

EM equities outlook: poised to build on 2023's progress

Emerging market (EM) equities participated in 2023's broad global rally, most notably in the fourth quarter, when cooling inflation and economic resilience boosted confidence that central bank tightening had peaked and a soft economic landing was achievable. While EM equities benefited from the year's positive tone, they trailed their developed market peers — extending a 15-year cycle of lagging returns. We believe a performance inflection point may be nearing, but it will require a combination of factors to serve as catalysts: compelling relative valuations, a potential reversal of the corporate earnings growth gap, further U.S. dollar weakening and renewed investor focus on the benefits of diversification. The following analysis explores these current themes and offers our best investment insights into this important but underappreciated asset class.

Emerging Market Equities Team
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2023: YEAR IN REVIEW

Emerging market (EM) equities staged a strong rally in the fourth quarter of 2023, with the MSCI EM Index returning +7.9% in U.S. dollar terms to end the full year up +9.8%. This gain trailed U.S. stocks as measured by the S&P 500 Index (+26.3% for the year), and non-U.S. developed markets, based on the MSCI EAFE Index (+18.2%). EM's performance was hampered by China (-11.2% for 2023, the worst result of all 24 countries in the EM index) while EM ex-China posted a highly respectable double-digit gain (+20.0%). (All returns are sourced from FactSet unless otherwise noted.)

Despite lagging the U.S. (and excluding China's outsized impact), the breadth of EM's rally was greater than the S&P 500's, where a narrow group of mega cap constituent stocks dominated returns. And unlike the U.S. market — which saw small caps (+16.9% for the Russell 2000 Index) underperform the S&P 500 by nearly 1,000 basis points (bps) — the MSCI EM Small Cap Index (+23.9%) handily beat the core EM index by 1,400+ bps.

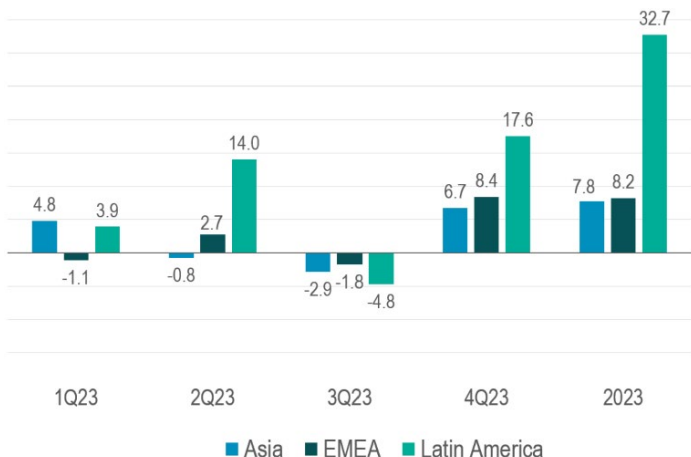
EM equity performance by geography

From a regional perspective, Latin America was the top EM performer in 2023, well ahead of Asia and EMEA (Europe, Middle East and Africa), as shown in Figure 1. Thirteen of the EM index's 24 countries outperformed the overall index. The five largest — China, India, Taiwan, South Korea and Brazil — collectively made up 78% of the index's total market capitalization as of year-end. With the exception of China (the largest constituent at 26.5%), these countries were among the year's top EM performers. (See "Current themes in emerging markets" on pages 2-3 for more perspective on China.)

The MSCI EM Currency USD Index gained 4.8% in 2023, with 11 of the index's 20 non-pegged constituents appreciating against the U.S. dollar for the year.¹ The most significant of these were the Mexican peso (+14.9%) and Brazilian real (+8.9%) — unsurprising results given solid economic growth and exceptionally high real interest rates in those two countries.

Figure 1. Latin America's regional dominance

Total return (%) of MSCI EM Index regions in \$U.S.



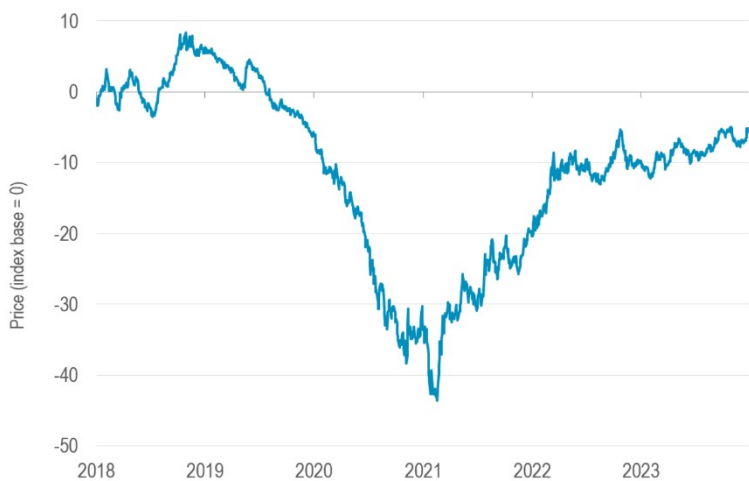
Source: Bloomberg, L.P. as of 31 December 2023.

