

February 2024

Emerging Markets Outlook*

*Guardian Partners Inc. is providing, with permission, this market commentary, which was authored by our affiliate, Guardian Capital LP.

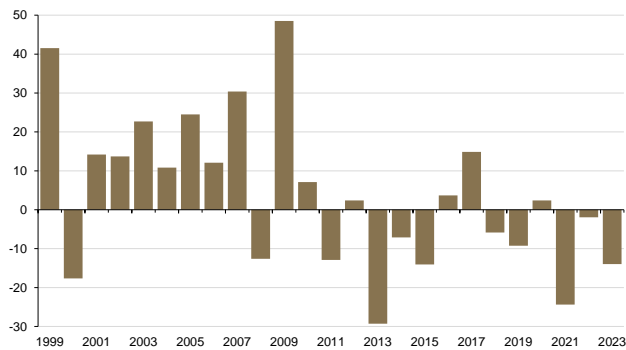
More dragging in the Year of the Dragon?

In what has become a common refrain, Emerging Market (EM) equities once again found themselves lagging behind their Developed Market (DM) peers over the last calendar year.

The MSCI Emerging Markets¹ Index generated a 10% total return in 2023, its best performance in three years, but that materially trailed the 24% return recorded by the DM benchmark MSCI World Index² — the former has now underperformed the latter for three straight years, in five of the last six, and nine of the last 13.

CHART 1: NOT KEEPING PACE

MSCI EM total return less MSCI World total return
(percentage point difference; US dollar basis)



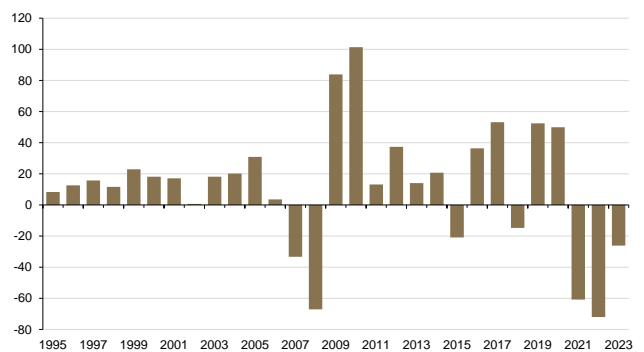
Source: Guardian Capital based on data from Bloomberg to December 31, 2023

The persistence of disappointing returns — EM stocks have underperformed DM by nearly 200 *percentage* points since 2010 — combined with the relatively higher risk profile amid the already highly uncertain market backdrop, has seen investors increasingly eschew the asset class altogether.

Data³ from the Organisation for Economic Co-operation and Development⁴ (OECD) shows that global investors have pulled money out of EM equities on net for three years straight following a quarter-century of sparsely interrupted inflows to these developing capital markets.

CHART 2: FLOWING OUT

Net portfolio equity flows, Emerging Markets
(billions of US dollars)



Source: Guardian Capital based on data from the OECD Monthly Capital Flow Dataset to November 30, 2023

While it is the case in the investment world that past performance does not guarantee future results, these sustained negative trends are clearly a source of investor concern and raise the question of whether there is a good reason to anticipate a turnaround in the months to come.

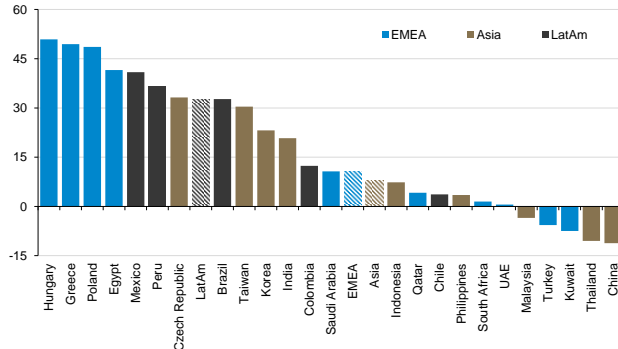
The China Syndrome⁵

A point worth emphasizing at the outset is that EM is far from being a homogeneous group. There are extreme variations in terms of economies of the 24 constituent countries (and more than 1,400 stocks) that make up the aggregate EM index — and there has been notable variation in performance.

