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INVESTMENT INSIGHTS
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Measured optimism ahead for emerging market equities

Despite a late-year rebound, emerging market (EM) equities endured negative returns in 2022 amid several headwinds. Headlines for EM were almost uniformly downbeat — focused on persistently high inflation and China's struggle to contain Covid — but ultimately the asset class only modestly lagged broad global equity markets. Looking forward, we see a number of bright spots for EM equities as part of a long-term, diversified portfolio. At the top of the list: the diversity of the EM universe across countries, regions and investment characteristics, which provides a rich source of potential alpha that is uncorrelated with other markets. In the analysis that follows, Nuveen's equity team offers its perspective on current themes in EM, an assessment of the factors that could influence relative performance and a cautiously optimistic outlook for this dynamic and often overlooked asset class.

Global Equities Team
Nuveen

2022: YEAR IN REVIEW

Based on the MSCI Emerging Markets Index, EM stocks struggled from January through October 2022 (returning -29.4% in U.S. dollar terms), buffeted by a strong U.S. dollar, recession fears and a commitment from central banks worldwide to cool inflation by raising interest rates.[1] (A strong dollar makes it harder for countries to service and repay dollar-denominated debt, among other drawbacks.) This steep selloff extended EM equities' descent into bear-market territory, as they plummeted more than 38% from their February 2021 high.[2]

But the asset class rallied hard in November (+14.8%), due largely to optimism that (1) the U.S. Federal Reserve would slow the pace of its rate hikes as inflation began to slow (leading to a weaker dollar) and (2) hopes that China would loosen its strict "zero-Covid" policies, which it ultimately did.[3] For the full year, EM equities (-20.1%) slightly underperformed their developed market peers (MSCI World Index, -18.1%).[4]

Within the EM asset class, regional performance varied widely, as shown in Figure 1. Europe, the Middle East and Africa (EMEA, -28.3%) struggled the most, followed by Asia, which returned -21.1%.[5] EMEA was hampered both by MSCI's marking down all Russian equity securities to zero in March following the invasion of Ukraine and the proximity of other European countries to the conflict. Prior to its removal, Russia was the benchmark's sixth-largest country by market capitalization.

In contrast, Latin America (+8.9%) easily outpaced other regions, led by commodity-heavy exporters such as Brazil. (See Figure 1.) Commodities are typically considered economically sensitive (i.e., cyclical), yet they "played defense" in 2022's tough EM environment.[6] Brazil, one of Latin America's worst performers in 2021 (-17.4%), rebounded last year (+14.2%) despite concerns about potentially

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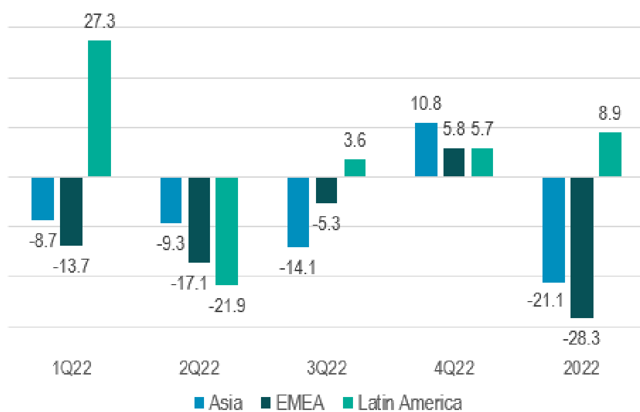
less-than-market-friendly cabinet appointments made by newly elected president Luiz Inácio Lula da Silva ("Lula").[7] Brazil's economy, the largest in South America, appears to be on firm ground, with upward revisions to GDP and steep declines in unemployment and inflation.

Figure 1. Latin America led the way in 2022

Total return (%) of MSCI EM Index regions



Source: Bloomberg, L.P. as of 31 December 2022. **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.

Further, because China represented 31.4% of the MSCI EM Index as of 31 December 2022 — making it by far the benchmark's largest constituent in terms of market capitalization — its -21.9% return contributed significantly to EM's 2022 downturn.[8] (See page 3 for more on China.)

