

Emerging Markets Quarterly Outlook

Quarter Four 2021



GLIMMERS OF LIGHT EMERGING ON THE HORIZON

The last few months have been quite challenging for Emerging Market (EM) economies and financial markets alike as a confluence of factors have provided headwinds and weighed on equity market performance across the group of 27 developing economies.

As of the end of October, the MSCI Emerging Markets Index had erased all of its gains from the first half and was effectively flat for the year in US dollar terms — this is a stark (and widening) underperformance relative to the 19% total return for the Developed Market (DM) benchmark MSCI World Index and stands to mark the biggest performance differential since 2013 (and fifth widest gap over the last three decades).

This inability of EM stocks in aggregate to sustain any traction this year has undoubtedly been a disappointing outturn for investors — and the combination of the persistent pandemic-related uncertainty lingering over the broad global economic outlook and more idiosyncratic EM-specific risks provides reason for caution as 2021 enters its home stretch.

With that said, there are some fundamental shifts underway for the global macroeconomic backdrop that appear favourable for the EM complex and suggest that better days may well be ahead as the new year starts to peek out over the horizon.

CHART 1: TWO ROADS DIVERGED...

Year-to-date MSCI Index total return (percent)

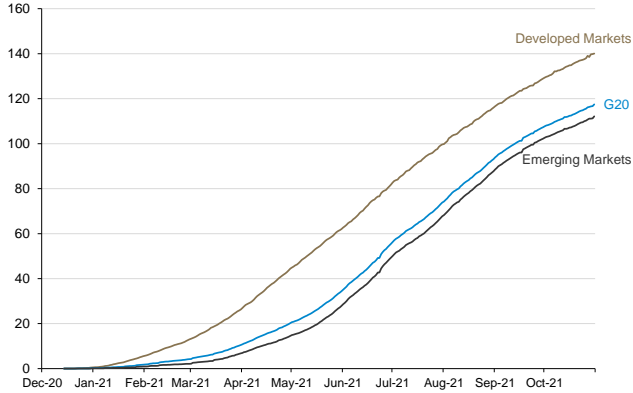


Data to October 31, 2021; EM=MSCI EM; DM=MSCI World

Source: Bloomberg, Guardian Capital

A shot across the bow

Starting with a broad lens, a notable portion of the relative weakness of EM versus DM can be attributed to the management of the pandemic. While vaccination rates have picked up since the spring, the EM has still notably lagged its more developed peers in immunizing its populations, leaving them more vulnerable to infection.

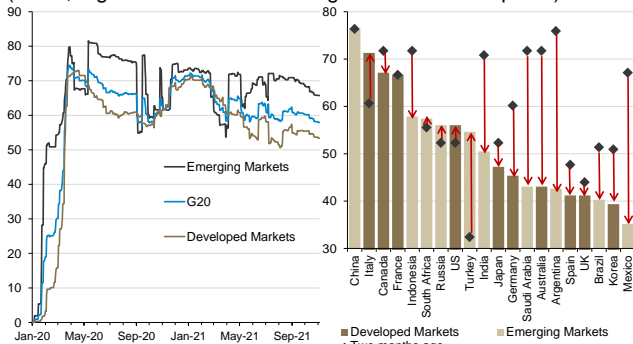
CHART 2: PLAYING CATCH-UP
COVID-19 vaccine doses administered, G20
 (doses per 100 people)


Data to October 31, 2021

Source: Our World in Data, Bloomberg, Guardian Capital

This exposure became evident over the summer as the Delta variant of COVID-19 spread rapidly (most notably in South Africa, Mexico, Indonesia, Malaysia, India, Russia and Turkey) and forced governments to reinstitute restrictions that hampered economic activity in the name of public health.

