



August 2023

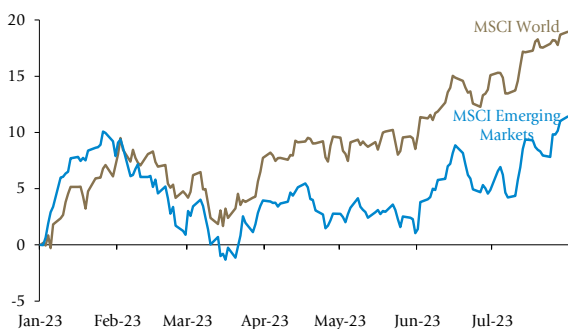
# Emerging Markets Outlook

## Head(wind)s or tail(wind)s?

After a strong start to the year, Emerging Market (EM) equities lost momentum and struggled to regain traction as stocks in Developed Markets (DM) rallied. The result has been a widening performance gap and another year of underwhelming returns for EM investors (MSCI Emerging Markets Total Return Index<sup>1</sup>+11% year-to-July) versus their DM counterparts (MSCI World Index<sup>2</sup>+19%) in US dollar terms.

### CHART 1: LAGGING BEHIND, AGAIN

MSCI Index year-to-date total return  
(percent change since January 1, 2023; US dollar basis)



Source: Guardian Capital based on data from Bloomberg to July 31, 2023

That said, these aggregates mask the fairly notable variance under the hood and somewhat exaggerate the gap in returns for many investors.

For starters, the strong relative performance of DM equities this year has not been a case of a rising tide lifting all boats. Instead, it has been the product of an extremely narrow subset of stocks soaring while the rest have been bobbing closer to the surface.

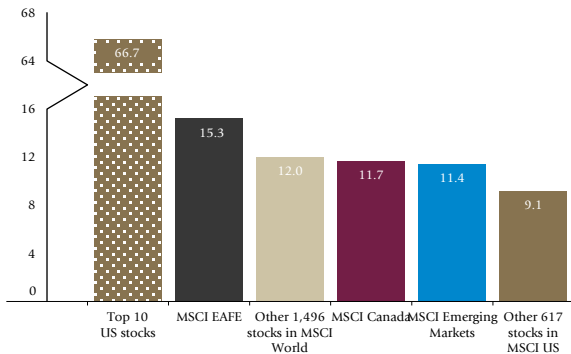
Indeed, half of the gain recorded in the MSCI World Index over the year-to-date can be attributed to the returns on stocks of just 10 US companies that account for less than 15% of the index's weight.

Any portfolio that does not hold these stocks, or is underweight relative to the market benchmark (such as value or income-biased strategies), is very likely underperforming the core index by a fairly significant margin.

For example, absent the near 70% weighted-average increase in these 10 American (Tech and artificial intelligence (AI)-adjacent) stocks, the other 1,496 stocks in the DM equity benchmark are up by a far more modest 12% — with EM keeping pace.

## CHART 2: BETTER BY COMPARISON

MSCI Index year-to-date total return  
(percent change since January 1, 2023; US dollar basis)



Source: Guardian Capital based on data from Bloomberg to July 31, 2023

Further, market performance within the EM grouping has been highly varied as well.

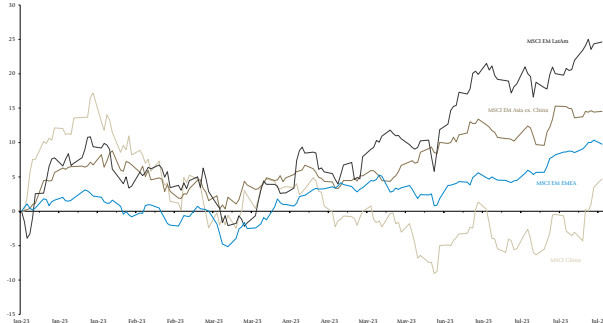
Latin America (LatAm) has turned in an extremely strong performance against indications of resilient demand and solid near-shoring-supported investment, combined with moderating inflation and rising expectations of less restrictive policy.

