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INVESTMENT MANAGEMENT

THE BIG PICTURE
Emerging Markets: Stepping Into the Spotlight

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In the 2010s, emerging market (EM) equities suffered their worst performance as an asset class since the 1930s *(Display 1)*.[1] They returned a mere +49%, compared to an average of +203% in the previous seven decades.[2] Emerging market countries ran high twin deficits, which led to currency depreciation and forced a cleanup of excesses from their precarious balance sheets, a legacy of loose fiscal and monetary policies. An important factor inhibiting EM equity performance in the last decade was the deterioration in the growth differential between emerging economies and the developed world, the key driver historically of relative returns of the asset class. After lagging the developed economies (DM), especially U.S. equities, for more than a decade, emerging markets are in a much stronger position to outperform developed countries this decade.

Despite global crises like the COVID pandemic and Russia's invasion of Ukraine, as well as monetary policy tightening by the Fed and the continued strength of the U.S. dollar (USD), several emerging markets have thrived. Brazil, Mexico, India, Indonesia and the GCC (Gulf Cooperation Council) have not

[1] MSIM, Bloomberg, FactSet, Haver.

[2] MSIM, Bloomberg, FactSet, Haver. EM returns based on MSCI EM Index.

only outperformed the MSCI EM index but even the U.S. so far in 2022.[3] In fact 9 of the 10 top performing markets this year are emerging countries. The headwinds of the past are becoming tailwinds in several markets, with the exception of China, that we believe should provide support for many years to come. Various factors contributing to this outperformance should continue to serve as catalysts for a broader EM rally:

- Relative growth differentials now favor EM equities *(Display 2)*
- EM sovereigns are in healthier shape compared to DM governments due to better public debt and fiscal situations
- EM corporates are in a better position compared to DM corporates due to deleveraging
- EM external balances have improved compared to the past decade
- EM equities and currencies are trading at crisis-level valuations

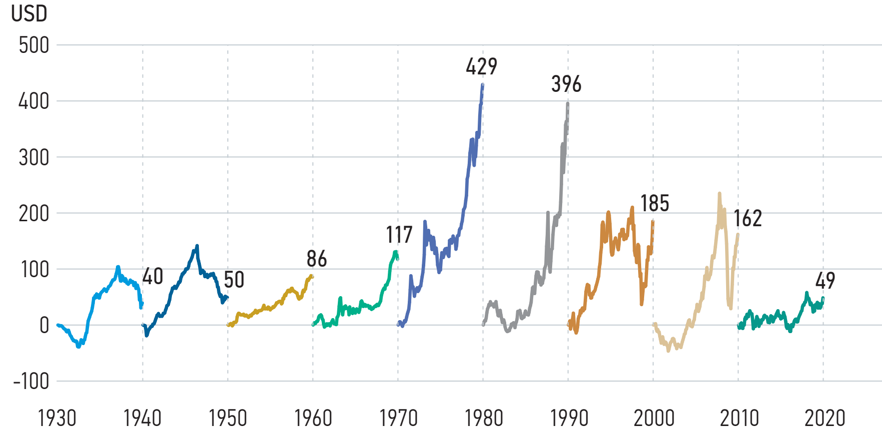
Relative growth differentials now favor EM equities

Growth in EM used to be seen as dependent on China's economic performance. However, we think this relationship will change over the decade. Growth in China is likely to be weighed down due to its high debt, declining working-age population growth and falling contribution from exports. In the 2000s, China became the manufacturer to the world, and in the 2010s, China's economy grew thanks to consumer internet giants. The big focus this decade will be on green technology and science-based industries like semiconductors, artificial intelligence and high-end manufacturing. EM is a heterogeneous asset class—despite the slowdown in China, we expect many other emerging market countries to see an acceleration in their growth, which will drive relative earnings and market share. The growth story of EM is underpinned by several factors across countries:

