February 2023

Emerging Markets Quarterly Outlook

No rest for the weary in Emerging Markets

The last 12 months have been extremely challenging for economies and financial markets, but perhaps nowhere was as impacted as Emerging Markets (EM).

The broad expectation at the outset of last year was that the global economy would slow from 2021's elevated pandemic recovery-boosted rate of growth, but that the ongoing reopening would still support a pace of growth above pre-crisis levels and provide a reprieve for beleaguered EM investors.

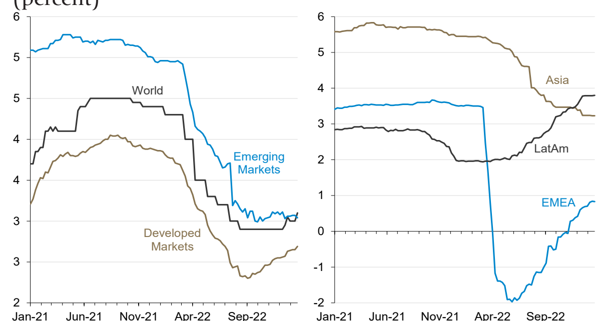
This optimism was quickly quashed as more and more clouds emerged and darkened the outlook, chief among them:

- Financial conditions tightened as EM central banks raised rates further to combat high inflation, and the US dollar strengthened as Developed Markets (DM) kicked off their own tightening campaign;
- Russia's invasion of Ukraine and the resulting sanctions created shockwaves and sent prices of energy and agricultural goods sharply higher, compounding inflationary pressures and acutely impacting EM households for which necessities of life take up a relatively larger share of budgets;
- Chinese economic growth momentum slowed drastically as the country's "zero COVID" policy spurred rolling lockdowns in response to its first significant waves of the pandemic, while the property sector crisis continued.

The impact of these developments was felt globally, but their points of origin and the knock-on effects, given the economic grouping's dependence on DM, meant EM bore the brunt of the downgrades. Latin America (LatAm) was a notable exception, with the stronger commodity market boosting the outlook for its resource-heavy economies.

CHART 1: KNIVES OUT

Consensus real GDP growth forecasts, 2022 (percent)

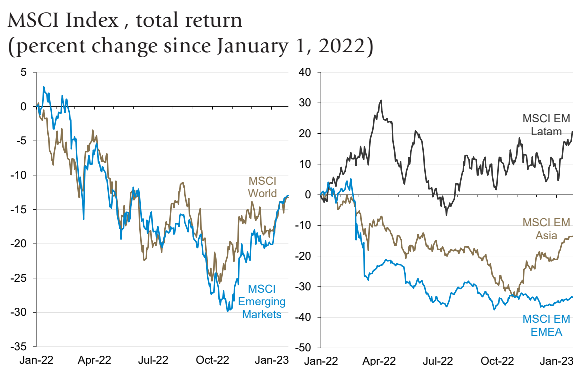


Source: Guardian Capital based on data from Bloomberg to January 27, 2023

Market performance echoed the macro. Emerging Europe, the Middle East & Africa (EMEA) was at the bottom of the heap, thanks to a Russia-sized hole in activity; Asia was weighed down by China but fared somewhat better (and the late rally narrowed the gap); LatAm managed to generate decent overall returns — one of the few areas globally to end the year in the green.

CHART 2: REGIONAL VARIATION

MSCI Index , total return
(percent change since January 1, 2022)

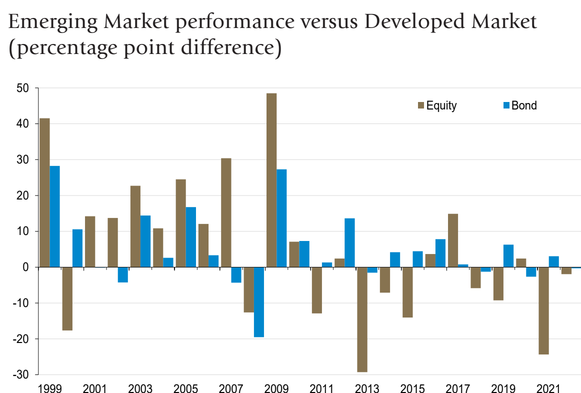


Source: Guardian Capital based on data from Bloomberg to January 20, 2023

Overall, EM equities lagged behind their DM counterparts yet again — though a late China-driven rally narrowed the gap in the final weeks — the eighth year in the last 10 of underperformance.