For example, within that 10% US dollar total return for the aggregate EM index were gains of roughly 50% (in US dollar terms) in Hungary, Greece and Poland, and more than 20% in major economies like Mexico (+41%), Brazil (+33%), Taiwan (+30%), South Korea (+23%), and India (+21%). Commodity-centric markets such as Saudi Arabia (+11%), Indonesia (+7%), Chile (+4%), and South Africa (+2%) saw more middling performance while other areas notched declines for the year including Turkey (-6%) and, most notably, China (-11%).

CHART 3: REGIONAL VARIATION

MSCI Emerging Market Index component return, 2023
(percent; US dollar basis)



Source: Guardian Capital based on data from Bloomberg to December 31, 2023

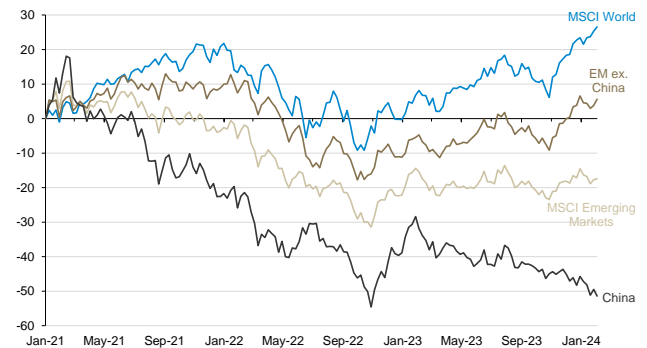
That weakness in China warrants attention. The world's second-largest economy accounts for one-quarter of the EM index and if it was removed from the equation, performance in the rest of the group would be more comparable to DM. The MSCI Emerging Markets ex. China Index⁶ was up 20% in 2023.

The heavier weight in China has been a significant factor behind the magnitude of underperformance of EM versus DM over the previous two years as well.

In total, Chinese equities have shed half their value since the start of 2021 while the rest of the EM equities are up by 5% — still paltry relative to the 26% rise in the MSCI World Index, but better general performance for the broad group than the near-20% decline for the MSCI EM Index would otherwise suggest.

CHART 4: CRACKS IN CHINA

Index total return
(percent change since January 1, 2021; US dollar basis)

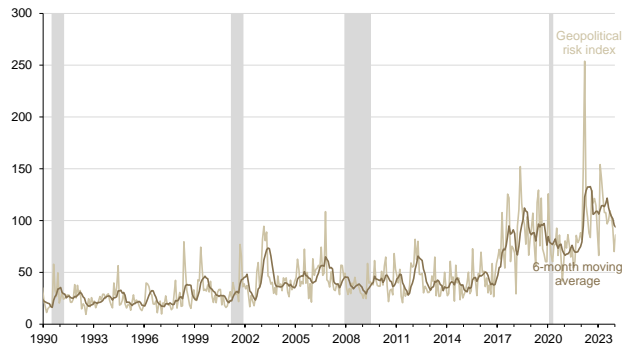


Source: Guardian Capital based on data from Bloomberg to February 9, 2024

A big driver of the poor China outcome relates to the impact of the rise in perceived risks associated with investing in the country in recent years.

While relations between China and the US are not as outwardly antagonistic at the moment as they were, tensions are simmering and barriers to trade remain in place — the impending election stateside could see a turn for the worse.

Add to that the lingering potential of Chinese military action against Taiwan — which saw the re-election, albeit with a loss of its majority, of the pro-independence Democratic Progressive Party — and geopolitical risks around China are elevated.