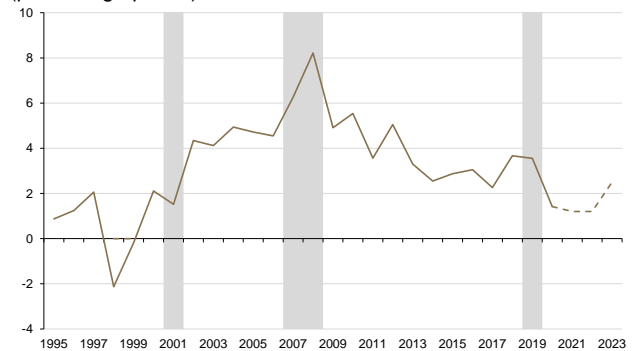
EM policymakers have subsequently lagged their DM counterparts in reopening their economies and easing mobility constraints as the latest wave of contagion has ebbed — this is particularly the case in China, where the government is one of the few remaining adhering to a “zero COVID” policy.

CHART 3: ZERO TOLERANCE
Government COVID-19 stringency response index
 (index; higher denotes more stringent measures in place)


(L) data to October 31, 2021; (R) data as at October 31, 2021

Source: Oxford COVID-19 Government Response Tracker, Guardian Capital

The net result has been that growth has been relatively restrained in the EM versus DM that have reopened more broadly — and while it is the case that the overall rate of economic expansion across EM is still expected to outpace DM, the magnitude of the growth premium is projected to be the smallest since EM were dealing with the fallout of the Asian financial crisis at the turn of the millennium.

CHART 4: MIND THE GAP
EM real GDP growth premium over DM
 (percentage points)


Data to 2020; dashed line is estimate based on Bloomberg consensus forecasts as at November 4, 2021

Source: Bloomberg, Guardian Capital

Growth delayed, not derailed

What is important to note with respect to the outlook, however, is that the nature of the major impediments to growth this year do not so much suggest that the recovery has been derailed but instead simply delayed.

Continued progress with vaccination should permit EM economies to catch up to DM and get back to running at full capacity — this would enable to EM to outpace DM and widen the growth differential.

Further, a broader reopening would help alleviate global supply chain constraints given EM economies’ roles as major suppliers of inputs to production and finished goods (especially consumer goods) to DM.

Indeed, the supply side of the equation has been the biggest hindrance to global growth.

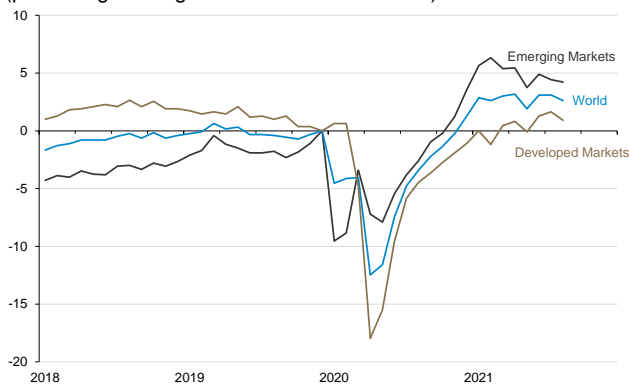
Demand for goods and services has been robust, but businesses face growing pressures to meet that demand as earlier COVID-19-driven stoppages in production and logistical constraints are still being felt throughout supply chains.

Industrial production has ramped up globally, with EM factories leading the rebound.

CHART 5: FACTORIES FIRED UP

Industrial production

(percentage change versus December 2019)



Data to August 2021

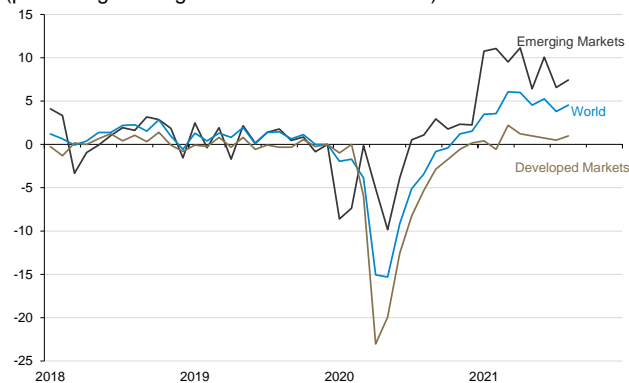
Source: Netherlands' Centraal Planbureau, Bloomberg, Guardian Capital

This in turn has driven a renewed upswing in international trade following largely stagnant flows over the previous half decade due to the backdrop of heightened tensions and rising barriers — with EM also benefitting from this development as well.