Technology and semiconductor-heavy markets in Emerging Asia outside of China, particularly South Korea and Taiwan, have benefitted from the fervour surrounding developments in AI. China, on the other hand, has notably underperformed.

Emerging Europe, Middle East and Africa (EMEA) have registered moderate gains as positives coming out of Europe — Greece, for example, has been the top performing market following its recent elections and expectations of a continuation of market-friendly policies — are offset by underperformance of the heavily-weighted commodity-dependent regions amid the giveback in natural resource prices following last year's surge.

## CHART 3: REGIONAL VARIATION

MSCI Index<sup>3</sup> year-to-date total return  
(percent change since January 1, 2023; US dollar basis)



Source: Guardian Capital based on data from Bloomberg to July 31, 2023

## The Market and the Macro

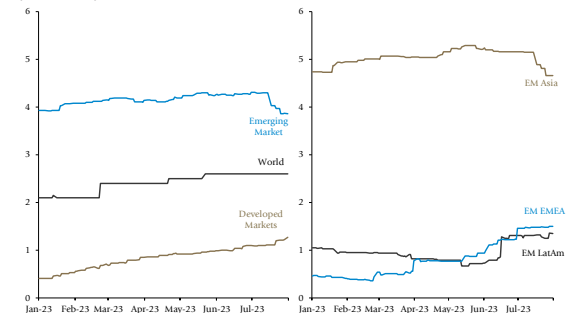
More generally, market performance this year has been largely consistent with the evolution of regional macroeconomic trends.

The baseline expectation at the outset of the year was for a recession to come to DM. However, activity in the major industrialized economies has remained surprisingly positive, with persistent consumer-driven underlying momentum necessitating upward revisions to growth forecasts.

In contrast, EM has seen forecast downgrades predominantly reflecting lowered expectations for Asia (namely China) that have diminished the anticipated widening growth premium for the group.

## CHART 4: UPON REVISION

Consensus real GDP growth forecasts, 2023  
(percent)

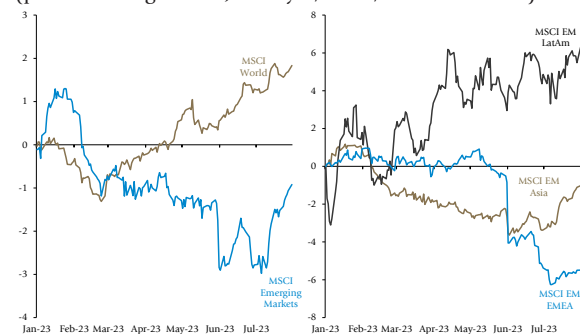


Source: Guardian Capital based on data from Bloomberg to July 31, 2023

These adjustments have been echoed in earnings forecasts with DM and LatAm stocks registering persistent upgrades while those for EM Asia and EMEA, and EM overall, being reduced.

## CHART 5: UPON REVISION

Consensus 12-month forward earnings per share forecasts  
(percent change since January 1, 2023; US dollar basis)



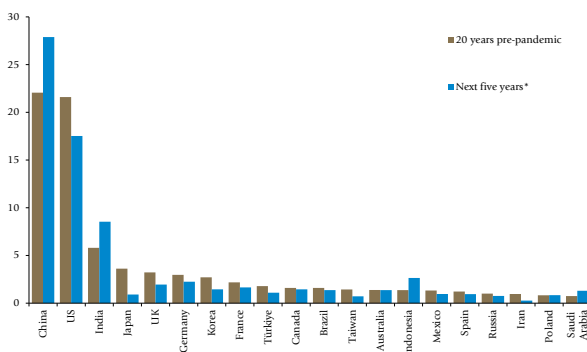
Source: Guardian Capital based on data from Bloomberg to July 31, 2023

## Cracks in China

China warrants more focus given its increasingly significant role, not just in EM but in the world. China was the biggest driver of global growth over the two decades pre-pandemic, and it is expected to be a bigger contributor in the years ahead as DM growth downshifts against more structural headwinds (aging demographics in particular).