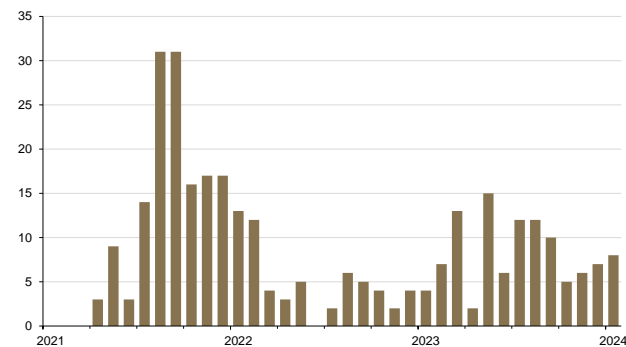
CHART 5: PLAYING POLITICS
Geopolitical risk index⁷, China
(index)


Shaded regions represent periods of US recession; source: Guardian Capital based on data from PolicyUncertainty.com to January 2024

The regulatory environment within China has also been a headwind for the market and economy.

Since 2021, the government has introduced a wave of measures designed to rein in domestic business influence and impede foreign economic involvement in the name of national security.

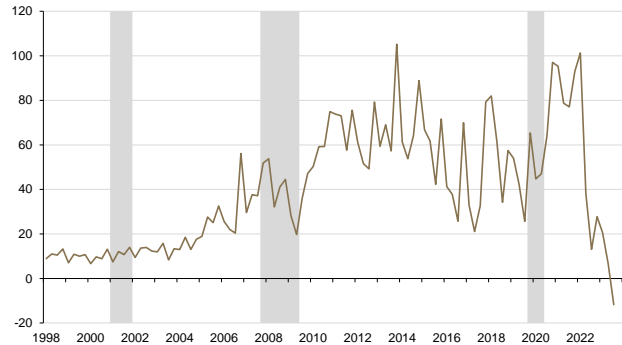
Consumer confidence in China is plumbing historical depths and households are restraining spending in favour of shoring up savings, in turn.

CHART 6: REGULATORY SYSTEM
Government regulatory measures⁸ introduced, China
(number)


Source: Guardian Capital using data from Piper Sandler to January 31, 2024

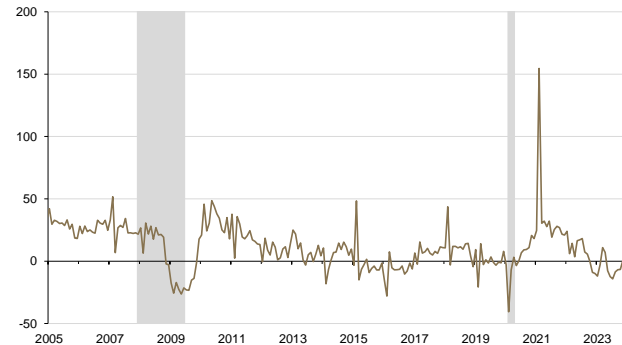
The government intervention has weighed on investor sentiment and combined with experiences through the pandemic, motivated companies to diversify their supply chains to the detriment of the Middle Kingdom — and to the benefit of other economies in South Asia and Latin America.

Not uncoincidentally, net foreign direct investment in China turned negative in the three months ended September 2023 for the first time since at least 1998 (i.e., before China joined the World Trade Organization in 2001).

CHART 7: LOSING FOREIGN INVESTORS
Net foreign direct investment in China
(billions of US dollars)


Shaded regions represent periods of US recession; source: Guardian Capital using data from China's State Administration of Foreign Exchange to Q3 2023

The increased reliance on production outside of China combined with a pullback in demand for goods globally following the post-pandemic boom, has factored into the slump in exports that, in turn, weighed on production in the country's important factory sector.