CHART 6: TRADING PLACES

International trade/export volumes

(percentage change versus December 2019)



Data to August 2021

Source: Netherlands' Centraal Planbureau, Bloomberg, Guardian Capital

The increased domestic and foreign production, however, has not been sufficient to meet demand, particularly for consumer products. As such, firms globally have had to draw down stockpiles to fill orders.

Even without increases in sales to end customers (which is not the base case), depleted inventory levels create a large need for businesses to restock, creating additional demand for goods producers and further compounding bottlenecks — moreover, recent experiences with difficulties maintaining supply channels suggest firms may target higher precautionary inventory levels than before.

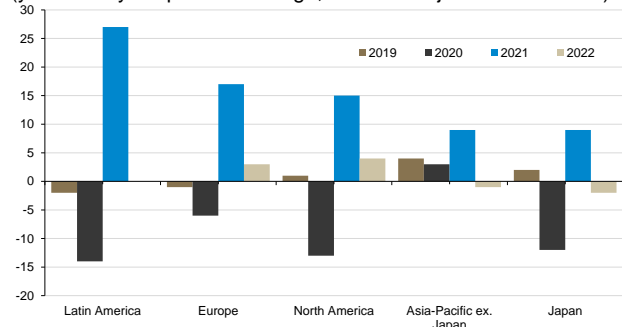
With this in mind, there is a clear need for increased capacity against the strong demand at all stages of the production pipeline, and buoyant business sentiment, low costs of capital and improved clarity on the outlook, as the latest COVID-19 wave ebbs, are resulting in surging expectations for capital expenditure.

A recent global survey indicated that business investment is slated to rise materially across all regions and sectors — with EM goods producers seeing a strong rise in expected capital flows, while the broad commodity space is expected to register increases as well after a period of significant weakness.

CHART 7: PLANT GROWTH

Nonfinancial capital expenditure plans by region

(year-over-year percent change; inflation-adjusted US dollars)



Estimates from S&P Global Corporate Capex Survey (July 2021)

Source: S&P Global Market Intelligence, S&P Global Ratings Capital

Feeling the pressure

Increases in productivity-enhancing investments are definitely welcome and should help to ease supply constraints — not to mention support the long-term prospects for the EM and broader global economy.

The benefits, however, will not be felt immediately. Most estimates suggest that it could be well into next year before supply pressures ease, meaning supply bottlenecks are likely to persist near-term and continue to put pressure on prices for a growing variety of goods across the world.

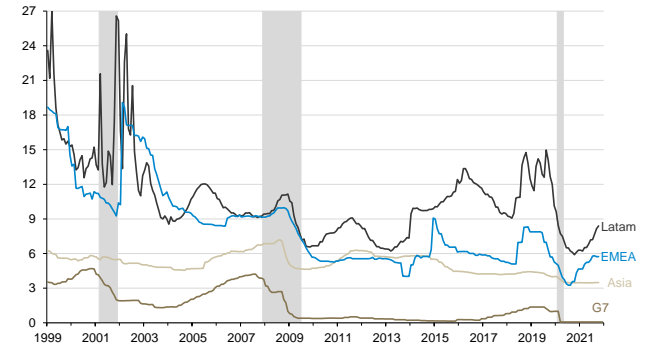
The supply/demand imbalances combined with the “base” and “reopening” effects stemming from the softness in inflation last year (which will fade in the coming months) have resulted in measures of consumer price inflation jumping sharply in recent months to multi-decade-high headline rates.

While major DM central banks are taking the approach that the bulk of the gains will prove transitory and thus do not warrant immediate response, EM policymakers, with their poor history of keeping a lid on inflationary pressures, have been pressed into action — the likes of Brazil, Mexico, Russia and, to a lesser extent, South Korea, have taken steps to tighten monetary policy.