Performance data shown represents past performance and does not predict or guarantee future results. It is not possible to invest directly in an index. Asia (77.7% of EM by market capitalization) consists of China, India, Taiwan, Korea, Thailand, Indonesia, Malaysia and the Philippines; EMEA (13.2% of EM) consists of Egypt, Saudi Arabia, South Africa, United Arab Emirates, Qatar, Kuwait, Poland, Turkey, Greece, Hungary and the Czech Republic; Latin America (8.5% of EM) consists of Brazil, Mexico, Chile, Peru and Colombia.

In terms of investment style, EM value continued to outperform EM growth, extending a three-year trend. Based on MSCI indexes, value (+14.2%) finished the year 800+ bps ahead of growth (+5.8%). Since bottoming in the fourth quarter of 2020, EM value has bested EM growth by a cumulative +26.3% (Figure 2).

Figure 2. In EM, value again dominated growth

MSCI EM Value vs. MSCI EM Growth indexes (price)



Source: FactSet as of 31 December 2023. Past performance does not predict or guarantee future results. It is not possible to invest directly in an index.

CURRENT THEMES IN EMERGING MARKETS

Looking ahead, we examine in greater detail three noteworthy aspects of the EM equity universe:

1. Countries of interest. Although the MSCI EM Index is concentrated, with only five of its 24 constituent countries accounting for nearly 80% of its market capitalization, EM equity is not a monolithic asset class. The varying market-cap profiles and country characteristics across the index provide numerous ways for active managers to enhance portfolio diversification and performance potential. The following summary highlights notable markets in the index as well as some key countries where we are finding new opportunities.

- **China** remains a key driver of the MSCI EM Index, accounting for more than a quarter of its market capitalization, but the country's economic performance and profit recovery have fallen short of post-pandemic reopening optimism at the end of 2022. Choppy data and the continued decline of the Chinese property sector have taken a toll on confidence, while piecemeal government stimulus has failed to excite the market.

Anxious equity investors responded to these signs of weakness as if China were on the verge of collapse, but the data does not support such a dire prognosis. In 2023, national sales revenue and profit margins were higher than at the end of 2022, as was hiring, while manufacturing activity remained solid, according to the China Beige Book.² Nonetheless, China is still a difficult market for investors.

After years of sudden and seemingly arbitrary policy decisions affecting multiple sectors (education, internet, healthcare, property), trust in President Xi Jinping has suffered among corporations and consumers, discouraging domestic sentiment more broadly. Policymakers have attempted to support the market and private sector with rhetoric and minor policy tweaks, but these measures haven't gained much traction.

Another concern is the notion that capitalism in China may be "dead," with consumers reluctant to spend while losing wealth in the declining property market. If young, educated and ambitious segments of the Chinese population would rather strive for senior positions in government than seek to become

the next tech tycoon, then the entrepreneurial spirit of the country might well fade, causing capitalism to struggle.

Investors whose benchmark excludes China may be able to avoid the market, but the country can't be ignored by those for whom China is a major benchmark component. That said, China appears to remain a structural underweight throughout the industry. But what degree of underweight can be tolerated from a risk perspective? China often presents short-term upside potential that can materialize quickly, leaving investors who lack Chinese exposure flat-footed.

- After surging from the fourth-largest to the second-largest country weighting in the MSCI EM Index in 2022, **India** overtook China as the world's most populous nation in 2023.³ India also has the fifth-largest equity market capitalization globally.⁴ Its future is supported by compelling demographics (including a young population), a pro-market, reform-minded government, rapidly growing manufacturing base, solid educational system (producing the second-highest number of STEM graduates annually)⁵, and low levels of credit and consumption penetration.

