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The HUB

NEWS AND VIEWS FOR INSTITUTIONAL INVESTORS

Emerging market opportunities abound

Many high-quality companies can be unearthed if you are willing to turn over some rocks

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After a bruising two years which saw the wider emerging market equity index swoon more than 20%, many investors are understandably wary.[1] But, from the vantage point of Loomis, Sayles & Company, an affiliate of Natixis Investment Managers, the outlook for emerging equities in 2023 and beyond is strong.

There are three key reasons for this, according to Ashish Chugh, portfolio manager at Loomis:

- **Subsiding inflation:** Emerging market central banks were among the first to hike interest rates, well ahead of the Fed and the ECB, and Loomis believe the monetary tightening cycle in emerging markets is nearing an end. Inflation is peaking, and in many countries, it's actually receding. So, falling inflation and more dovish central banks should offer support going forward.
- **Rising growth:** Secondly, the growth in emerging markets should be strong this year and next. "If you look at IMF projections, they're predicting that emerging markets should grow at three times the rate of developed markets," says Chugh. And China and India alone should grow at 5% to 6%, and most likely will be responsible for more than half of global growth.[2]
- **Attractive valuations:** Finally, valuations are looking very attractive in emerging markets relative to earnings growth – and relative to history. Across the emerging market universe, Loomis believe that earnings should grow in the mid-teens this year and next. And yet they are still only trading at PE multiples of around 11 times, which is very attractive relative to developed markets.[3]

That said, while the outlook overall looks good, all companies should not benefit from the tailwinds described above. Indeed, one could go so far as to say the vast majority of companies in emerging markets are low quality. But, if you are prepared to turn over a lot of rocks, you will be rewarded with some significant opportunities.

In fact, because there are so many stocks in the broader universe, and fewer analysts covering the space, emerging markets tend to be less efficient than developed markets, something that dedicated and active investors can exploit.

In simple terms, most investors tend to underappreciate the quality of high-quality companies and overestimate the value of low-quality companies within emerging markets. And they also tend to overlook the shift from one end of the quality spectrum to the other – resulting in missed opportunities and, all too often, holding underperforming positions for too long.

Key takeaways:

- After a tough couple of years for emerging markets, they are now well positioned for growth amid subsiding inflation, rising growth metrics and historically low valuations.
- Many of the best prospects can be found in out-of-favour China, which has many high-quality stocks, many of which are trading at very low multiples.
- Emerging markets tend to be less efficient than developed markets, something that dedicated and active investors can exploit if they are willing to do the hard work of understanding the fundamentals from the bottom up.

1 Source: Bloomberg (MSCI Emerging Markets TR (USD) returned -22.12 from 31/12/2020 – 31/12/2022

2 Source: IMF https://www.imf.org/en/Publications/WEO#:~:text=Description%3A%20The%20baseline%20forecast%20is,to%20 1.3%20percent%20in%202023.

3 Source: Bloomberg. MSCI EM As at 22/05/2023

However, this quality inefficiency can be exploited if investors are willing to do the hard work of actually understanding the fundamentals of the businesses in question, from the bottom up.

So, where do opportunities lie? Looking at the universe today, many of the best prospects can be found in China.

Loomis believe that the Chinese economy should grow by 5% to 6% following the reopening of the economy after the cancellation of the zero COVID policy. "Chinese policymakers have a single-minded focus to revive the domestic economy and we're seeing strong policy support," says Chugh.

Moreover, the People's Bank of China has been reducing reserve requirements and adding liquidity. In addition, the state-owned banks have been supporting the real estate sector, which has been under a lot of stress. And the regulatory tightening that was seen for private enterprises, especially the tech sector, has receded.

Not only is there a strong policy push to revive the domestic economy, but Chinese equity market valuations are looking quite attractive. Chugh says: "We believe that many Chinese companies should grow earnings by 15% to 16%, and many of these companies are trading at very low multiples, around 12 times."[4]

Like the wider emerging market complex, China's economy is finally turning a corner. "In our opinion, out of favour – but still very high-quality – Chinese stocks are poised to do well going forward," Chugh adds.

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4 Source: Bloomberg MSCI China (As at 22/05/2023)

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