DISPLAY 1

2010s: Worst Decadal Returns for EM Since the 1930s

Emerging Markets Cumulative Total Returns Each Decade



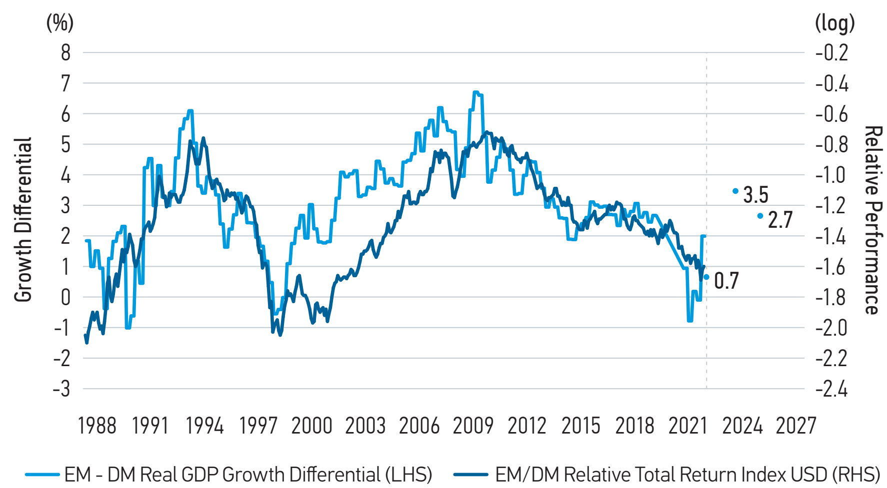
Data as of December 31, 2019.

Source: MSIM, Bloomberg, FactSet, Haver. Equity Total Returns, USD.

DISPLAY 2

Relative Growth Differentials Favor EM

EM vs DM Real GDP Growth Differential and Relative Performance



Data as of December 5, 2022. GDP-weighted.

Source: MSIM, Bloomberg, FactSet, Haver. Forecasts = Bloomberg consensus private sector estimates. Forecasts/estimates are based on current market conditions, subject to change, and may not necessarily come to pass.

- A manufacturing revival in competitive markets led by a "China plus one" strategy driving reshoring and friend-shoring
- A commodity upcycle driven by supply constraints and increased demand for green metals and minerals supporting decarbonization, benefiting resource-rich economies
- A digitization-led productivity boost will help growth across most EM regions
- A favorable political cycle in several pockets of emerging markets

[3] MSIM, Bloomberg. Data as of December 11, 2022. U.S. returns based on the S&P 500® Index.

EM sovereigns are in healthier shape compared to DM governments due to better public debt and fiscal situations

The absence of fiscal excesses in emerging economies has helped keep inflation more contained compared to the developed world. In fact, barring a brief period in the mid-2000s, inflation in EM for the first time is lower than in the U.S. *(Display 3)*.[4] Historically, fiscal spending and money printing was done by EM governments and central banks, which inevitably stoked inflation and currency crises. *But this time it was the Fed, and other developed world central banks, that resorted to printing money during the pandemic.*

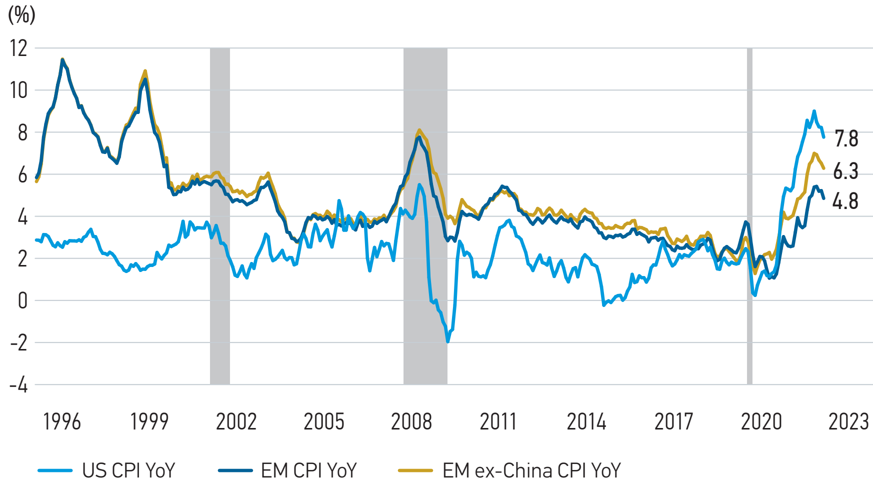
While total EM government debt/GDP (Gross Domestic Product) has risen, EM excluding China government debt has in fact fallen 1% to 53.8%, with improving fiscal deficits and higher nominal growth.[5] In another major development, EM borrowing has shifted to local funding, with about 85% of EM government debt now funded from domestic sources, reducing past vulnerabilities related to outflows and currency pressures during Fed hiking cycles.[6] For example, in 2017, 40% of Indonesia's government securities were owned by foreign investors. Today that figure has fallen to 14%.[7]