Among the world's top 20 countries, India's 10-year compounded annual GDP growth rate (+5.6%) lags China's (+7.0%), although India has surpassed China handily post-Covid.⁶

- **Brazil** continues to be in a macroeconomic sweet spot, with better-than-expected growth, moderating inflation and a five-month-old rate-cutting cycle. With some of the world's highest real interest rates over the past year, Brazil may see additional steady rate cuts over the coming two to four quarters. Its currency, the real, appreciated 8.9% against the U.S. dollar during the past year⁷ and is at the same level it was in early August 2023, when the Brazilian central bank kicked off an easing campaign (200 bps of cuts so far). Forward rates are pricing in further cuts of about 275 bps through the third quarter of 2024. The market is also pricing in a trough policy rate of 9% by that same timeframe — in our view, a reasonable expectation that should provide a tailwind for the economy and corporate earnings. All eyes will remain on future inflation trends, economic data, and any developments on

fiscal spending and the budget deficit. Brazilian equities remain attractively valued at more than one standard deviation below their 10-year average,⁸ with strong companies providing a high return on capital.

- In 2023, **Mexico** overtook China as the United States' largest trading partner.⁹ A boom in “near-shoring” — whereby U.S.-based multi-nationals bring their supply chains closer to home to take advantage of Mexico's strong logistics and industrial base — has boosted the country's trade fortunes and should continue to widen the country's lead over China in coming years. U.S. imports from China are now at a 20-year low, while foreign direct investment in China is at its lowest since 1998.¹⁰ Meanwhile, U.S. imports from Mexico have grown at a compounded rate of 6.5% over the past five years, while U.S. imports from China have fallen by 4.8% per year.¹¹ This diversification away from China has benefited other major U.S. trading partners in Asia, including Vietnam, Taiwan, South Korea and India.¹²

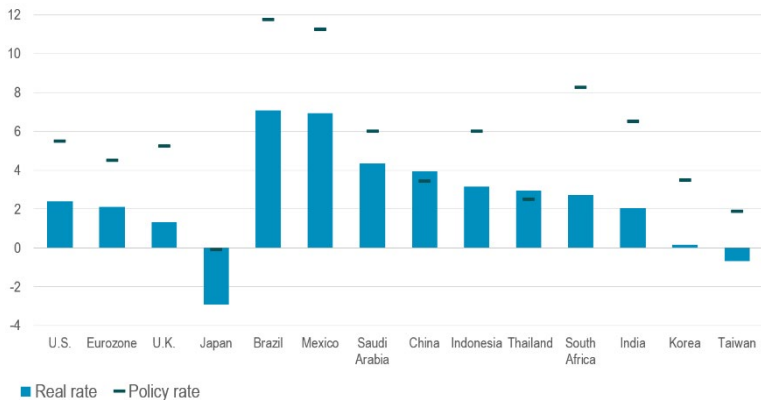
The Mexican economy is closely tied to U.S. growth and monetary policy. Mexico's central bank typically moves in step with the Fed, but with greater amplitude of tightening and easing. For example, Mexico has raised rates by 725 bps since the second quarter of 2021, compared to the Fed's 525 bps starting in the first quarter of 2022. Nonetheless, Mexican real rates are currently 6.9%, versus 2.4% for the U.S.

2. **Global inflation and rates.** Markets continue to debate how long the Fed will maintain higher interest rates amid moderating inflation across the world. Not surprisingly, three Latin American countries started cutting rates in the third quarter of 2023: Brazil (-200 bps), Peru (-100 bps) and Chile (-300 bps). Latin America as a region still has the highest real rates globally and will likely continue easing over the coming quarters.

In Asia, China has been cutting rates since early 2023, while South Korea, Taiwan, India and Malaysia have been on hold during that timeframe. Indonesia, Thailand and the Philippines all hiked rates another 25 bps, likely their last increase, in either September or October. There are currently 14 EM countries with real rates above 2.0%, including all five Latin American countries in the MSCI index. Topping the list are Brazil at 7.1% and Mexico at 6.9% (Figure 3).

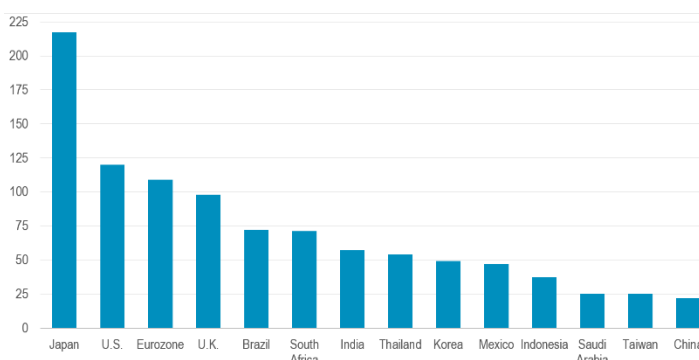
Figure 3. Brazil and Mexico have higher real rates ...