CHART 3: PALING IN COMPARISON

Emerging Market performance versus Developed Market
(percentage point difference)



Equity = MSCI Emerging Markets[2] – MSCI World[1]; Bond = Bloomberg Global Aggregate – Bloomberg EM Hard Currewncy Aggregate; source: Guardian Capital based on data from Bloomberg to December 31, 2022

Fool me once, shame on you; fool me twice…

This less-than-stellar track record over the last decade — when DM generated cumulative excess performance over EM of roughly 120 percentage points — has scared (and scarred) investors and resulted in significant outflows of capital from the asset class.

What would it take to get these once-bitten, twice-shy investors to return?

The first decade of the millennium offers a suggestion.

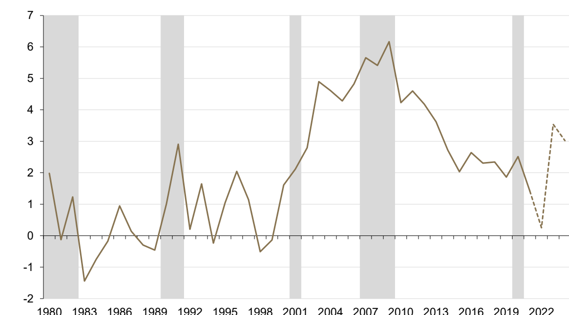
From 2001 to 2010, EM equities consistently and substantially outperformed DM, with higher returns registered in nine of 10 years and a cumulative beat of more than 300 percentage points.

One of the main factors underpinning that stellar decade was the significant increase in EM's growth premium, fueled by China's rapid industrialization and broader integration with the West after it joined the World Trade Organization in December 2001.

This economic outperformance peaked around the global financial crisis as the low-hanging fruit was picked. The Chinese economy entered a more mature phase of its development and has been trending lower since — the shocks of the past year are estimated to have resulted in EM growth effectively just keeping pace with DM, its worst relative performance in 22 years.

CHART 4: MIND THE GAP

EM versus DM real GDP growth differential
(percentage points)



Dashed line represents consensus forecasts as of January 27, 2023; shaded regions represent periods of US recession; source: Guardian Capital based on data from International Monetary Fund and Bloomberg to 2021

There is reason to expect, however, that the past 12 months could well represent the nadir — indeed, current forecasts suggest that the EM should re-establish a hefty growth premium in the near term.

Fine China?

The outlook for EM, and the world more broadly, has taken a decisive turn for the better in the last couple of months, and a major reason for that is China.

The world's second-largest economy has struggled over the past year, as it dealt with a homegrown

property market crisis and adhered to a strict "zero COVID" policy. The former stymied domestic investment and eroded wealth, while the latter stifled consumer spending and exacerbated global supply chain issues.

With neither issue resolving itself, policymakers finally decided to step in and address the problems.

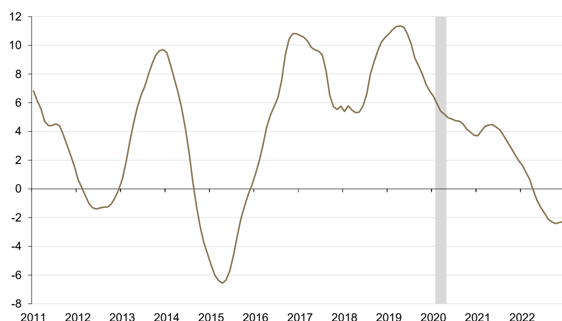
Starting with real estate, Chinese monetary policy authorities and financial regulators have introduced initiatives to stabilize the sector.

The policies focus on supporting developers in moving forward with projects and easing mortgage conditions. The goal is to underpin confidence that contracts between homebuyers and builders will be honored and ensure a willingness to make payments (many homebuyers have been boycotting payments against concerns that homes will not end up being built).

While it is uncertain whether this will be sufficient to revive the beaten-down real estate sectors, at a minimum, it may ease concerns and provide something of a floor under prices.