In terms of currencies, the MSCI EM Currency Index fell -4.3%% versus the U.S. dollar, dragged down by the following major EM currencies: the Taiwanese dollar (-9.9%), Chinese yuan (-7.9%) and Korean won (-5.6%). A number of currencies, including the top-performing Brazilian *real* (+5.4%) and Mexican peso (+5.3%), strengthened against the U.S. dollar. Interestingly, EM currencies generally held up better than their developed-market counterparts. The Japanese yen (-12.2%) and British pound (-7.6%), for example, depreciated more versus the greenback.[9]

From a sector perspective, utilities and financials were the benchmark's best performers despite posting negative returns. Driven mainly by China's volatile technology sector, information technology delivered the worst results, followed by communication services.[10]

CURRENT THEMES IN EMERGING MARKETS

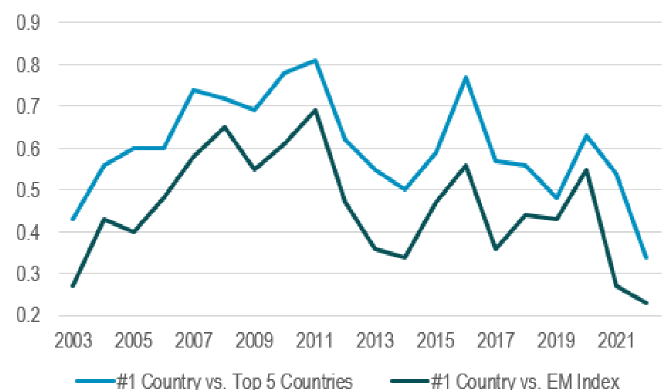
Looking ahead, we examine in greater detail two noteworthy aspects of the EM equity universe.

1. Diversity among EM countries: Take a look at the broad EM sphere

Some EM investors and analysts tend to home in on China, given its prominence in the index. Such scrutiny was all the more intense in 2022 amid the flow of headlines following China's struggles to contain Covid-19 and the economic impact of the government's severe lockdown measures, tense relations with the U.S. and heightened fears of a Chinese invasion of Taiwan. With that persistent pressure, it was no surprise that Chinese stocks lagged the broad index during the year. In fact, some analysts considered China's shares "uninvestable" based in part on the country's weak accounting standards, lack of transparency and poor regulatory oversight.

But as noted above, EM returns weren't uniformly bleak last year, with performance among the benchmark's individual markets deviating significantly: of the 24 countries making up the MSCI EM Index, eight posted gains and 10 others delivered negative returns but still beat the index as a whole.[11] Moreover, correlations between the largest constituent country (China) versus the next five-largest countries, as well as the EM index overall, touched 20-year lows in 2022 (see Figure 2).

Figure 2. EM correlations have been declining



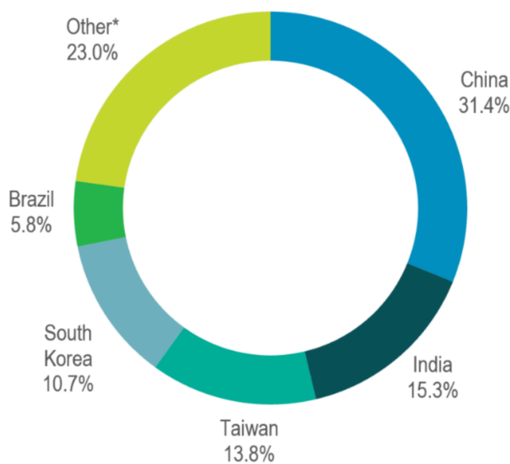
Source: Bloomberg as of 31 December 2022. Note: The largest constituent has varied over the period shown in this chart: It was South Korea from 2003-2007, Brazil in 2008 and China since 2009. **Past performance does not predict or guarantee future results.**

Taken together, these results demonstrate that EM is not a monolithic asset class. It is, however, heavily concentrated, with the five largest markets making up 77% of the index by market capitalization as of year-end 2022 (see Figure 3). At the same time, this market-cap profile across all 24 countries also offers the opportunity for active management to generate greater portfolio diversification and relative outperformance.

Indeed, as we see it, EM countries are subject to more idiosyncratic risk than in the past. Broad globalization is no longer a driving force, and geopolitics is a new, stronger factor determining economic relationships.

Figure 3. EM heavily concentrated, but not monolithic

Five largest countries in MSCI EM Index, by market capitalization



Source: Bloomberg, L.P. as of 31 December 2022. *The benchmark's "other" countries are Chile, Colombia, Czech Republic, Egypt, Greece, Hungary, Indonesia, Kuwait, Malaysia, Mexico, Peru, Philippines, Poland, Qatar, Saudi Arabia, South Africa, Thailand, Turkey and United Arab Emirates.