Clearly, higher interest rates have a negative effect on domestic financial conditions, particularly in Emerging Europe and Latin America, where inflationary pressures have been more intense and triggered greater tightening. That said, the still-ample liquidity provided by loose DM policy has been a mitigating factor to this point, while the added carry available on these sovereigns could draw added flows from yield-hungry investors abroad.

CHART 8: ONE STEP AT A TIME

Short-term official/policy interest rate (percent)



GDP-weighted average policy interest rate; G7=Canada, France, Germany, Italy, Japan, US and UK; data to October 2021

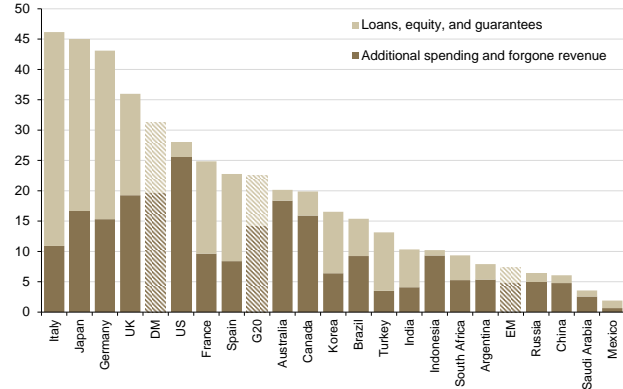
Source: BIS, IMF, World Bank, Guardian Capital

Let's get fiscal

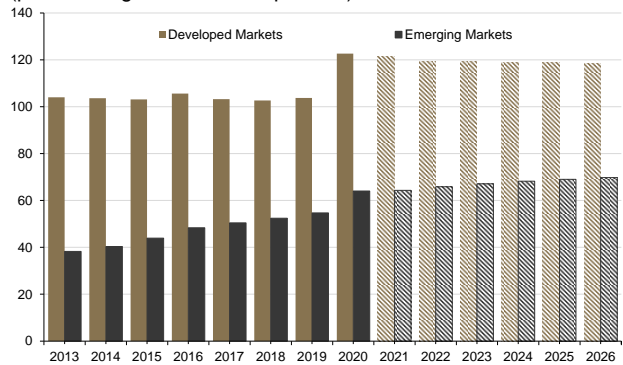
In addition to the cyclical tailwinds and still generally benign financial conditions, EM stand to experience a relative benefit versus DM from a comparatively smaller fiscal headwind. Governments in DM released a flood of fiscal support to their economies to help mitigate the impact of the pandemic — these policies have undoubtedly proved successful in softening the blow of pandemic measures and underpinned the persistent strength in demand.

The International Monetary Fund (IMF) estimates that G20 DM have committed more than US\$13 trillion (roughly one-third of the group's aggregated GDP) to COVID-19-related relief measures and other initiatives (such as private loan payment deferral programs).

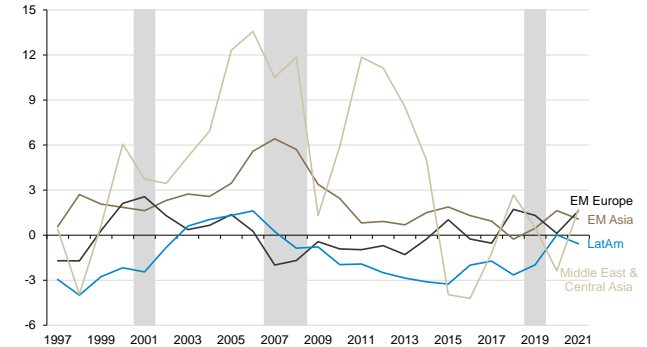
The response from EM, in contrast, has been far more muted — the tally as of October is less than US\$2 trillion, or less than 10% of cumulative GDP.