### CHART 6: GAINING WEIGHT

Contribution to global GDP growth (percent of total)



\*Based on forecasts from the International Monetary Fund's July 2023 World Economic Outlook; source: Guardian Capital based on data from Bloomberg and the International Monetary Fund

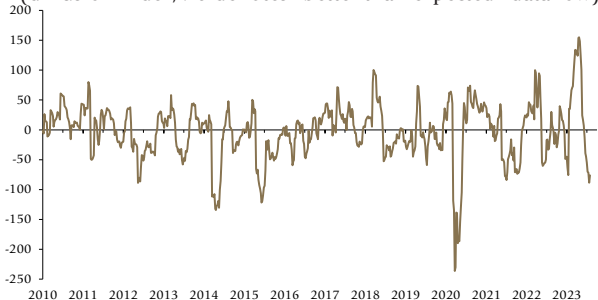
The abrupt shift by policymakers in Beijing away from the long-held "COVID zero" policy late last year drove a rapid turn in economic momentum, as public health restrictions were scaled back and the economy started to reopen in earnest.

Given the boost to overall activity elsewhere, expectations were high that China would see a sustained acceleration this year that would help offset a moderation among other economies that were further along in their post-pandemic strategies.

However, the initial boom proved to be unsustainable and the rebound has underwhelmed since, especially over the last few months with the dataflow coming in materially below expectations.

### CHART 7: DATA DISAPPOINTMENTS

Economic surprise index<sup>5</sup>, China (diffusion index; >0 denotes "better than expected" dataflow)

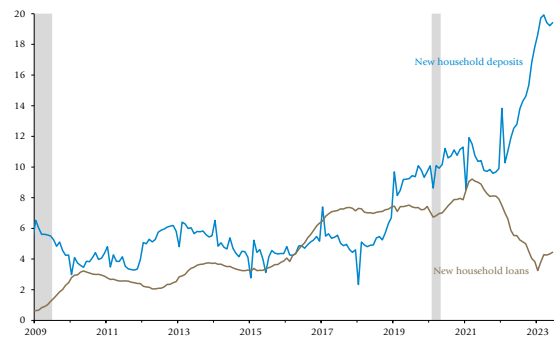


Source: Guardian Capital based on data from Bloomberg to July 31, 2023

Consumer spending in China has been fairly lacklustre after a surge to start the year, with households opting to build rather than draw down savings against depressed sentiment and ongoing concerns about the domestic property market (which accounts for roughly one-third of the Chinese economy).

### CHART 8: MONEY IN, NOT OUT OF, THE BANK

New household deposits & loans, China (trillions of renminbi, 12-month rolling total)

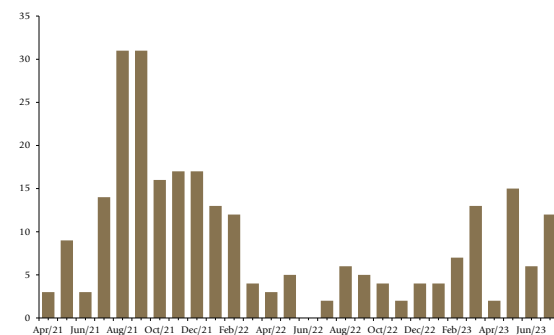


Shaded regions represent periods of US recession; source: Guardian Capital based on data from the People's Bank of China (PBOC) and Bloomberg to June 2023

The troubles in real estate have also served to restrain business' appetite for investment, which was already weighed down by indebtedness and the uncertainty generated by the government's regulatory crackdowns — Beijing's pressure on companies has ticked back up in recent months, however, recent fines imposed on Tech companies represent the end of a regulatory overhaul in the sector; a positive development

### CHART 9: REGULATORY OVERSIGHT

Government regulatory measures introduced, China (number)

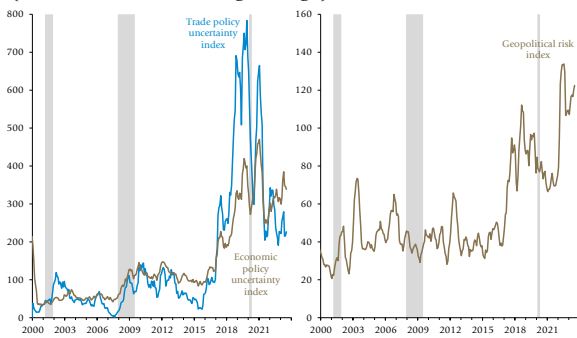


Source: Guardian Capital based on data from Piper Sandler to July 2023

As well, the once dependable flows of foreign investment have increasingly been moving toward other South Asian economies such as Vietnam, Indonesia and Malaysia, against perceived rising geopolitical risks in China — the potential for an escalation of tensions over Taiwan and increasingly strained diplomatic ties with the US loom large.