CHART 5: A SUSTAINED SLIDE

Newly built commercial/residential building price index, China
(year-over-year percent change)



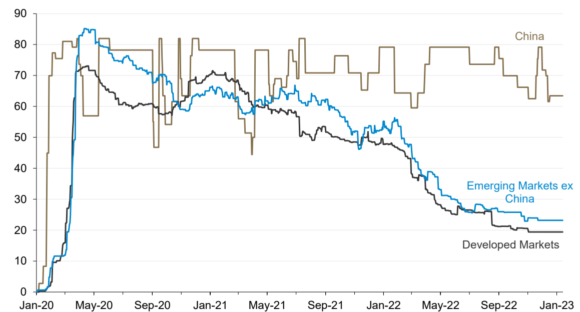
Shaded region represents a period of US recession; source: Guardian Capital based on data from Bloomberg to December 2022

China's shift with respect to pandemic management is something that carries much broader implications for the global economic outlook.

Amid growing civil unrest over lockdowns and rising economic pressures (this coming alongside a slowing in demand for consumer goods that had offset the soft domestic activity data is unlikely a coincidence), the Chinese government has decided to follow the rest of the world in scaling back its more stringent public health measures.

CHART 6: LOOSENING THE RESTRAINTS

Government COVID-19 response stringency index, G20
(index; higher denotes more restrictive measures in place)



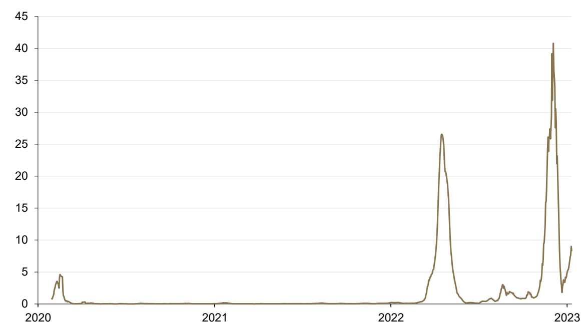
Source: Guardian Capital based on data from Oxford COVID-19 Government Response Tracker, IMF and Bloomberg to January 13, 2023

After the 20th National Congress of the Chinese Communist Party in November 2022 — which saw President Xi Jinping secure his unprecedented third five-year term as China's leader — there was a marked shift toward easing the more stringent restrictions followed by a further scaling back of the "zero COVID" policies in December.

This laxer approach to pandemic management has resulted in an aggressive wave of infection that China had, up until now, largely avoided. This has been particularly harsh given the lack of natural immunity established by earlier infection within the populations and the dearth of full vaccination among the elder portion of the population.

CHART 7: THE DAM HAS BURST

Confirmed daily COVID-19 cases, China
(thousands, seven-day moving average)



Source: Guardian Capital based on data from Our World In Data to January 9, 2023

As has been the case elsewhere in the world over the last three years, the wave is likely to be short-lived. The infection will run its course, and some semblance of herd immunity will be established, resulting in more benign cycles going forward.

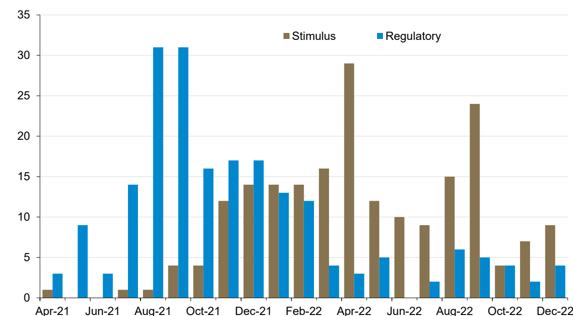
The Chinese government is trading (hopefully) short-term pain for more upbeat medium- and long-term economic prospects. The spread of infection and the possibility of lockdowns in response may restrain activity in the near term. Still, the rollback of restrictions stands, and the broad reopening of the Chinese economy is likely to accelerate growth momentum in the coming months.

On top of this, Beijing has recently adopted a more conciliatory approach to managing its relationships with its domestic and international partners. While recent history provides plenty of reason for caution, the importance of China in the global economic machine means that these developments cannot be discounted.

Internally, regulators have softened their approach toward private enterprise after years of crackdowns, particularly in technology. As a result, the balance between new stimulus measures and regulatory actions is now tilted in favour of the former.

CHART 8: CRACKING CRACKDOWNS

Government regulatory actions & stimulus measures, China (number of measures introduced)



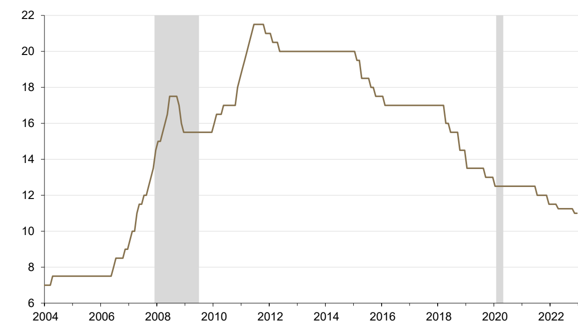
Source: Guardian Capital based on data from Piper Sandler to January 13, 2022

Abroad, Chinese delegations have adopted a less aggressive tone, softening diplomatic relationships in the interest of shoring up foreign investment and exports to support its economic goals.