Smaller frontier economies like Egypt, Ghana, Ethiopia, Pakistan and others still face debt problems, but they constitute only approximately 5% of global GDP and hence do not pose systemic risk.[8] A positive: Larger emerging economies have no external debt issue—the original sin in emerging market countries.

DISPLAY 3

Inflation in EM Now Lower Than in the U.S.

Headline CPI Inflation Rate by Region



Data as of October 31, 2022. Market Cap Weighted
Source: MSIM, Bloomberg, FactSet, Haver.

EM corporates are in a better position compared to DM corporates due to deleveraging

Over the past year, the private sector debt/GDP ratio of emerging economies, excluding China, decreased by 4.5% to 85.8% of GDP.[9] The deleveraging was led by domestic corporate and household credit. Although private external debt rose by $1 trillion over the past five years—reaching $7.4 trillion in 2021—this acceleration reflects growth in China alongside borrowing by the Hong Kong and Singapore financial centers to fund Asian entities.[10] Elsewhere, external private sector borrowing has flatlined and is falling as a share of GDP, suggesting corporate-sector balance sheets are generally healthy across EM. Several EMs are starting a credit cycle with domestic liquidity, a healthy banking sector and a favorable asset-quality situation. Credit could support higher growth in these markets going forward.

EM external balances have improved compared to the past decade

A better macro environment with stronger sovereign, corporate and household balance sheets along with lower external vulnerabilities has helped improve the current account balances for several emerging markets. Commodity tailwinds are helping the external accounts of resource-rich countries and lowering their reliance on foreign capital. Reserves in EM are higher than where they were at the beginning of last decade.[11] In contrast to the past, EM economies now exhibit healthier balance-of-payments accounts and balance sheets. This should support currencies in emerging economies, excluding China, that are trading at historical lows.

[4] MSIM, Bloomberg, FactSet, Haver. Data as of October 2022.
[5] MSIM, J.P. Morgan, IMF.
[6] MSIM, J.P. Morgan, IMF.
[7] MSIM, Bloomberg, FactSet, Haver. Data as of November 2022.
[8] MSIM, The Economist.
[9] J.P. Morgan, IMF.
[10] J.P. Morgan, IIF.
[11] MSIM, Bloomberg, FactSet, Haver.

EM equities and currencies are trading at crisis-level valuations *(Displays 4 and 5)*

Despite better relative growth prospects, improved external balances and competitiveness and sustainable sovereign and private debt, relative valuations of currencies and equities have dropped to lows last seen in 2000.[12] That was when several markets were only beginning to recover from a series of crises—from the Mexican Tequila Crisis in 1994 to the Asian financial crisis in 1997 and the Russian debt default just a year later. *Crisis-level valuations have been great starting points for EM outperformance in the past.*

Currency valuations in emerging economies are critical as favorable currency moves on average have contributed to one third of total returns historically for dollar investors.[13] While the euro, pound and yen have tumbled against the USD this year, EM currencies have performed significantly better.[14] In fact, the EM currencies are holding up much better than other DM currencies compared to past Fed hiking cycles in the last 25 years.[15] Strength in these currencies relative to DM may be a harbinger of positive trends for the asset class. And notably, orthodox EM central banks began raising rates well ahead of the Fed in 2021.