**CHART 10: PLAYING POLITICS**

Policy uncertainty<sup>7</sup> & geopolitical risk<sup>8</sup> indexes, China (index; 6-month moving average)

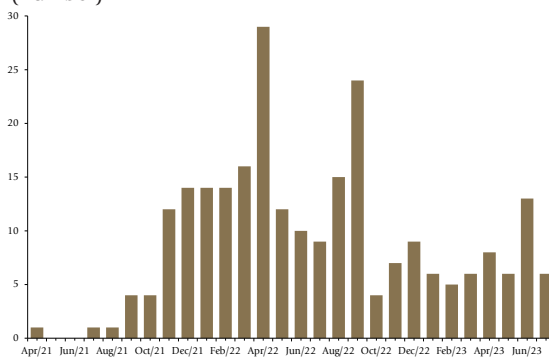


Shaded regions represent periods of US recession; source: Guardian Capital based on data from PolicyUncertainty.com to July 2023

The Chinese government has responded by introducing an increasing slate of initiatives to give the domestic economy a shot in the arm try to provide support to the Real Estate sector — the tone toward Tech has also turned for the better, with the statement following the Politburo meeting in late July flagging the need for the “healthy development of platform companies.”<sup>9</sup>

**CHART 11: STIMULATING CONVERSATIONS**

Government stimulus measures introduced, China (number)

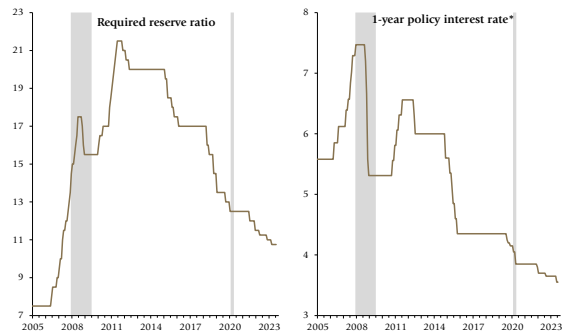


Source: Guardian Capital based on data from Piper Sandler to July 2023

As well, China’s central bank has bucked the tightening trend of its DM peers this year. The People’s Bank of China (PBOC) has been steadily easing, with the required reserve ratio and interest rates both being reduced in an effort to inject more liquidity into the financial system and economy.

**CHART 12: GOING DOWN**

Reserve requirement ratio & policy interest rate\*, China (percent)



\*China’s policy interest rate is 1-year prime loan rate since August 20, 2019; prior to that, 1-year Official lending rate; shaded regions represent periods of US recession; source: Guardian Capital based on data from Bloomberg and the Bank for International Settlements<sup>10</sup> to July 31, 2022

So far, these initiatives have little to show in terms of results, which is clearly a concerning development for the global economy. It raises the prospect that a desired pickup in activity in China may not have enough verve to counterbalance a moderation in DM economies that are further along in their recoveries.

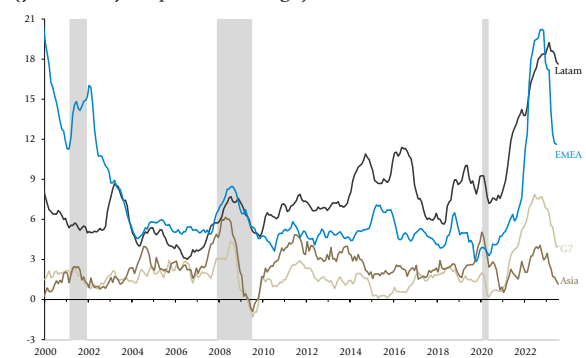
**Policy pivot point**

The likelihood of stimulus in the coming months is not unique to China in EM — monetary policy in particular appears set to shift from headwind to tailwind for the grouping in the near future.