CHART 9: A MUTED RESPONSE BY EM
COVID-19 fiscal response, G20
 (percent of gross domestic product)

 Data as per the IMF's October 2021 Fiscal Monitor
 Source: IMF, Guardian Capital

As a direct result, there is a much smaller fiscal hole in EM that needs to be addressed at some point in the not too distant future — DM are expected to experience a greater fiscal drag as emergency policy supports fade and focus shifts increasingly toward reining in gaping deficits and onerous debt burdens.

CHART 10: BETTER FISCAL SHAPE
General government gross debt
 (percent of gross domestic product)

 Forecasts as per IMF's October 2021 Fiscal Monitor
 Source: IMF, Guardian Capital

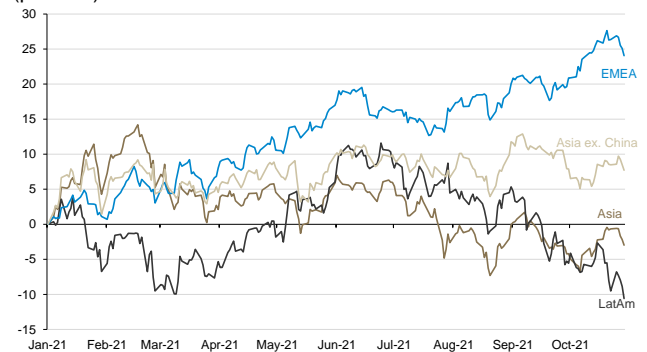
Add to this that current account balances across the EM have improved over the last two years on the strength in exports, as well as that financial vulnerabilities due to a dependence on external funding — that historically have a tendency of coming to the fore and spurring crises in EM — appear to have eased. These factors should provide support to the sovereign debt going forward.

CHART 11: FINDING BALANCE
Current account balance
 (percent of gross domestic product)

 Forecasts as per IMF's October 2021 Fiscal Monitor
 Source: IMF, Guardian Capital

Political discourse

Looking beneath the broad veneer of the “Emerging Market” classification, there is significant dispersion in the fortunes of the regional groupings that has translated into notably different market performance.

For example, a significant share of the relative weakness of EM equity performance can be attributed to the slump in Chinese stock markets. The MSCI China index has declined 16% in US dollar terms since June and absent China, the EM stock market composite is up closer to 9% thanks to strength across the rest of Asia and the natural resource-heavy Europe, Middle East and Africa (EMEA).

CHART 12: DISPERSE!
Year-to-date MSCI EM Index regional total return
 (percent)

 Data to October 31, 2021
 Source: Bloomberg, Guardian Capital

China has been dealing with a series of economic and market shocks, many of their own making.

As mentioned, the adherence of a ‘zero COVID’ approach to managing the pandemic has resulted in persistently heightened stringency that constrained activity amid the now-ebbing delta wave of the virus.

More recently, energy shortages — the result of supply/demand imbalances compounded by seasonal factors, emissions targets and deteriorating trade relationships with a major supplier of coal — have further constrained industrial activity.

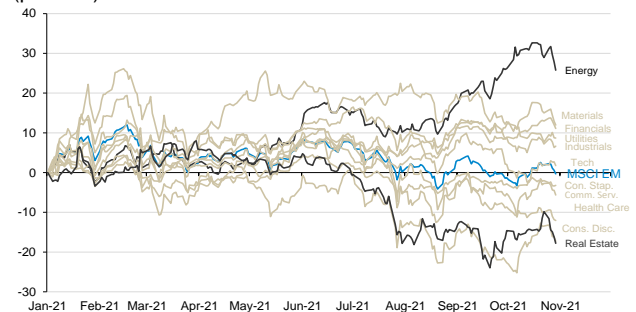
The intensification of the regulatory crackdowns by Beijing over the summer — designed to combat the sources of systematic inequality that can threaten social instability (anti-competitiveness and areas like education, health care and real estate) and address concerns over financial risk and data security — roiled markets and materially increased the embedded risks associated with investing in the Middle Kingdom.