CHART 8: THE FLOW OF GOODS SLOWS
Exports, China
(year-over-year percent change)


Shaded regions represent periods of US recession; source: Guardian Capital using data from Bloomberg to December 2023

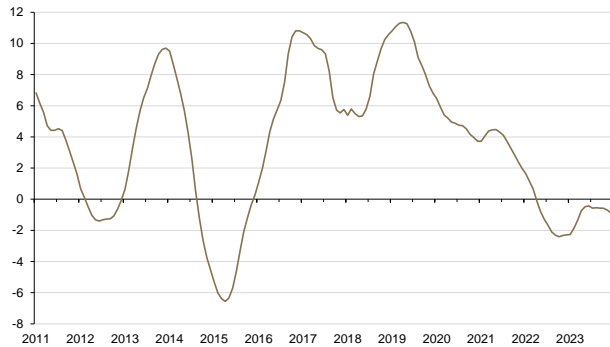
The softness in China's externally focused economic segments has compounded its more homegrown issues.

Real estate markets, previously a major focus of domestic investment and a source of strength in recent

years, have struggled as affordability impaired demand and put pressure on highly levered developers. This, in turn, spurred a crisis in confidence among would-be buyers that has driven a sustained decline in activity and prices.

CHART 9: A SUSTAINED SLIDE

Newly built commercial/residential building price index⁹, China (year-over-year percent change)



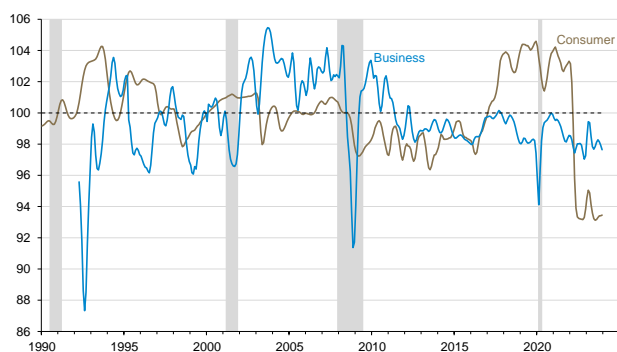
Source: Guardian Capital using data from Bloomberg to December 2023

The resulting negative wealth effect and related impact on sentiment factors into the generally lackluster performance of China's consumers even as the country abandoned its highly restrictive "COVID Zero" policy in earnest at the start of 2023.

Consumer confidence in China is plumbing historical depths and households are restraining spending in favour of shoring up savings, in turn weighing on activity and sapping business confidence.

CHART 10: SENTIMENT SLUMP

Consumer and business confidence, China (index; 100=long-term average)



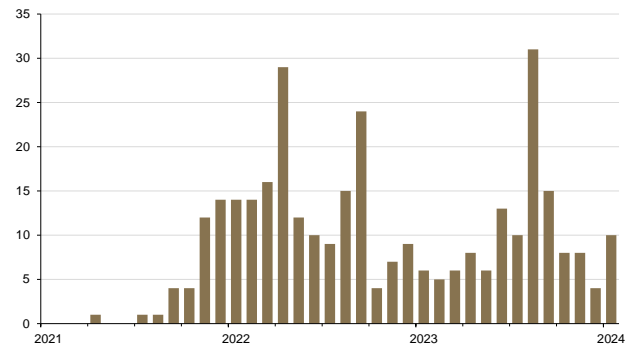
Shaded regions represent periods of US recession; source: Guardian Capital based on data from the OECD to December 2023

China's leaders have increased efforts to bolster demand, particularly in real estate markets, with the introduction of a slate of regulatory, fiscal, and

monetary policy easing measures. That said, the scale of stimulus proposals remains fairly limited.

CHART 11: STIMULATING CONVERSATIONS

Government stimulus measures¹⁰ introduced, China (number)



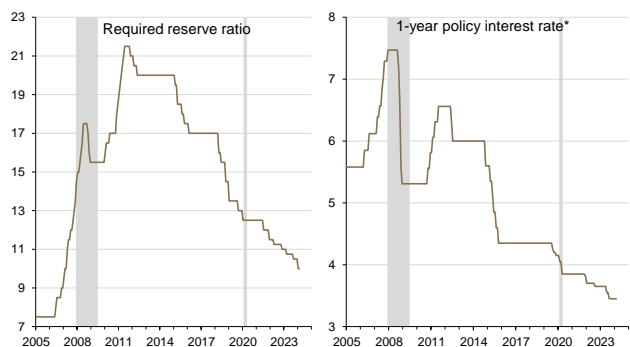
Source: Guardian Capital using data from Piper Sandler to January 31, 2024

Concerning monetary policy, Beijing is digging into its toolbox to improve liquidity conditions.