Policy rates and real rates (%) by country/region



...and stricter fiscal discipline than the U.S.

Government debt as % of GDP



Source: FactSet data as of 31 December 2023. Charts show the four primary developed market regions/countries plus the top 10 EM countries by market cap weight, representing 91.7% of the MSCI EM Index.

Historically, EM countries have had a tendency toward less rigid monetary policy and fiscal discipline, targeting growth over inflation, but this has changed in many cases. Today, the U.S. is running much higher deficits and a government debt/GDP ratio than those of the EM countries shown in Figure 3 above.

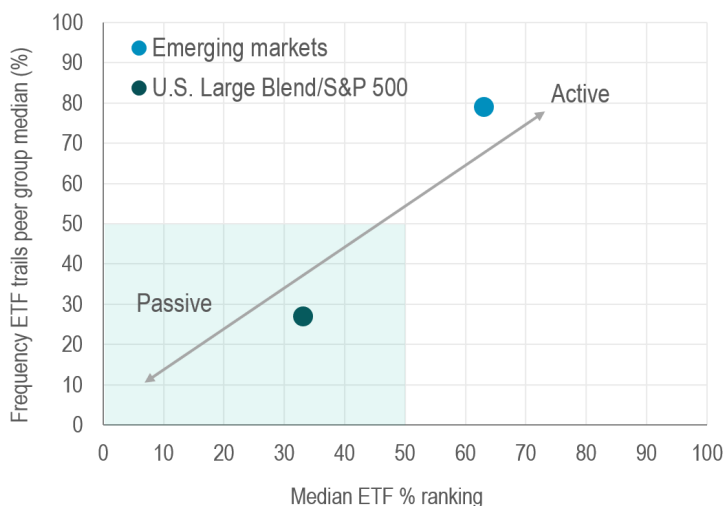
“Historically, EM countries have had a tendency toward less rigid monetary policy and fiscal discipline, but this has changed in many cases.”

3. Active management in EM equities. One useful way to evaluate the effectiveness of fundamental active management in EM equities is to compare the performance of such approaches relative to a commonly used passive investment alternative.

As Figure 4 shows, across 205 monthly observations of rolling 3-year rankings from 2004 to present, the median actively managed EM strategy bested the median passive EM ETF a convincing 79% of the time. Additionally, the median passive EM ETF ranked in the 63rd percentile, meaning it underperformed the majority of its actively managed EM strategy peers.

Given the unique and diverse characteristics of EM, similar degrees of active versus passive management appear to be less prevalent in other equity asset classes. For example, during the same 205 months of rolling 3-year rankings, the median active U.S. Large Blend fund benchmarked to the S&P 500 Index outperformed the corresponding median passive S&P 500 ETF only about a quarter of the time (27%). Moreover, the median passive strategy in this space ranked in the 33rd percentile — beating the majority of its actively managed peers. This comparative analysis supports our view that active management is particularly well-suited to EM equity strategies.

Figure 4. Active management has proven effective for EM equity strategies



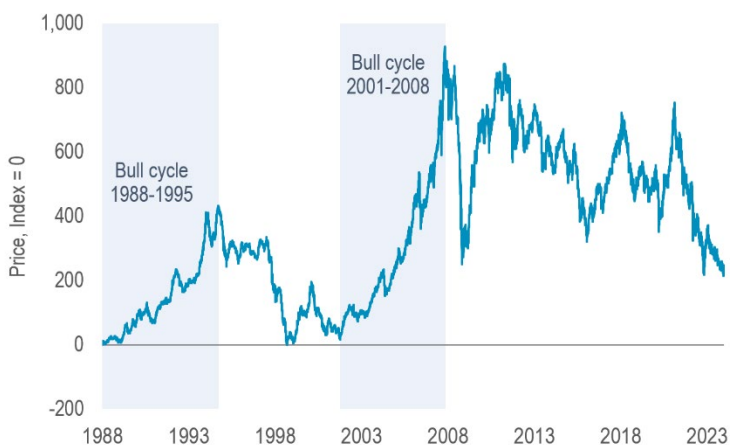
Source: Morningstar. Chart shows 205 monthly 3-year periods from January 2004 to December 2023. EM ETF Proxy = iShares MSCI EM ETF; U.S. ETF Proxy = SPDR S&P 500 ETF Trust. Universes consist of fundamental active strategies, lowest-priced share class per portfolio with extended performance. EM: 149 Morningstar Diversified EM portfolios benchmarked to MSCI EM Index. U.S.: 194 Morningstar U.S. Large Blend portfolios benchmarked to S&P 500 Index. **Performance data shown represents past performance and does not predict or guarantee future results.**