While inflation rates remain elevated, they are well off their peaks globally and the moderating trend appears likely to remain intact in the months ahead.

**CHART 13: PASSED THE PEAK**

Consumer price index<sup>11</sup> (year-over-year percent change)



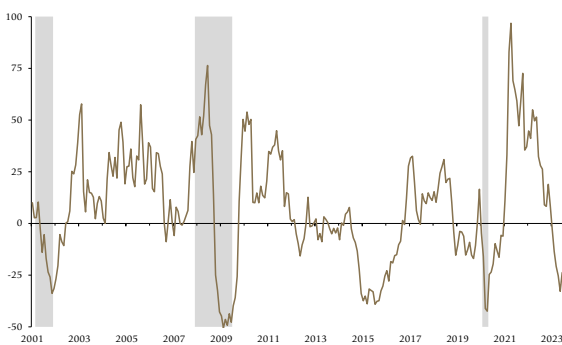
GDP-weighted inflation rates; shaded regions represent periods of US recession; source: Guardian Capital based on data from Bloomberg to December 2022

The reversal of last year's Russian-invasion-driven surge in food and energy commodity prices has played a significant role in bringing inflation rates down to earth — and this is especially beneficial for EM that allocate a greater share of household budgets to these necessities of life.

Commodity prices in the aggregate are 20% below year-ago levels, and while this is less than ideal for the more commodity-sensitive EM, the absence of a material shift higher in the coming months means that they will continue to exert downward pressure on inflation rates in the coming months.

#### CHART 14: NO LONGER A HOT COMMODITY

S&P/Goldman Sachs spot commodity price index<sup>12</sup>  
(year-over-year percent change)



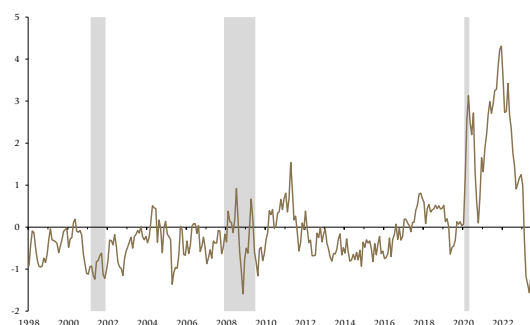
Shaded regions represent periods of US recession; source: Guardian Capital based on data from Bloomberg to July 2023

As well, while they may have proven to be less “transitory” than assumed, the pandemic-driven upward pressures on prices throughout supply chains are fading quickly.

Port congestion has been alleviated, order backlogs caught up, inventories replenished, and transportation and shipping costs have come back down to earth. Aggregated gauges of supply-side pressures have returned to pre-pandemic levels.

#### CHART 15: PRESSURE RELEASE

Supply chain pressure index<sup>13</sup>, world  
(standard deviations from the average)

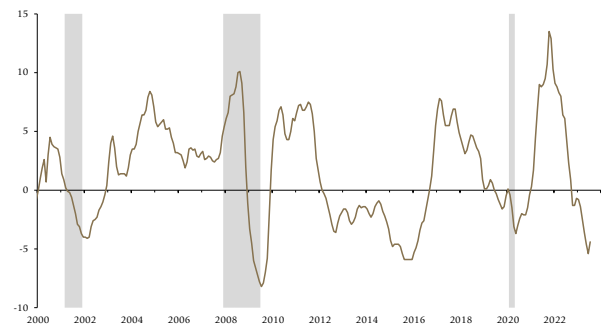


Shaded regions represent periods of US recession; source: Guardian Capital based on data from New York Federal Reserve Bank to June 2023

Against these positive developments, indicators of price pressures in the production pipeline have plunged worldwide — China, which is often the first step in the value chain, has seen producer prices decline particularly sharply relative to last year.