While much the rest of the world has been engaged in an aggressive tightening cycle over the last two years, the People's Bank of China (PBOC) has been steadily easing, with the required reserve ratio and interest rates both being cut, while its balance sheet has expanded to support both supply of and demand for credit in the domestic economy.

CHART 12: GOING DOWN

Reserve requirement ratio and policy interest rate*, China (percent)



*China's policy interest rate is 1-year prime loan rate since August 20, 2019; prior to that, 1-year Official lending rate; shaded regions represent periods of US recession; source: Guardian Capital based on data from Bloomberg and the Bank for International Settlements to January 31, 2024

There are some nascent signs that these measures are having some success in establishing traction as the Year of the Dragon, which is associated with good fortune, gets underway.

The recent data flow has shown some improvement in China, with indications that property markets may be carving out a bottom and consumers are deploying some of the abundance of cash holdings.

CHART 13: MONEY IN, NOT OUT OF, THE BANK

New household deposits and loans, China
(trillions of renminbi, 12-month rolling total)

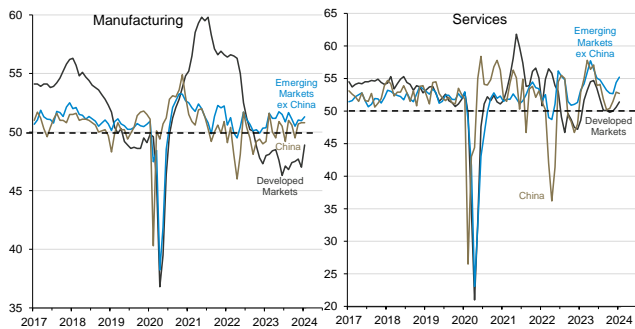


Shaded regions represent periods of US recession; source: Guardian Capital based on data from the PBOC and Bloomberg to January 2024

As well, the forward-looking purchasing managers' indexes for both the manufacturing and services sectors are pointing to a pickup in economic momentum in the New Year — to a lesser degree than other parts of EM, but more robust than DM.

CHART 14: ACTIVITY ACCELERATING

Purchasing managers' indexes¹
(diffusion index; >50 denotes expansion)



Source: Guardian Capital using data from Bloomberg to January 2024

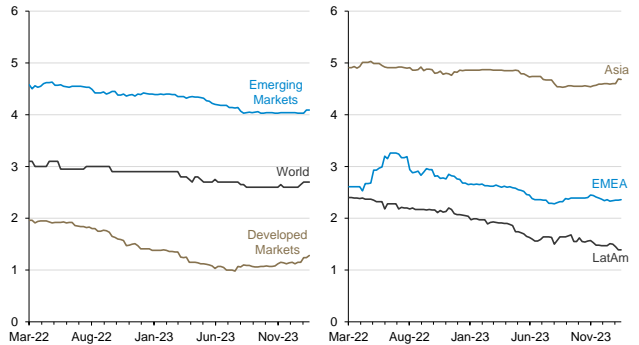
Relatively better

The base case is that China continues to see a deceleration in growth in the year ahead as the headwinds create difficulties in attaining the government's official target of "about 5%."

With that said, growth in China is still likely to be materially stronger than that in the DM — and that goes for the rest of the EM as well, albeit to a lesser degree in EMEA (Europe, Middle East, and Africa) and LatAm (Latin America) than Asia.