2024 EMERGING MARKETS OUTLOOK

The market appears to be sanguine about a soft landing for the U.S. economy — a narrative that could well prove incorrect. What would a U.S. recession mean for EM? Historically, sharp economic downturns in the U.S. have led to EM underperformance as money flowed to safe-haven U.S. Treasuries. After the initial correction passed, however, the MSCI EM Index always led the U.S. and developed non-U.S. markets during the recovery phase, outperforming significantly following the last four U.S. recessions.¹³

Figure 5. Are EM equities nearing their next bull cycle?

Emerging vs. developed markets



Source: FactSet as of 31 December 2023.

Performance data shown represents past performance and does not predict or guarantee future results. Representative indexes: emerging markets: MSCI EM Index; developed markets: MSCI World Index. It is not possible to invest directly in an index.

Since its inception in 1987, the index has experienced two long-term up cycles relative to developed markets, and two long-term down cycles, including the current one, which has lasted 16 years and counting (Figure 5 above). If a major U.S. recession is avoided in 2024, EM equities might finally approach a performance inflection point for their next bull cycle. In our view, whether this materializes will depend in large part on several potential catalysts, including:

Attractive valuations

Lower valuations have long been a perennial topic of conversation about EM (and all non-U.S.) stocks compared to the more expensive U.S. market, and the fact remains that EM equities are extremely cheap.

Based on 2024 estimated price-to-earnings (P/E) ratios, EM's overall valuation (11.9x) is at a roughly 40% discount to the U.S. (19.5x) and a slight premium to developed non-U.S. markets (11.5x).¹⁴

A potential reversal of the earnings growth gap

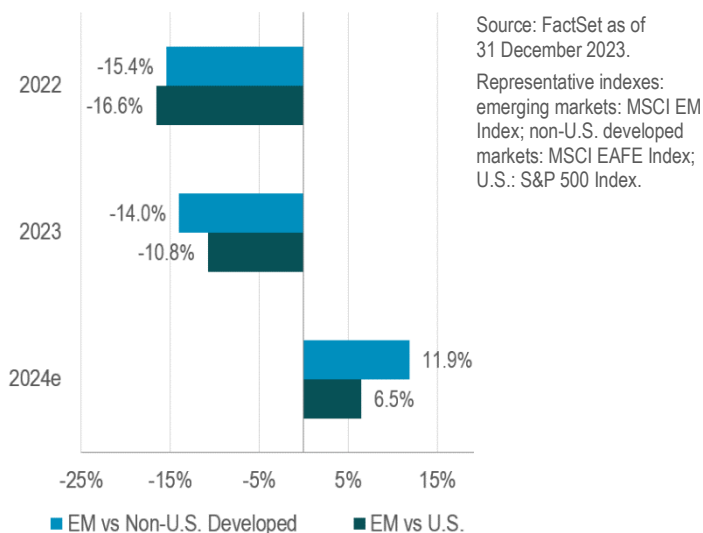
Negative growth in EM earnings per share (EPS) has been a stiff headwind over the past two years, with double-digit declines in 2022 (-11.5%) and 2023 (-10.6%).¹⁵ It's worth noting that, despite China's challenges (pages 2-3), EPS growth for Chinese stocks was relatively solid in 2023, and consensus downward revisions less severe than might be expected.

Meanwhile, the EPS growth gap between all of EM and developed markets narrowed in the past two years and is expected to reverse in 2024 (Figure 6). As of this writing, consensus estimates call for +18% EPS growth for EM in 2024, substantially higher than that for the U.S. (+11.5%) and non-U.S. developed markets (+6.1%).

If relative EM earnings growth continues to improve, it could be a driver of EM outperformance. But there's a caveat: EM EPS estimates have been upgraded in only two of the past seven years, and downgrades for the other five years have averaged 8.4%.¹⁶ On the other hand, given the difference in monetary cycles between EM and other parts of the world, forward EPS growth estimates for the U.S. and Europe may be more at risk than those for EM. Higher-for-longer Fed rates are potentially quite problematic for future U.S. earnings.

