Quarter 4, 2021

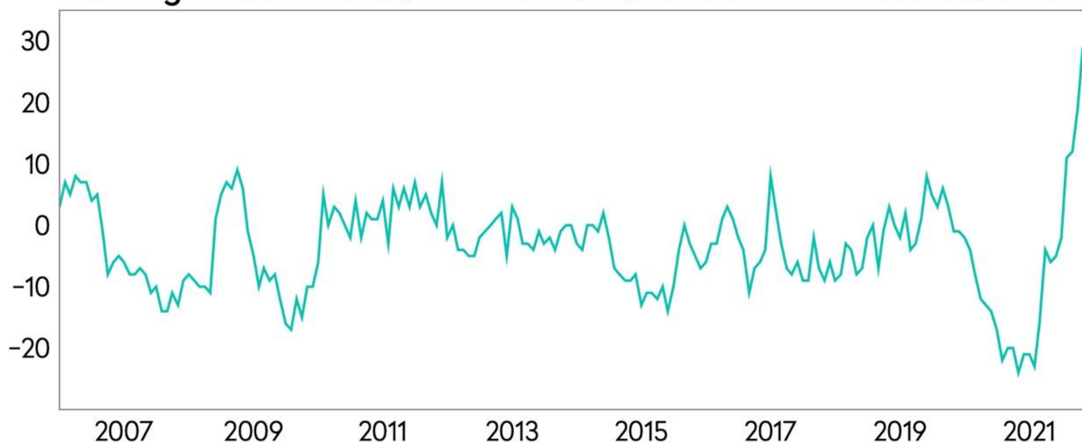
Emerging Markets Investment Outlook

2021 Review

If global news flow in 2020 was dominated by a lethal virus that originated in China, 2021 in emerging markets (EM) were subject to countless policy related headlines placing a question mark over the health of investing in Chinese equities. Although 2021 was notable for strong equity markets globally as a result of a post Covid-19 vaccine fueled recovery, MSCI China fell 21.7%. While many parts of the asset class posted strong returns, China was the notable laggard. MSCI EM therefore fell 2.5% despite MSCI EM ex-China appreciating 10%. While China accounts for approximately one third of MSCI EM, for EM overall to produce robust returns in 2022, a reversal in Chinese fortunes will be essential. Below we will review 2021 and discuss our expectations for 2022.

To begin with sectors, the worst were those dominated by the most troubled Chinese areas – consumer internet related stocks and real estate - consumer discretionary fell 29%, real estate 22% and communication services 9%. While the portfolio had no exposure to real estate and was underweight discretionary, an overweight to communication services combined with poor stock selection weighed on relative and absolute performance. The portfolio's overweight to IT however added over 300 basis points in value given strong performance across most names held. We remain overweight given the long term structural growth in sustainable demand we envisage for products and services. Energy was the strongest sector given the oil price rally during the year. The portfolio was roughly in line with the benchmark weight and slightly added value from energy stock selection.

Given strong energy prices, the best performing region last year was the Middle East which gained 35% as did Saudi Arabia, making it the best performing 'major' market. We have no exposure to the region as we have struggled to find value there, especially when we layer on the ESG risks we consider. The underweight here cost approximately 150 bps in relative performance. Strong energy markets also helped Russia post a 19% gain. We are slightly underweight Russia but do own oil major Lukoil which gained 28%. However, our other holding is a gold company, Polymetal, which fell during the year and therefore saw us lose 30 bps from Russian positioning. When we layer on top our zero exposure to Central Eastern European markets which also outperformed, we lost c.200 bps in total from being underweight the EMEA region. This positioning was the main reason for our underperformance in 2021. In fact, as can be seen in the chart below, last year's outperformance of EMEA was the greatest versus EM on record. Hence, any mean reversion this year would help us regain some of this lost alpha which we think is likely given relatively lofty valuations in the Middle East in particular.



Source: MSCI

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Latin America was the weakest region as many countries exhibited political volatility amid a disappointing response to Covid-19, and continuing structural challenges dampening growth. Brazil, Peru, Chile and Colombia all fell between 17-20%, with only Mexico posting a positive return of 22.5%. Our positioning in the region was mixed with zero exposure to Colombia and Chile helping, as did the holding in the Mexican bank, Banorte, and more defensive stock selection in Brazil. However, this was somewhat offset by an overweight to Peru via the holding in the leading bank, Credicorp. We remain cautious towards Brazil ahead of the presidential election in October 2022, which often creates heightened volatility, but do see deep value in some names so have moved slightly overweight while retaining a natural currency hedge through our exposures. We also added to Credicorp given particularly attractive long term valuations.