CHART 15: STEADY AS SHE GOES

Consensus real GDP growth forecasts, 2024
(percent)

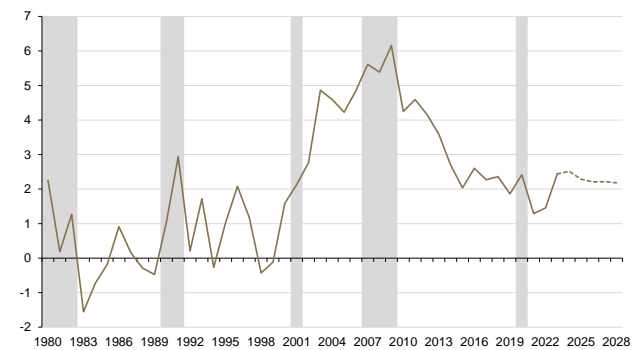


Source: Guardian Capital based on data from Bloomberg to February 9, 2024

In fact, the expectation is that the EM growth premium that was eroded during the pandemic will return to and be maintained at pre-COVID levels, which could draw fund flows back to EM.

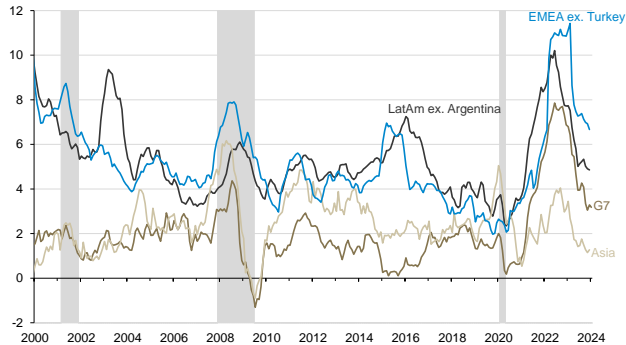
CHART 16: MIND THE GAP

EM versus DM real GDP growth differential
(percentage points)



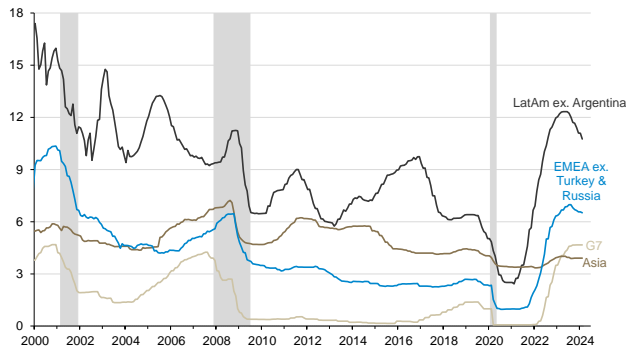
The dashed line represents consensus forecasts per the International Monetary Fund's January World Economic Outlook Update; shaded regions represent periods of US recession; source: Guardian Capital based on data from International Monetary Fund and Bloomberg to 2023

Further, while inflation remains elevated, the sharp moderation in price pressures against broadly falling costs for the goods — that carry more weight in the EM consumer basket — means that monetary policy could provide an increasing tailwind.

CHART 17: PASSED THE PEAK
Consumer price index¹²
 (year-over-year percent change)


GDP-weighted inflation rates; shaded regions represent periods of US recession; source: Guardian Capital based on data from Bloomberg to January 2024

In fact, Brazil, Chile, Colombia, Peru, Hungary, the Czech Republic, and Poland have already begun their easing campaigns while more are expected to follow suit in the months ahead, likely before DM central banks begin to scale back their restrictive stances in the second half of the year.

CHART 18: STARTING THE DESCENT
Central bank policy interest rates*
 (percent)


GDP-weighted inflation rates; source: Guardian Capital based on data from the Bank for International Settlements and Bloomberg to February 9, 2024

In addition to reducing the restraint on growth, lower rates could also provide a fundamental lift to market valuations that are historically depressed.

While stocks in EM typically trade at a discount to the DM given their higher risk profile — and the significant slate of elections this year, including Indonesia (February), South Korea (April), India (April or May), South Africa (likely May), and Mexico (June), in addition to the American election in November add to that — the investor exodus from the

asset class has seen valuation gaps hit extremes.

