

EMERGING MARKET EQUITIES

EMERGING MARKET EQUITIES OUTLOOK

**CHARLES WALSH**

Portfolio Manager

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We believe the current outlook for emerging market (EM) equities is, on balance, positive for the following reasons:

- China has committed to supporting the economy and the domestic property sector, in particular. They have adopted a “results orientated” approach to restoring stability to the property sector, effectively the same as Draghi’s famous “whatever it takes” stance.
- Growth in China has begun to reaccelerate – August data showed unemployment falling, retail sales and industrial production accelerating, as well as PMIs recovering back to expansionary territory.
- We expect to see a new corporate earnings cycle beginning and building momentum from the end of 2023 through 2024.
- We believe China’s current challenges are effectively priced in, with pessimism levels extreme.
- Positioning is very light following August’s bout of capitulation, with many brokers downgrading China’s outlook with commensurate outflows from Asia ex-Japan equities.
- EM countries experienced far lower inflation than developed market countries and have largely managed to bring inflation rates down towards trend levels. We’re now witnessing the start of growth-boosting interest rate cutting cycles, well ahead of western economies.

- The flexibility to cut rates ahead of the US, in particular, does in some cases highlight new-found economic resilience. Take Indonesia, historically a member of the so-called “fragile five” due to a persistent current account deficit. The country has moved to a structural current account surplus owing to years of focus on the domestic nickel industry (key for EV batteries) and having taken tough steps to restructure its labour market.
- Reshoring / replication of supply chains is creating opportunities across South East Asia and Latin America and will have limited success in reducing China’s role, in our view.
- Artificial Intelligence – this huge structural opportunity benefits the technology supply chains of Korea and Taiwan directly.
- Heterogeneity – EM is a diverse universe, providing optionality of investment ideas. It also has a host of frontier markets eager to join and widen the opportunity-set.
- Labour force productivity has huge headroom to increase towards global standards, which should help offset the declining absolute numbers in employment.
- China’s retirement age is amongst the lowest in the world, at 60 for men, 55 for white-collar women and 50 for blue-collar women. This is set to increase gradually, which should support labour force growth, or at least go some way to offsetting its decline.
- There are still limits to urban expansion in the form of China’s Hukou system and home purchase restrictions. The adjustment or removal of these should provide a further boost to urbanisation and investment.
- Improving state healthcare provision over time should enable households to divert an increasing proportion of their earnings from precautionary savings towards consumption.
- The relatively high youth unemployment situation could be partially alleviated by changes to the system whereby job applicants require a specific degree to apply.

We believe the above outlook highlights the strong opportunity-set within EM equities.

THE RISKS TO EM EQUITIES

The key risks currently are geopolitics and the ongoing supply chain reorganisation. Will the US succeed in its efforts to contain China’s rise and will countries succeed in replicating China’s supply chains?

GEOPOLITICS

Geopolitics remains the wildcard and hard to predict. Initial expectations that the Biden administration would go easier on China than Trump’s were misplaced. With the US heading into

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elections in 2024, being tough on China plays well to the voter base on both sides. That said, the power balance may have started to shift back towards China's favour. The numerous visits by high-level US politicians over recent months have been met with a new response – China has questioned the sincerity of the words, given the contradiction with the actions of the US.

In our view, the US seeks to contain and restrict China whilst maintaining a dialogue to manage the risk of accidental conflict. China understandably rejects the containment aspect and is simultaneously finding its feet on the global stage. Xi's refusal to attend September's G20 is, in our view, less about challenging India's role and more about rejecting the proposed meeting with Biden. China has been unusually direct in indicating that they likely won't attend the November's Asia-Pacific Economic Cooperation (APEC) meeting in San Francisco unless the US begins to show sincerity. We therefore expect to see more progress in bilateral discussions.

Amongst other things, China is a huge market for US and European companies and plays an essential role in meeting future net-zero targets. Attempts by the US to marginalise China will only work for so long. So far, China has been largely passive but has many tactics it could employ to deter further containment.

THE THREAT OF GLOBAL "RE-SHORING"

We believe attempts to diversify supply chains away from Greater China will have natural limitations. Some point to China's labour costs versus Mexico's as a reason it's losing its place. In fact, China's labour costs surpassed those of its Latin American competitor in 2017. The established nature of integrated supply chains has been a far more powerful driver of China exports than cheap workers for many years now.

Another key reality check is the fact that new supply chains take such a long time to build at scale (they are also less profitable, even with subsidies). Taiwan Semiconductor Manufacturing Company's (TSMC) construction of two new semiconductor production facilities in Arizona at a cost of USD40bn, once operational in 2026 will represent only 3-4% of TSMC's installed capacity. Add to that the fact that even where new manufacturing bases are created, for example, in Vietnam and Malaysia, they still need to import materials and components from China. Supply chains are global, and China is inextricably woven into them.

CONCLUSION

Investing in EM equities requires a different approach than in developed markets, in our view, partly due to the more cyclical nature of returns, even within structural growth opportunities. The best investment opportunities are often found when the outlook appears most bleak. This takes a tolerance for

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contrarianism, a flexible approach and a dedicated focus on uncovering the truth at a country, industry and company level.

Investing in EM equities, with over 26,000 companies across 24 countries is a diverse and heterogenous landscape full of opportunities and importantly, full of inefficiencies for the active manager to uncover and capitalise on. We believe EM countries still provide superior long-term growth opportunities and some of the most exciting structural themes the world has to offer. With approximately 85% of the world's population living and working in EM, striving for

personal and societal betterment, the opportunities for great companies to capture and grow are vast. By definition, EM equities remains a growth asset class and we continue to believe that by adhering to a strict process of uncovering and investing in great businesses at decent valuations we can deliver superior long-term growth for our investors. We also believe that through our decades of experience investing in EM equities we are ideally placed to do just that.

We certainly do live in interesting times. The multi-faceted, unique and continually evolving EM story will be at the core of the global opportunity-set for many years to come.

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