Finally, the concerns surrounding the solvency of a large Chinese real estate firm which started a year ago amid government-imposed constraints on debt limits for property developers — as well as potential spillovers and the government’s response — have added to the pile and constrained activity in the previously buoyant real estate market.

It is notable, however, that the domestic focus of these shifts compared with economic adjustments of 2015 (currency devaluation) and 2018 (trade tensions) has meant that the contagion has been minimal — though the heavy weight of China in the EM has reverberated in significant underperformance of EM Real Estate, Consumer Discretionary and Communication Services.

CHART 13: THE CHINA SYNDROME

Year-to-date MSCI EM Index sector total return (percent)



Data to October 31, 2021

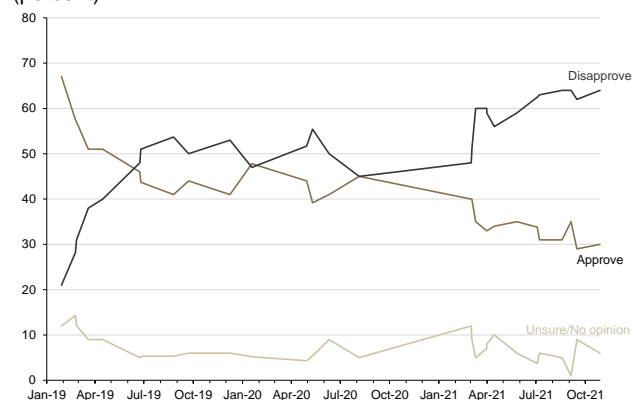
Source: Bloomberg, Guardian Capital

Similarly, the domestic political concerns permeating Latin America may not be causing big waves in global markets, but they are having impacts within the region.

Brazilian President Jair Bolsonaro has fallen out of favour largely due to his Administration’s handling of the pandemic — so much so that the Brazilian senate recently levelled accusations of crimes against humanity against the ruling government for its role in the country’s public health disaster.

CHART 14: FALLING OUT OF FAVOUR

Brazilian presidential approval (percent)



Data to October 29, 2021

Source: Wikipedia, Guardian Capital

This bodes poorly for Bolsonaro retaining his authority following next October's election against formidable challenger, left-wing former president Luiz Inácio Lula da Silva — Lula holds a double-digit advantage in the latest opinion polling.

A political shift in Latin America's largest economy would follow the recent trends within the region, where incumbents on both the left and right have endured a rebuke at the polls — upping the political risk in the region and EM more broadly.

Marrying the macro and the micro

The macroeconomic fundamentals look favourable for the EM re-establishing its growth momentum and premium over DM, which should provide support for the grouping's financial markets.

That said, the more micro-level issues suggest a selective approach to managing exposures within the complex is warranted.

Areas that are integral to global supply chains and natural resource production — particularly EMEA and Northeast Asia — would seem positioned to benefit from the economic cycle and the prevailing supply/demand imbalances.

In China, the clampdowns are concentrated on industries that are perceived to threaten long-term sustainability and social fairness in China — additional moves in areas such as healthcare and real estate seem likely and markets are pricing in a tighter regulatory backdrop.

The positive structural macroeconomic drivers within the Chinese economy, however, remain in place, and the government appears likely to ramp up its support of industries that are advancing the interests of the country (and thereby the Party) — innovators that are driving the rotation of the economy toward higher-valued-added production and technologies, and those supporting a stronger consumer class.

Elevated policy risk in China may deter some investors and businesses, but that creates opportunities for other EM economies that can step up, particularly tech and export-oriented markets of South Korea and Taiwan.

The bottom line is that while the near-term fortunes may well be dimmed by the pandemic and country-specific concerns, the underlying fundamental backdrop looks constructive, and relative valuations suggest that there is scope for EM assets to perform in the months ahead.

CHART 15: LOOKING FOR VALUE

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



EM=MSCI EM Index, DM=MSCI World Index

Data to October 2021; shaded regions represent periods of US recession
Source: Bloomberg, Guardian Capital

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