EM equities are trading at 50% and 40% discounts to DM on a price-to-book basis and price-to-earnings basis, respectively, both of which are well in excess of one standard deviation events versus the norms of the last two decades; the 80-basis point dividend yield premium is two standard deviations above that long-term average.

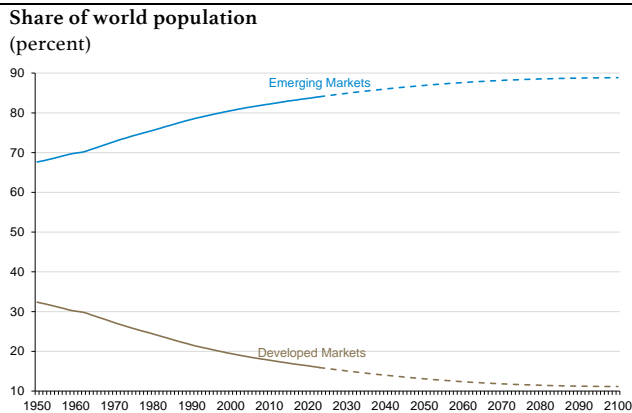
CHART 19: BARGAIN BASEMENT DISCOUNTS
EM price-to-book ratio discount versus DM
 (percent)


EM=MSCI Emerging Markets; DM=MSCI World; dashed line represents historic average; solid black lines are +/-1 standard deviation from this average; source: Guardian Capital based on data from Bloomberg to February 9, 2024

Too big to ignore

Over and above the more near-term outlook, the case for investing in EM is much stronger when looking from a longer-term perspective. Quite simply, EM is too big to ignore from portfolio allocations and is only set to get bigger.

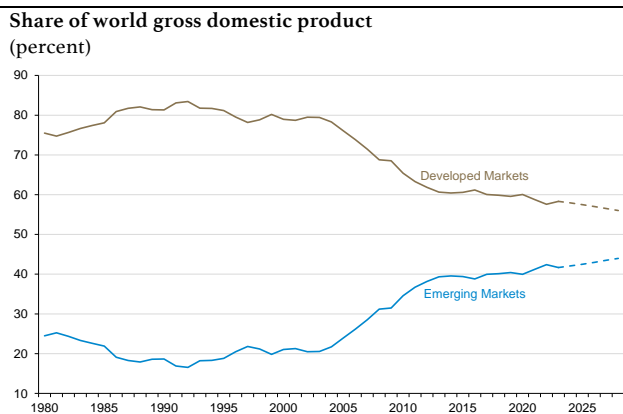
As it currently stands, 85% of the world's population resides outside of the DM and almost half of that can be attributed to just two countries (China and India). The EM share is projected to rise further in the years to come as population growth across DM stagnates — though, EM is not immune to poor demographics, as the increasingly visible impact of China's "one-child policy" can attest.

CHART 20: POWER TO THE PEOPLE


Dashed lines represent forecast data from the United Nations Population Prospects; source: Guardian Capital based on data from the United Nations

In a similar vein, EM has been the largest driver of global economic growth over the last two decades, as gross domestic product has expanded at more than double the rates across DM.

As a result, EM has doubled its share of global output, and the expectations of continued EM growth outperformance over the forecast horizon suggest that the gap with DM will narrow further.

CHART 21: WEIGHT GAIN


Dashed lines represent forecast data from the IMF World Economic Outlook; source: Guardian Capital based on data from the IMF

For some perspective, the Chinese economy, despite its expected slowing, is projected to expand by US\$6 trillion over the next five years, which is the equivalent of adding an economy the size of the United Kingdom and France combined in that span.

Growth of this magnitude combined with depressed market valuations will likely result in investment opportunities that will make the associated risks in EM worthwhile for investors who currently find themselves underexposed.

David Onyett-Jeffries

David Onyett-Jeffries is Vice President, Economics & Multi Asset Solutions, at Guardian Capital LP (GCLP) and provides macro-economic guidance to GCLP and its affiliates—Alta Capital Management LLC and GuardCap Asset Management Limited.