#### CHART 16: PLUNGING PIPELINE PRICE PRESSURE

Producer price index<sup>14</sup>, China  
(year-over-year percent change)



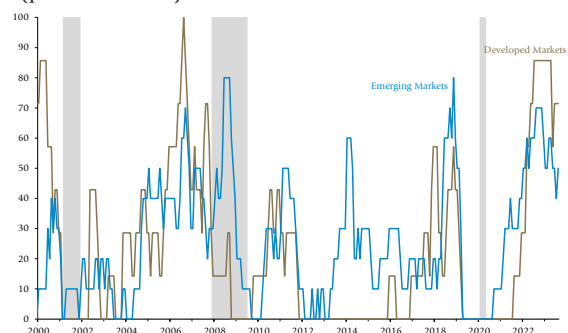
Shaded regions represent periods of US recession; source: Guardian Capital based on data from Bloomberg to July 2023

Evidence of broadening disinflationary pressures is easing the pressure on central banks to keep tightening the screws, especially in EM where policymakers have notoriously poor track records for keeping inflation in check.

Accordingly, EM central banks that were spurred into action early have increasingly been moving to the sidelines even as their DM counterparts have restarted their own tightening campaigns.

#### CHART 17: FIRST IN, FIRST OUT?

Central banks raising policy rates, G20  
(percent of total)



Source: Guardian Capital based on data from the Bank for International Settlements and Bloomberg to July 31, 2023

Moreover, in addition to China as mentioned, Chile’s Monetary Policy Committee cuts its benchmark interest rate in July and Brazil’s central bank reduced its own in early August — and expectations are rising that others, particularly in EM Europe and LatAm, will soon follow suit.

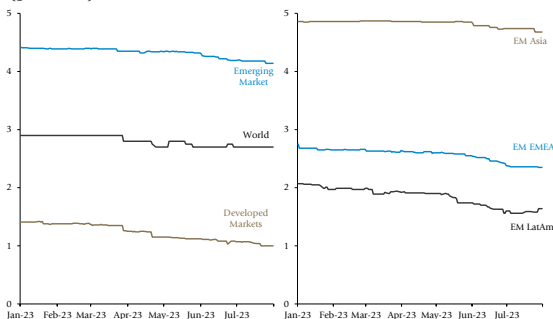
Less stringent EM financial conditions would ease pressure on households and business, while the US Federal Reserve approaching the end point in its own hiking cycle would offer up relief via the US dollar and serve as a further tailwind for EM growth — any softening in the greenback has also historically been a boon for EM investors.

## Looking forward

Turning attention to the road ahead, the consensus at the moment is that the headwinds and tailwinds to growth will largely balance out and leave the overall pace of expansion in the EM largely in line with what has played out this year — DM, for their part, are anticipated to see a further deceleration.

### CHART 18: STEADY AS SHE GOES

Consensus real GDP growth forecasts, 2024 (percent)

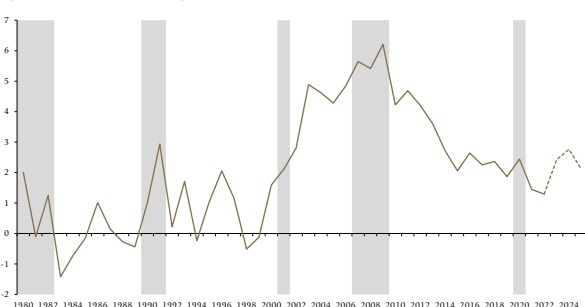


Source: Guardian Capital based on data from Bloomberg to July 31, 2023

The net result is that EM economies appear set to widen their performance gap over DM and maintain their growth premium in the coming years.

### CHART 19: MIND THE GAP

EM versus DM real GDP growth differential (percentage points)



Dashed line represents consensus forecasts per the International Monetary Fund’s July World Economic Outlook Update; shaded regions represent periods of US recession; source: Guardian Capital based on data from International Monetary Fund and Bloomberg to 2022

The comparatively constructive economic and policy backdrop could help support a return of capital flows that have undergone an exodus in recent years and left EM trading at historic discounts to DM.