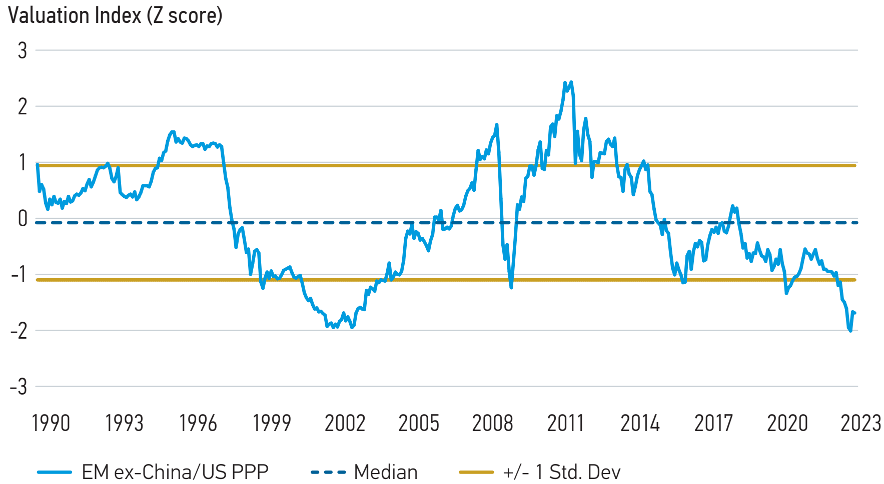
NAVIGATING BEYOND CHINA

The Chinese economy and markets have also followed a decadal cycle. While the 2000s saw the last surge of the Old China and the 2010s the rise of New China, the 2020s will be the decade of "China 3.0"—with the government prioritizing hard sciences and frontier technologies. The drivers of China's economy and markets should also evolve in this decade. With China making up 30% of the MSCI EM Index, we do not think passive investing can capture these thematics, given a large part of the index is still made up of Old and New China companies. Currently, China 3.0 is a small part of the index, with only a few interesting constituent companies positioned for this decade. It's time to look beyond China's 30% weight in the index and focus on markets, sectors and companies that look structurally better as new trends emerge.

DISPLAY 4

EM ex-China Currencies Are at Crisis-level Lows

EM Currencies ex-China PPP Valuations



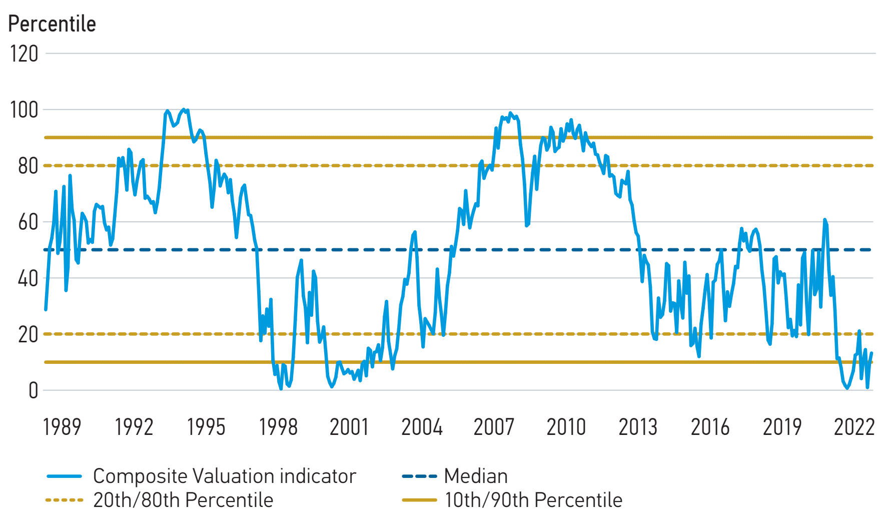
Data as of December 5, 2022. Market Cap Weighted.