End notes

- ¹ The MSCI Emerging Markets Index (MSCI EM Index) captures mid- and large-cap representation across 27 Emerging Markets countries.
- ² The MSCI World Index captures large and mid-cap representation across 23 Developed Markets (DM) countries.
- ³ OECD Monthly Capital Flow Dataset (De Crescenzo and Lepers 2021), <https://www.oecd.org/daf/inv/investment-policy/oecd-monthly-capital-flow-dataset.xlsx>
- ⁴ OECD+ is an aggregate including the 38 OECD economies and six major non-member economies (Brazil, China, India, Indonesia, Russia and South Africa).
- ⁵ "China Syndrome" is the term for a nuclear reactor operations accident characterized by the severe meltdown of the core components of the reactor, which then burn through the containment vessel and the housing building, then (figuratively) through the crust and body of the Earth until reaching the opposite end, presumed to be in "China".
- ⁶ The MSCI Emerging Markets ex-China Index captures large and mid-cap representation across 23 of the 24 Emerging Markets (EM) countries excluding China.
- ⁷ The Geopolitical Risk Index, created by Dario Caldara and Matteo Iacoviello, is a measure of adverse geopolitical events and associated risks based on a tally of newspaper articles covering geopolitical tensions. The index reflects automated text-search results of the electronic archives of 10 newspapers related to adverse geopolitical events in each newspaper for each month (as a share of the total number of news articles).
- ⁸ A number of regulatory measures enacted by the Chinese government.
- ⁹ The Price Indices of Newly Constructed Residential Buildings (by Floor Space) in 70 Medium- and Large-sized Cities. This index shows the year-over-year change in new home building prices in China and is calculated in the weighted average method and the weight of each city is based on the population.
- ¹⁰ A number of economic stimulus measures enacted by the Chinese government.
- ¹¹ The Purchasing Managers Index (PMI) is a measure of the prevailing direction of economic trends in manufacturing and services sectors; based on a monthly survey of companies to determine whether business conditions are improving, unchanged, or deteriorating compared to the previous survey, seasonally adjusted.
- ¹² Inflation measured by the consumer price index (CPI) is defined as the change in the prices of a basket of goods and services that are typically purchased by specific groups of households.

This document is confidential and may not be copied, reproduced or distributed, in whole or in part, to others at any time without the prior written consent of Guardian Partners Inc. The material contained herein is not intended for distribution to, or to be used by, any person or entity in any jurisdiction or country in which distribution or use would be contrary to law or regulation. Except as otherwise permitted herein, distribution of this material to any person other than the person to whom this was originally delivered and to such person's advisors is unauthorized and any reproduction, in whole or in part, or the divulgence of its contents, without the prior consent of Guardian Partners Inc. in each such instance is prohibited. The statements and opinions expressed herein are as of the date hereof (unless otherwise indicated) and are subject to change as economic and market conditions dictate. This document includes information concerning financial markets that was developed at a particular point in time. This information is subject to change at any time, without notice, and without update. This commentary may also include forward-looking statements concerning anticipated results, circumstances, and expectations regarding future events. Forward-looking statements require assumptions to be made and are, therefore, subject to inherent risks and uncertainties. There is significant risk that predictions and other forward-looking statements will not prove to be accurate. This document is not intended to be, nor should it be construed or used as investment, financial, accounting, tax or legal advice. Information or data about past performance is no assurance of future results. The material contained herein has been prepared solely for informational purposes and is not an offer to buy or sell or a solicitation of an offer to buy or sell any security or instrument or to participate in any trading strategy.

Guardian Partners Inc. provides private client investment services and is a wholly owned subsidiary of Guardian Capital Group Limited, a publicly traded firm listed on the Toronto Stock Exchange. For further information on Guardian Capital Group Limited and its affiliates, please visit www.guardiancapital.com/. For further information on Guardian Partners Inc., please visit www.guardiancapital.com/gpi. All trademarks, registered and unregistered, are owned by Guardian Capital Group Limited and are used under license.

Published: February 2024