Finally, in stark contrast to virtually every other central bank, the People's Bank of China has eased its policy stance. China's central bank cut its reserve requirement ratio (which determines how much banks can lend relative to deposits) further in December, which stands to inject added liquidity into their financial system and economy.

CHART 9: LOOSENING THE SCREWS

Reserve requirement ratio, China (percent)



Shaded regions represent periods of US recession; source: Guardian Capital based on data from Bloomberg to December 31, 2022

Taken together, the shift in policies within China is unambiguously positive for the broader EM and global economic outlook.

While there is the potential for an uptick in demand from China to add some verve to inflationary pressures, the potential for more rapid easing of supply chain pressures, resulting from a less constrained Chinese economy, would provide some offset.

Past the peak

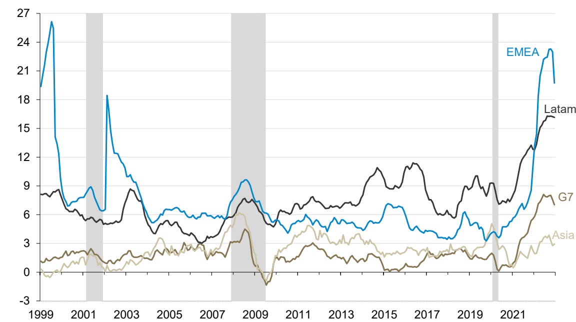
On the topic of inflation, as things stand, it is increasingly looking as though the peak has passed.

The kinks in the supply chain are being smoothed out, and commodity prices have fallen materially from their earlier heights, easing "cost-push" inflation pressures. Additionally, the pullback in demand across economies against the sharp tightening in global financial conditions over the last year results in waning "demand-pull" forces.

While inflation rates everywhere remain elevated (aside from Asia, largely reflecting the benign pricing backdrop in China), the trajectory has turned in the last three months.

CHART 10: INFLATED SENSE OF SELF-WORTH

Consumer price index
(year-over-year percent change)



GDP-weighted inflation rates; shaded regions represent periods of US recession; source: Guardian Capital based on data from Bloomberg to December 2022

The cooperative pricing data and indications that disinflationary trends are likely to continue, as supply pressures ease further with the continued normalization of activity, along with the impacts of previous rate hikes becoming more evident, suggest that there is not much left in the tightening cycle.

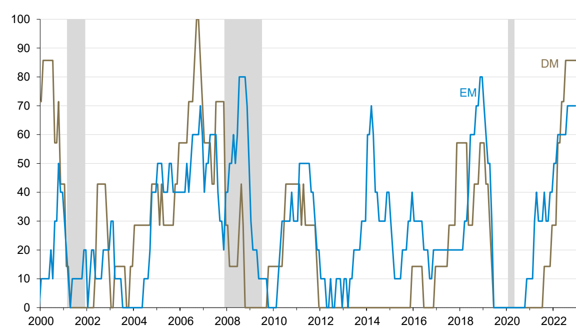
For sure, inflation remains uncomfortably high for policymakers, who are not yet willing to declare "mission accomplished" while there is the possibility for hawkish surprises in upcoming decisions. But worries of central bankers having to drive rates ever higher to rein in inflation have been largely quashed.

In fact, indications that there may be scope for inflation to fall even faster than currently anticipated could even open the door for policy to move from restrictive toward a more "neutral" position.

This is especially the case in EM, where central banks, with their spotty history of managing inflation, were spurred into action well ahead of their DM counterparts.

CHART 11: FIRST IN, FIRST OUT?

Central banks raising policy rates, G20
(six-month rolling average share of central banks)



Source: Guardian Capital based on data from the Bank for International Settlements and Bloomberg to January 27, 2023

The prospect of easing financial conditions would relieve pressure on households and businesses, and serve as a further tailwind for the year ahead.

Moreover, rising anticipations that the US Federal Reserve will take its foot off the gas have seen the US dollar, which has strengthened materially over the last two years, weaken — the expectation of a widening EM growth premium stands to help this trend continue.