Its massive size aside, China marches to its own tune — with the government as "conductor" — almost making it an asset class unto itself. Unlike nearly all countries across the developed and EM world, it has remained disconnected from U.S. monetary policy, which tends to influence central bank activity worldwide. Moreover, state-owned enterprises (SOEs) dominate the Chinese economy, especially in key sectors such as energy, telecommunications and banking.

Lastly, regarding the diversity of the asset class, we've identified distinctly different EM "buckets" that are also worth noting. For example:

- Taiwan and Korea are export driven, reflecting the preponderance of technology companies. Taiwan's longer-term prospects are tied to a possible Chinese invasion — a worst-case, albeit low-probability geopolitical scenario — discussed on page 4.
- South Africa, the Middle East, Latin America and parts of Southeast Asia are highly influenced by oil and other commodities.
- Economies in Eastern European EM countries such as Poland, Hungary and the Czech Republic are closely tied to those of developed-market Europe.

2. China's crosscurrents, responses and outlook

While the EM landscape provides investors with a wide range of alpha drivers, China remains the biggest "swing factor" of performance. For most of 2022, Chinese equities were knocked off course by Covid and to a lesser degree by (1) the possibility of sanctions if China were to aid Russia in its war against Ukraine; (2) ongoing trade disputes with the U.S. and (3) the U.S. Securities and Exchange Commission's demand for detailed audit documents from U.S.-listed Chinese firms. This last point of contention contributed to a wave of first-quarter selling in China's American Depositary Receipts (ADRs) amid fears the securities could be delisted.

Figure 4. Chinese stocks rallied late in 2022

MSCI China Index (price)

Source: FactSet as of 31 December 2022. **Performance data shown represents past performance and does not predict or guarantee future results.** It is not possible to invest directly in an index.

But the MSCI China Index caught fire in late October and November (see Figure 4), thanks to "the-worst-is-over" investor sentiment, reducing the full-year loss for Chinese index stocks. And in our view, that sentiment may prevail because of:

- **A propped-up property sector.** In November, the government approved a series of programs providing subsidies, cutting mortgage rates and allowing smaller down payments for homebuyers, while offering loan repayment extensions for cash-strapped developers. We expect these and other measures to shore up the sector — a key driver of China's GDP — and if these measures prove insufficient, then further policy action is in store.
- **Taiwan trouble?** Despite photos of U.S. President Joe Biden and Chinese leader Xi Jinping warmly shaking hands during last November's summit, they clashed over the issue of Taiwan's sovereignty. Xi emphasized China's willingness to use military force to retain unification, while Biden asserted that the U.S. would respond to a Chinese invasion by committing U.S. troops.

  While seemingly unthinkable just 12 months ago, an armed conflict can't be ruled out during Xi's next five-year term. If one were to occur, the value of Chinese stocks could be lowered to zero — similar to MSCI's decision regarding Russian assets after the country invaded Ukraine. The knock-on effects to the global economy would also be significant given the interconnectedness of global supply chains and foreign direct investment. Ultimately, we think such a showdown between China and the U.S. is extremely unlikely given the catastrophic costs to all parties.
- **A license to gamble.** In late November, Macau, a special administrative region of China that is heavily reliant on tourism, granted new licenses to all six of its casino operators for the next 10 years. Officials cited the main considerations for the licensures to be, among other things, ensuring local employment, developing overseas tourist markets and expanding non-gaming projects. As Chinese tourism restarts following the pandemic, the benefits should accrue to all major operators given this greater certainty.
- **Our 2023 China outlook.** China is positioned for a cyclical recovery in 2023 after posting disappointing GDP growth last year. Fundamental support for a lasting economic rebound will take some time, in our view, but the needle seems to be pointing in the right direction in light of the government's renewed desire to reopen the economy by relaxing Covid lockdown protocols. A healthy China would attract capital, bolstering the country's currency while leading to higher valuations for securities, which would more accurately reflect their long-term growth prospects.
- **Investment opportunities.** We believe China is unlikely to continue relying on trade and its property markets for its next phase of growth. Its digital economy offers greater opportunities, with the Chinese internet sector poised to drive this expansion. The catalysts that could benefit many of China's large internet platforms in the new digital economy should become clearer as the government greenlights new policies and projects. In the meantime, attractive names can be found among beaten-down technology/internet stocks.

LOOKING AHEAD

Center stage: inflation and monetary policy

Broad EM results hinge on the trajectory of inflation, which has showed signs of cooling. In particular, energy and food costs should stabilize, which is especially important because of generally lower per capita income in many EM countries.