Figure 6. Brighter outlook for EM earnings growth

Consensus 1-yr EPS growth estimates vs. developed markets

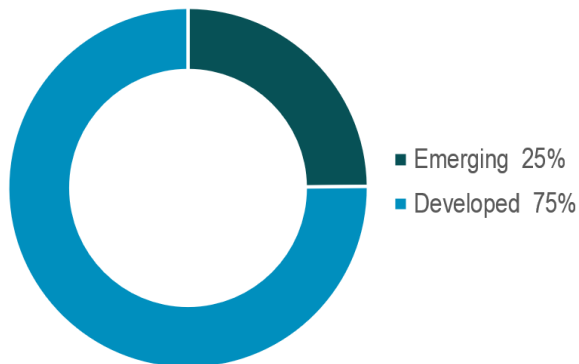


Source: FactSet as of 31 December 2023.

Representative indexes: emerging markets: MSCI EM Index; non-U.S. developed markets: MSCI EAFE Index; U.S.: S&P 500 Index.

Figure 7. \$23 trillion of investment potential

% share of global market capitalization
MSCI indexes as of 31 December 2023



Source: FactSet
Representative indexes: emerging markets: MSCI EM Index; developed markets: MSCI World Index. It is not possible to invest directly in an index.

U.S. dollar weakening

A Fed pause typically signals dollar weakness ahead, which tends to be a positive for EM asset classes. With the Fed likely at the end of its rate-hiking cycle, we expect last year's decline in the value of the dollar versus EM currencies to continue in 2024, benefiting EM equities. Several EM central banks began tightening monetary policy to combat inflation well before the Fed, resulting in real rates that are higher than those in non-EM countries, as noted on pages 3-4. This gives EM policymakers room to cut at least in line with the Fed.

A refocus on diversification

Despite the accepted wisdom that diversifying assets is crucial for long-term investment success, global allocations to EM equities have been extremely light in recent years compared to longer-term averages. Today many portfolios lack meaningful exposure to the asset class. It may be a challenge to reinvigorate EM equity inflows, but with \$23 trillion in market capitalization, or 25% of the world's total,¹⁷ EM equities offer vast potential that investors seeking diversified global equity opportunities can ill afford to ignore.

CONCLUSION

Forecasting the outlook for global and U.S. equity markets is particularly difficult in the current climate, given multiple moving parts, including Fed policy, a narrow U.S. market rally and the possible fallout from geopolitical tensions and outright war. Scenarios range from a U.S. soft landing to a potential crisis triggered by one or more macro shocks or black swan events.

Still, following a solid 2023 despite trailing developed markets, EM equities could see continued improvement in 2024 and perhaps move closer to an inflection point representing the start of another bull cycle. Among the forces that could catalyze such a shift are EM's extremely low relative valuations, stronger earnings growth prospects, the potential for further weakening of the U.S. dollar versus EM currencies and greater confidence on the part of long-term equity investors to embrace and maintain an allocation to the asset class.

At the same time, despite China's dominant presence, EM equities are not monolithic. Market dynamics vary from country to country — a reality that is best addressed by active management to navigate and take advantage of macroeconomic, geopolitical and idiosyncratic opportunities and risks. And while some signs appear to be pointing toward EM equities' next leg of outperformance, there is no foolproof way to know precisely when this might occur. In our view, investors seeking to capture upside in the asset class are best served by keeping their toe in the water, boosting their odds of being buoyed when the next high tide rolls in.

“ Following a solid 2023, EM equities could see continued improvement in 2024 and perhaps move closer to an inflection point representing the start of another bull cycle.

For more information, please visit us at nuveen.com.

Endnotes:

- 1 Source: Bloomberg, L.P.
- 2 Source: China Beige Book, Fourth Quarter 2023
- 3 Source: U.N. Department of Economic and Social Affairs Economic Analysis, 24 April 2023
- 4 Source: Bloomberg, L.P. data cited by The Economic Times, 27 December 2023
- 5 Source: Center for Security and Emerging Technology (CSET), Georgetown University, 27 November 2023
- 6 Source: FactSet, tradingeconomics.com
- 7 Source: Bloomberg, L.P.
- 8 Source: FactSet
- 9 Source: U.S. Census Bureau, Federal Reserve Bank of Dallas
- 10 Source: U.S. Census Bureau
- 11 Source: U.S. Census Bureau
- 12 Source: U.S. Census Bureau
- 13 Source: FactSet, National Bureau of Economic Research, MSCI.com
- 14 Source: FactSet
- 15 Source: FactSet
- 16 Source: FactSet
- 17 Source: FactSet

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