Source: MSIM analysis, Bloomberg, FactSet, Haver.

DISPLAY 5

Relative EM Equity Valuations Are Also at Crisis-level Lows

Emerging Markets vs Developed Markets Composite Valuation Indicator



Data as of December 5, 2022.

Source: MSIM, Bloomberg, FactSet, Haver. Composite measure of 6 valuation metrics: price/book, 12m-fwd. P/E, P/E, price/sales, price/cash earnings, dividend yield.

[12] MSIM, Bloomberg, FactSet, Haver.

[13] MSIM, Bloomberg, FactSet, Haver.

[14] MSIM, Bloomberg, FactSet, Global Insight. Data as of December 5, 2022.

[15] MSIM, Bloomberg, FactSet, Global Insight. Data as of December 5, 2022.

Supply-chain diversion leading to reshoring and friend shoring: Under this era of deglobalization, countries feel a greater need to become more self-reliant and less dependent on China. This has led to the so-called "China plus one" strategy, a manufacturing revival and spreading of production to other countries to diversify supply chains away from China. Countries where wages are low and relatively high skills are appealing—such as India, Indonesia, Thailand, Vietnam and Mexico—are benefitting from this supply-chain diversification.

Decarbonization benefits commodity exporters: The global push to build a greener global economy has increased the demand for energy and raw materials while green politics have made it increasingly difficult to invest in new oil fields, aluminum smelters or copper mines. This imbalance provides support for commodity prices of energy and green metals that are benefitting from increased demand at a time when supply has been cut and curtailed. Commodity exporting countries like Brazil, Mexico, South Africa and some GCC countries will benefit from these decarbonization tailwinds.

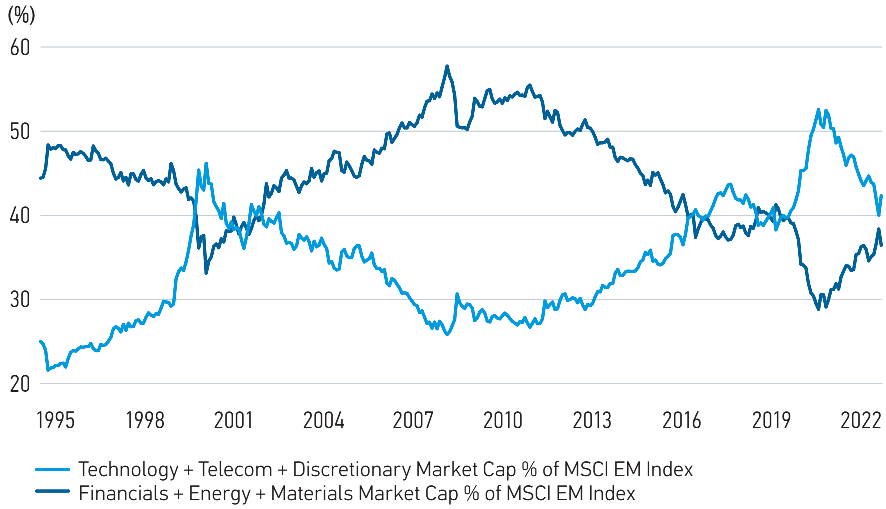
Digitization has a positive growth impact: The pandemic accelerated the digital revolution across the globe, but its impact will be felt more in emerging economies than developed ones. Consumers in emerging economies are moving quickly to adopt mobile internet services, from digital payments to online education and shopping. Digital revenue growth averaged 28% in emerging economies—more than double the 11% rate seen in developed ones.[16] Chinese internet and fintech prototypes are being used in several emerging markets to facilitate a new growth driver.

Policies and politics in EM are more favorable: Several countries have undertaken key economic reforms in recent years, such as the privatization of inefficient state-owned enterprises and tax changes in India and labor reforms in Indonesia, which will help benefit the quality of growth in these economies. The new red tide in Latin America, brought on by a surge of anti-incumbent voting as well as demands for social justice in some countries, is different from an earlier era. Today's socialist governments in LatAm countries are more inclined to be fiscally conscious and maintain an independent central bank to keep their economies humming along.