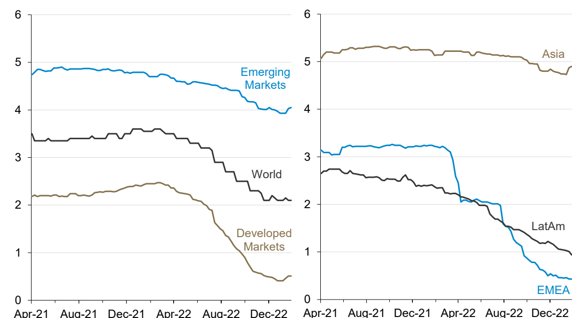
A strong US dollar is a big headwind for EM economies and financial market performance, so any further depreciation is a tick in the plus column.

Forward-looking markets

The near-term picture looks relatively better and suggests the scope for EM economies to re-establish their performance gap over DM. Forecasts for the year to come are ticking higher.

CHART 12: UPON REVISION

Consensus real GDP growth forecasts, 2023
(percent)



Source: Guardian Capital based on data from Bloomberg to January 27, 2023

This could serve as a draw for capital flows despite the ongoing uncertainty clouding the outlook (and will likely keep market volatility elevated).

But what stands to truly differentiate these economic groupings is the prospects over the longer term.

Once the pandemic is fully in the rear-view, and the boost from reopening and "normalization" of activity has been spent, the structural problems in DM (namely, poor demographics, flagging productivity and elevated public debt) will restrain growth.

In contrast, EM appears better positioned for the future with younger and increasingly more educated populations that are faster in adopting new technologies. The continuation of broader industrialization and urbanization trends are also clear positives for growth potential.

For investors that can look through near-term uncertainty and focus on the long-term (and investment performance in general; EM, in particular, should be measured in years or decades, not days or weeks), the current market environment offers significant opportunities.

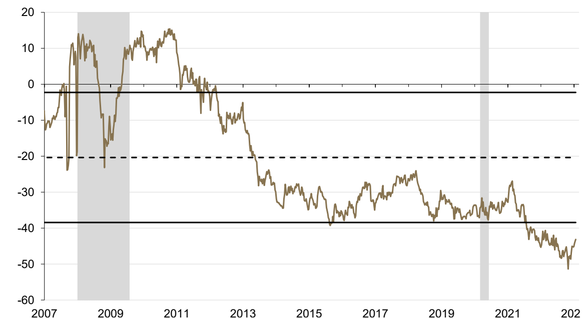
The rate-induced reset in financial markets in 2022 has made valuations for stocks and bonds far more attractive than they were a year ago.

That is particularly the case in EM, where relative values indicate that assets are historically inexpensive versus their DM peers.

EM equities are trading at 40% and 35% discounts to DM on a price-to-book basis and trailing price-to-earnings basis, respectively, both of which are in excess of one standard deviation events versus the norms of the last two decades; the 80-basis point dividend yield premium is two standard deviations above that long-term average.

CHART 13: A STEEP DISCOUNT

EM price-to-book ratio discount versus DM (percent)



EM=MSCI Emerging Markets[2]; DM=MSCI World[1]; dashed line represents historical average; solid black lines are +/-1 standard deviation from this average; source: Guardian Capital based on data from Bloomberg to January 27, 2023

The bottom line is that, while EM investors are rightfully weary after what has largely been a lost decade of material underperformance, there are reasons to believe that a reversal of fortunes may be on the cards despite what is likely to remain a challenging backdrop over the near term.

David Onyett-Jeffries

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End notes

[1]The MSCI World Index captures mid- and large-cap representation across 23 developed market countries.

[2]The MSCI Emerging Markets Index captures mid- and large-cap representation across 27 Emerging Markets countries.

[3]The Bloomberg Barclays Global Aggregate Bond Index is a flagship measure of global investment grade debt from twenty-four local currency markets.

[4]The Bloomberg EM Hard Currency Aggregate is a flagship hard currency Emerging Markets debt benchmark that includes fixed and floating-rate US dollar-denominated debt issued from sovereign, quasi-sovereign, and corporate EM issuers.

[5]Price Indices of Newly Constructed Residential Buildings (by Floor Space) in 70 Medium- and Large-sized Cities. This index shows the year-over-year change in new home building prices in China, and is calculated in weighted average method and the weight of each city is based on the population.

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