EM equities are trading at 45% and 30% discounts to DM on price-to-book basis and forward 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 20: A STEEP DISCOUNT

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



EM=MSCI Emerging Markets; DM=MSCI World; 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

So, while the market environment remains challenging amid the ongoing uncertainty over the outlook and persistent risks, the macro fundamentals and market valuations in EM suggest there are opportunities in an asset class to which many investors now find themselves underexposed.

**David Onyett-Jeffries**

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## End notes

<sup>1</sup>The MSCI Emerging Markets Index (MSCI EM Index) captures mid- and large-cap representation across 27 Emerging Markets countries.

<sup>2</sup>The MSCI World Index captures mid- and large-cap representation across 23 developed market countries.

<sup>3</sup>The MSCI EM EMEA Index captures mid and large cap representation across 12 Emerging Markets countries in Europe, the Middle East, and Africa. The MSCI EM Latin America Index captures mid and large cap representation across 6 Emerging Markets countries in Latin America. The MSCI China Index captures large and mid-cap representation across China A shares, H shares, B shares, Red chips, P chips and foreign listings (e.g. ADRs). The MSCI EM Asia ex. China Index captures large and mid-cap representation across 7 of the 8 Emerging Markets countries (India, Indonesia, Korea, Malaysia, the Philippines, Taiwan and Thailand) excluding China. The MSCI Canada Index is designed to measure the performance of the large- and mid-cap segments of the Canada market. With 87 constituents, the index covers approximately 85% of the free float-adjusted market capitalization in Canada. The MSCI USA Index is designed to measure the performance of the large- and mid-cap segments of the US market. With 627 constituents, the index covers approximately 85% of the free float-adjusted market capitalization in the US.

<sup>4</sup>International Monetary Fund, World Economic Outlook Update, Near-term Resilience, Persistent Challenges, July 2023, <https://www.imf.org/en/Publications/WEO/Issues/2023/07/10/world-economic-outlook-update-july-2023>

<sup>5</sup>The Citi Economic Surprise Index measures the pace at which economic indicators are coming in ahead of or below consensus forecasts. When the index is negative, it means that the majority of reports are coming in below expectations, while a positive reading indicates that most data is coming in ahead of expectations

<sup>6</sup>A number of economic stimulus measures enacted by the Chinese government.

<sup>7</sup>The "Global Economic Policy Uncertainty Index" is a GDP-weighted average of national Economic Policy Uncertainty (EPU) indices for 16 countries that account for two-thirds of global output. Each national EPU index reflects the relative frequency of own-country newspaper articles that contain a trio of terms pertaining to the economy, uncertainty and policy-related matters.

<sup>8</sup>The Geopolitical Risk Index, created by Dario Caldara and Matteo Iacoviello, is a measure of adverse geopolitical events and associated risks based on a tally of newspaper articles covering geopolitical tensions. The index reflects automated text-search results of the electronic archives of 10 newspapers related to adverse geopolitical events in each newspaper for each month (as a share of the total number of news articles).

<sup>9</sup>South China Morning Post, Economy, China Economy, China's tech giants off leash after years-long crackdown, as Beijing primes them to be the economic engine they once were, July 12, 2023, <https://www.scmp.com/economy/china-economy/article/3227403/china-unveils-wish-list-boost-big-tech-economy-amid-us-curbs-after-ending-probe-platform-companies>

<sup>10</sup>The Bank for International Settlements (BIS) supports central banks' pursuit of monetary and financial stability through international cooperation and to act as a bank for central banks

<sup>11</sup>Inflation measured by consumer price index (CPI) is defined as the change in the prices of a basket of goods and services that are typically purchased by specific groups of households.

<sup>12</sup>The S&P GSCI is the first major investable commodity index. It is one of the most widely recognized benchmarks that is broad-based and production weighted to represent the global commodity market beta. The index is designed to be investable by including the most liquid commodity futures, and provides diversification with low correlations to other asset classes

<sup>13</sup>The Federal Reserve Bank of New York Global Supply Chain Pressure Index is a measure of global supply chain conditions.

<sup>14</sup>A producer price index is a price index that measures the average changes in prices received by domestic producers for their output

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