DISPLAY 6

Changing Fortunes: New Economy vs Old Economy

Sector Weights in the MSCI EM Index Over Time



Data as of November 30, 2022

Source: MSIM, Bloomberg, FactSet, Haver.

EVOLUTION OF THE EM INDEX

Investors need to remember that the composition of the MSCI EM Index has continued to evolve since its inception in 1988. In the beginning, Malaysia made up 30% of the index, followed by Mexico, which became the top country, also with a 30% share in 1992.[17] Over the years China's share in the index grew gradually and peaked at 43% in 2020 and has since fallen to 30% today.[17] We think China's share will continue to fall as other economies grow faster. India's share has moved from 8% in 2020 to 15% today and could gain more, considering its economic and earnings growth.[17] Passive investment in EM allocates too much capital to the index heavyweights and misses out on capturing the positive trends in countries whose current index weights may not be reflective of their growth prospects going forward. We believe passive investing means buying the past, not the future.

Leadership also changes at the sector level *(Display 6)*. Old economy sectors like commodities and financials accounted for 57% of the index in 2008 and halved to a low of 29% in 2020. New economy sectors like tech, telecom and consumer platforms made up 46% of the index in 2000 at the height of the global dot com boom and again peaked at 52% in 2020, with a sharp increase in the first year of the pandemic when all activity turned online.[18] Now we are seeing another change in the fortune of the two with a convergence in the index weights of the new and old economy sectors in EM as old economy drivers like credit, manufacturing and commodities

[16] MSIM, Statista. Data as of March 2021. Includes 9 largest emerging and 11 largest developed digital markets.

[17] MSIM, Bloomberg, FactSet, Haver.

[18] MSIM, Bloomberg, FactSet, Haver.

propel growth in several EMs. Last decade's winners have to give way to new leaders. Both country and sector dispersion in EM have started increasing in the past two years and should continue going forward.

Yet, despite these changes, quality in EM has been a constant. We note that over the long term, quality has been the best performer through multiple cycles, even when there are short periods when either growth or value rise. Active management is critical in EM to capture the pockets of opportunities within countries, sectors and themes in the asset class.

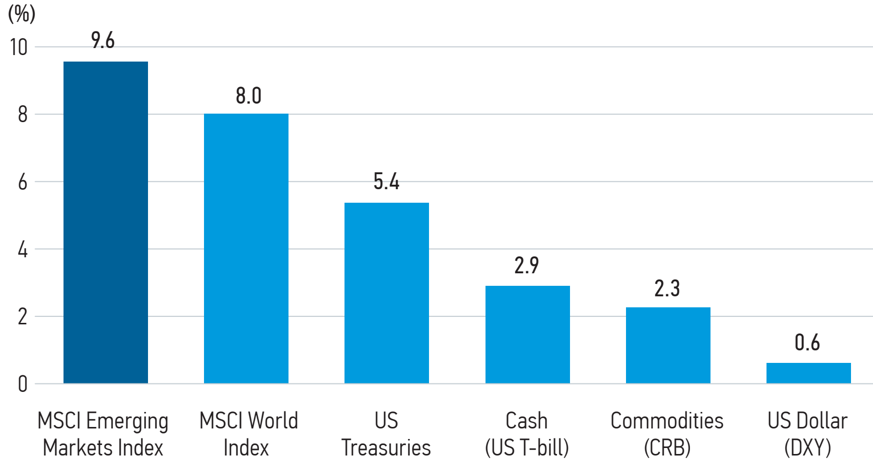
EM LONG-TERM OUTPERFORMANCE

It is important to note that since the inception of the MSCI EM Index in 1988, despite weathering many financial and economic storms, emerging economies have outperformed developed markets, perhaps surprising many commentators. Since 1988, the MSCI EM Index has gained 9.6% annualized, which is over 150 basis points above the MSCI World Index *(Display 7)*, and higher than other asset classes, albeit with higher volatility.[19] Drawdowns in EM are common and have historically offered the best entry points for gaining exposure to the long-term positive trend return. We believe that the higher volatility in EM offers greater opportunity for active management to add value over the long term.

