencent and it seemed like they were less likely to be regulated than their counterparts due to working with government and data sharing. They were the national champions and they were complicit with the government as they give information on the populace and control everybody.

And that got turned on its head. They realized these companies were getting too powerful and so valuations were de-rated to U.S. counterparts. That really never materialized and the Chinese companies were really in the crosshairs, particularly Alibaba.

Another example is healthcare in China. We always loved it as an offshoot of consumption. As people get wealthier, they want better drugs, better medical devices, and private hospitals. They spend more money on healthcare. But there's been a lot of movement towards forced price reduction on drugs and medical devices. So the business models in that area, which was a high multiple, high growth sector, have come crashing down. That has made it a no-go sector right now because we don't know what the policy changes are going to be and the impact on these companies and their business models

Looking at sectors within China, you need to see if they are on the right side of regulation. Those on the wrong side of regulation have a much higher hurdle rate because the winds are blowing in their face.

There are also external concerns. If the U.S. decides certain sectors are threats to national security and puts them on its Entity List, that stock is not going to react well. So sector investing is getting more and more complicated. There's still plenty of options, but you must be cognizant of both the U.S. and the Chinese objectives.

Goel: China has been very different from a large part of emerging markets in the last two or three years. It was first in and first

out of COVID. It had a very strong 2020 when everybody was struggling. Then problems started emerging in 2021 with fiscal tightening and property markets slowing down. At the end of last year, you saw consumption being hit as well.

With the economy slowly moving towards consumption and services, with COVID resurfacing, the slowdown in consumption has become a big issue. Everybody expects China to have a stimulus to manage its five per cent GDP growth target in 2022. I think short term, you could still have a very messy situation with COVID.

What's holding back more international equity investment in China?

Liu: In our view, we don't think that China is less looked at. The recent fund outflows were mainly due to Fed tightening, geopolitical conflict, and the narrowing U.S.-China yield spread, leading to negative sentiment and a risk-off mode.

But overall, the long-term structural trend is positive, as global investors' allocations to China increased since the market opened up to these investors with the QFII and Stock Connect investment programs, and we expect this trend to continue. Foreign holdings currently account for around five per cent of China's equities market and there is significant potential for global investors to increase their allocations. Despite different views on China, investors agree that China is a large market they cannot ignore.

China's first economic boom was based on investing in infrastructure. Its last stated goal was the 'Common Prosperity Program' to build domestic consumption. Is the Chinese economy nimble enough to pivot when consumption is dropping to take a different path?

Goel: We have to appreciate that it's such a large economy that these shifts are not five-year shifts, they are a couple of decades shifts. And direction becomes more important. I don't think there's any change in direction. It's an authoritarian regime where the economy is tightly governed by a government concerned about the perception of its people. They want to make sure that there is no hard landing.

So at a time when their consumption has been hit by pandemic lockdowns, they would obviously make sure that there is some part of the economy which is holding up its growth.

Long term, consumption will remain a larger part of the economy.

Liu: Regarding economic growth drivers, there are short- and long-term issues.

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China's economy was relatively soft in Q1 2022, due to weak property investment, retail sales consumption, and COVID lockdown disruptions. Since the government's 2022 goal is growth stability, we expect infrastructure investment supported by fiscal expansion to be the primary growth driver with high short-term certainty, especially in the first half of 2022. Meanwhile, export and manufacturing investment growth should remain stable and support robust growth.

However, in the mid- to long-term, China's 14th Five-Year Plan set strategic goals on innovation and core technologies, making the technology sector a key investment area; China's "engineering dividend" will drive an industrial upgrade and advanced manufacturing as part the national strategy for long-term sustainable development.

Lastly, the renewable energy sector (wind, solar battery storage) will be the main beneficiary of China's 2030 carbon emission peak and 2060 carbon-neutrality goals.

Still, China's "consumption upgrade" and the digital economy, which outperformed in recent years, will continue to provide sustainable growth drivers and help achieve common prosperity.

Wilson: Real estate is still a very significant constituent of Chinese GDP.

Last year, you saw negative credit impulse in addition to regulation which led to a confidence issue. Buyers effectively pulled back and you saw the material deterioration in property sales in China. That might be relatively difficult to fix.

In addition, you've got the restrictions in terms of COVID this year at least. It will take time to fix the problems in the real estate space. And on a medium-term basis, real estate would be a headwind because it is, in my view, an excessively large constituent of GDP.

McClone: The days of chasing infrastructure spending is probably gone. It's more on about consumption

If you looked at the common prosperity program before this, it looked like a pyramid. They've tried to squeeze spending more towards the middle class so now it looks like a football. So the consumption companies that are feeding into that are going to be the beneficiaries of this common prosperity program.

We're also more focused on buying companies that are in areas where the government wants China to be internationally competitive – such as the EV battery supply chain and solar power supply chain.

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