Regarding central banks, those in EM countries are generally closer to finishing their inflation-fighting tightening cycles than those in the developed world. For example, at its November meeting, the Bank of Korea hinted that it might start cutting rates. In contrast, the Fed has clearly signaled that it's prepared to keep raising them to bring inflation to heel, while the European Central Bank stated in December that "interest rates will still have to rise significantly at a steady pace" to curb rising costs.

Performance from countries including Brazil and China, as discussed previously, could also be driven by idiosyncratic factors.

Earnings per share (EPS) growth potential

Aided by diverse markets and economies, EM equities offer potentially compelling EPS growth (Figure 5). Valuations are currently below their long-term averages and remain inexpensive relative to the U.S. Not all of these valuations are equally promising, however. We believe Latin America has more upside potential than Asian markets. Investors wishing to initiate or add to their allocations can do so at attractive entry points.

Figure 5. EM earnings per share (EPS) growth estimates for major equity indexes

One-year EPS growth (%)

	EM	Non-U.S. developed	All non-U.S.	U.S.
2023e	-0.24	1.37	0.85	4.44
2024e	14.57	6.08	7.77	9.98
2025e	10.47	6.43	7.05	7.01

Source: FactSet as of 31 December 2022. Representative indexes: Emerging markets: MSCI Emerging Markets Index; Non-U.S. developed: MSCI EAFE Index; All non-U.S.: MSCI ACWI ex-US Index.; U.S.: S&P 500 Index. **Past performance does not predict or guarantee future results.** It is not possible to invest directly in an index.

Volatility is not uniformly high across the asset class

Lastly, there is the question of volatility. Although the standard deviation of the MSCI EM index rose in 2020 and 2022 as shown in Figure 6, the longer term demonstrates that such high levels are an anomaly. Additionally, the recent increases were driven by volatile Chinese stocks and don't reflect all EM countries and regions.

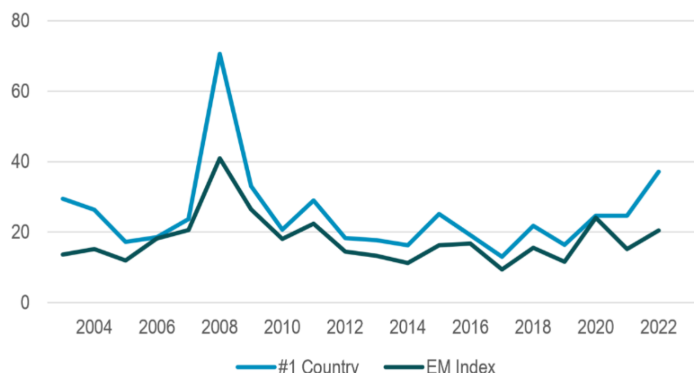
Measured optimism for EM

On balance, we think the long-term case for investing in EM equities is warranted. Our upside scenario for the asset class is based on the following:

- China's continued relaxation of Covid protocols, leading to a broad economic reopening in the first half of 2023.
- Further cooling of inflation globally, leading to looser monetary policy from central banks and a weaker U.S. dollar.
- Stable-to-higher energy and commodity prices, given the importance of commodity exports in EM.
- A possible ceasefire or resolution of the war in Ukraine.

The key to finding attractive opportunities in EM equities is knowing where to look. This is especially important because the asset class is not monolithic, with country performance often the result of idiosyncratic factors. For this reason, we believe active management, supported by research-driven, bottom-up stock selection, offers the best path to success in this diverse, dynamic asset class.

Figure 6. Higher EM standard deviation has been fueled by China



Source: Bloomberg as of 31 December 2022. Note: The largest constituent has varied over the period shown in this chart: It was South Korea from 2003-2007, Brazil in 2008 and China since 2009. **Past performance does not predict or guarantee future results.**

RISKS TO OUR OUTLOOK

We acknowledge a number of risk factors that could pose challenges to EM equity performance, such as:

- Economic contractions worldwide, which would likely weigh on demand, trade and commodity prices.
- Much weaker-than-forecast Chinese economic growth, given China's significant impact on EM equity returns.
- Stubbornly high inflation prompting further aggressive action from central banks.
- Trouble from a weak Japanese yen. The yen's 12.2% drop versus the U.S. dollar in 2022 helped improve the competitiveness of Japan's exports, but EM countries such as Taiwan and Korea could suffer as a result, as they're two of Japan's main trading competitors.

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

Endnotes

1-4 MSCI
5-11 Bloomberg, L.P.

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