Asia was extremely mixed. Taiwan continued to deliver above average returns, +26%, as semiconductor stocks such as TSMC, UMC and Mediatek made large gains on the back of sustained high demand for their chips and manufacturing services. The portfolio is overweight Taiwan and added value as a result. We continue to find value opportunities in Taiwan although we have taken profits throughout the year. India was also strong, adding 26% as stocks across sectors performed well as the economy bounced back from a Covid-19 induced slump. We started the year overweight India but valuations look less attractive now given the outperformance, and hence we have taken profits from software holdings, Infosys and HCL Tech, as well as Reliance Industries. We ended the year underweight India. Korea fell 8% and we took advantage of weakness to move the portfolio from an underweight to neutral position as certain stocks in the memory, EV battery and financials sectors look especially undervalued.

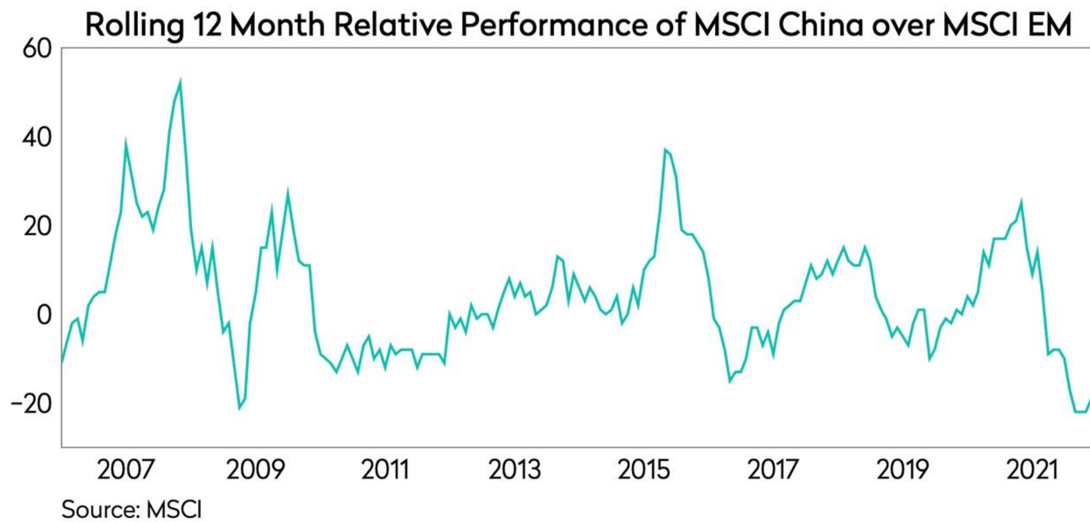
The main area dragging down EM though was of course China. Investors sold Chinese stocks during the year for three principal reasons.

1. Concerns regarding a more severe and unpredictable regulatory environment.
2. Concerns for the VIE structure used for most US listed ADRs, and some Hong Kong stocks.
3. Concerns for the underlying health of the Chinese economy as a result of the country's largest property developer defaulting on its debt.

We have already written at length explaining our China views in the Q3 Focus piece on China.

In short, while we are cognizant of all the above, we believe there is a great deal of bad news discounted in many China stocks now. While the regulatory environment can be unpredictable, as we enter 2022, investors and crucially the companies themselves are now fully aware of how serious the Chinese authorities are in achieving their goal of 'common prosperity'. We think stocks are already priced for regulatory risk, and furthermore we don't expect the impacts to be anywhere near as damaging as many prices suggest. The same is largely true for VIE risks where the Chinese authorities continued to implicitly endorse these structures. It is eminently possible that ADRs will be delisted in the next 2-3 years but all of our ADR holdings already have secondary Hong Kong listings, so we keep our focus on business fundamentals which are sound for the stocks we own. Regarding the economy, we do expect a moderate slowdown in economic growth but, at the same time, there remain many stimulus policy measures available to the Chinese government. Furthermore, in the short term China is unlike many economies in the world in that it is actually in a loosening not tightening monetary policy cycle. Over the medium term, we still expect China to sustainably grow faster than most EM economies, especially driven by consumption growth, which most of our investments are linked to.

As can be seen in the chart below, China's underperformance last year was the greatest on record vs EM. We think the likelihood of this reversing in some way during 2022 is reasonably high given the excessive pessimism implied by valuations.



Upholding our disciplined valuation process, we move into 2022 confidently positioned. That confidence though rests on a recovery in China and our selected stocks in particular. We have added to extremely undervalued Chinese stocks and sit approximately 6% overweight the market. Within EMEA where we see less compelling valuations we are c.7% underweight. Additionally, we have reduced India to c.4% underweight post strong performance and the market trading on the highest PE in EM of 27x and index low dividend yield of 1%. Therefore, any combination of mean reversion from 2021, with regard for underlying fundamental valuations, and 2022 should produce better relative and absolute returns for the portfolio.

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