DISPLAY 7

EM Is the Long-term Performance Winner

Annualized Total Return Since 1988, USD



Data as of November 30, 2022.

Source: MSIM, FactSet, Haver. The index performance is provided for illustrative purposes only. **Past performance is no guarantee of future results.**

CONCLUSION

Despite better growth, lower debt and lower inflation, EM equities are trading at crisis-level valuations. We believe that most investors are under-allocated to EM, considering the potential returns from the catalysts for this asset class for the next decade. The average active global equity fund allocation to EM is 5.2%, which is far below the 20-year average allocation of 9%.[20] For many investors EM remains unloved and under-owned. The environment for investing in EM will never be easy, but by focusing on country selection, stock selection and structural themes, we believe investors can reap the rewards of buying into these markets particularly at this stage of their economic and market cycle.

Risk Considerations

There is no assurance that a portfolio will achieve its investment objective. Portfolios are subject to market risk, which is the possibility that the market values of securities owned by the portfolio will decline and that the value of portfolio shares may therefore be less than what you paid for them. Market values can change daily due to economic and other events (e.g. natural disasters, health crises, terrorism, conflicts and social unrest) that affect markets, countries, companies or governments. It is difficult to predict the timing, duration, and potential adverse effects (e.g. portfolio liquidity) of events. Accordingly, you can lose money investing in this portfolio. Please be aware that this portfolio may be subject to certain additional risks. In general, **equities securities'** values also fluctuate in response to activities specific to a company. Investments in **foreign markets** entail special risks such as currency, political, economic, market and liquidity risks. The risks of investing in **emerging market countries** are greater than the risks generally associated with investments in foreign developed countries. Stocks of **small-capitalization companies** entail special risks, such as limited product lines, markets, and financial resources, and greater market volatility than securities of larger, more-established companies. **Derivative instruments** can be illiquid, may disproportionately increase losses and may have a potentially large negative impact on the Portfolio's performance. **Illiquid securities** may be more difficult to sell and value than public traded securities (liquidity risk). **Non-diversified portfolios** often invest in a more limited number of issuers. As such, changes in the financial condition or market value of a single issuer may cause greater volatility. **Cryptocurrency (notably, Bitcoin)** operates as a decentralized, peer-to-peer financial exchange and value storage that is used like money. It is not backed by any government. Federal, state or foreign governments may restrict the use and exchange of cryptocurrency. Cryptocurrency may experience very high volatility.

[19] MSIM, Bloomberg, FactSet, Haver. Data as of October 31, 2022.

[20] Morningstar.

DEFINITIONS

Gross Domestic Product (GDP) is the monetary value of all the finished goods and services produced within a country's borders in a specific time period. It includes all private and public consumption, government outlays, investments and net exports.

INDEX DEFINITIONS

The **MSCI Emerging Markets Index (MSCI EM)** is a free float-adjusted market capitalization weighted index that is designed to measure equity market performance of 23 emerging markets.

The **MSCI World Index** is a free float adjusted market capitalization weighted index that is designed to measure the global equity market performance of developed markets. The term "free float" represents the portion of shares outstanding that are deemed to be available for purchase in the public equity markets by investors. The performance of the Index is listed in U.S. dollars and assumes reinvestment of net dividends.

The **S&P 500® Index** measures the performance of the large cap segment of the U.S. equities market, covering approximately 75% of the U.S. equities market. The Index includes 500 leading companies in leading industries of the U.S. economy.

The **CRB Continuous Commodity Index (CRB)** is an index made up a of a broad grouping of different commodity futures, which is a benchmark of performance for commodities as an investment.

The **US Dollar Index (DXY)** is an index of the value of the United States dollar relative to a basket of foreign currencies, often referred to as a basket of US trade partners' currencies.

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