GUARDIAN PARTNERS INC

Emerging Markets Quarterly Outlook

QUARTER ONE 2021

HOPE AND CHANGE

As difficult and tumultuous as 2020 was for the global economy, a quick glance at financial market performance for the year would seem to provide a contradictory message — and this is especially the case for the typically cyclically-sensitive Emerging Markets (EM).

The MSCI Emerging Markets Index generated an 18% (US dollar basis) total return in 2020, a tally that effectively doubled its average annual increase over the last two decades, outpaced the gains in Developed Markets (DM; the MSCI World Index rose 16%) for the first time in three years, and brought the index of stock prices across the aggregated EM within 5% of its long-elusive high from October 2007 (the MSCI Emerging Markets Total Return Index did, however, end the year at its record high).

The solid overall returns for the calendar year as a whole, however, masked what was an incredibly volatile and highly uneven performance through the 12-month span.

The crisis-driven poor market performance in Q1 soon gave way to a rapid recovery against easing lockdowns and improving outlooks that saw EM stocks rally 70% from the lows (on par with the gains in the DM) while establishing among two of the best quarters for equity grouping on record in the process (Q2 and the just-ended Q4).

While superficially strong, the EM equity performance throughout this rebound could hardly be characterized as such in general, as beneath the veneer the returns were extremely narrowly concentrated in a handful of companies within a couple of sectors and a few countries, while effectively all other areas struggled.

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On one side there was the leaders: China, South Korea and Taiwan. Not only have these North Asian countries done a comparatively great job at controlling COVID-19 contagion within their borders, which permitted their economies to reopen to a greater degree, their markets are skewed toward the "internet-enabled" sectors (Communication Services, Consumer Discretionary, which includes e-commerce, and Information Technology) that have been able to flourish in the pandemic environment. The stock markets of these three countries generated a cumulative 34% (US dollar basis) in 2020 and were responsible for all of the gains within the EM benchmark index (and the top five performing companies of the 1,397 that comprise the MSCI EM Index were operating within those three mentioned sectors in those three mentioned countries and alone accounted for just under 60% of that gain).

On the other side were all the other EM economies, which have faced more problems in keeping the coronavirus contained and have economies that are generally skewed more toward the laggard natural resources and financial services sectors. These markets declined 9% as a group in 2020, with ten of the 23 posting declines in excess of 10% for the year (and five closing down more than 20%).

Deeper breadths

The lack of breadth in performance is less than ideal given that economic expansions and market rallies are typically stronger and more durable when there is broader participation. But on this score, the final months of 2020 provided some positive developments.

Not only did EM stocks turn in their best quarter in 11 years with the MSCI EM Index generating a near 20% total return in the three months ended December (outdoing the 14% return in DM), but gains were seen everywhere. On a geographic basis, 25 of 26 local stock markets rose in Q4 (Egypt's and its -5% US dollar return was the sole decliner) while all 11 equity sectors were up in the quarter as well (and nine of them posted double-digit increases).

It was still the case that the three North Asian markets and the three "internet-enabled" industrial groups were responsible for the bulk of the gains in the period, but the magnitude of their contribution was commensurate with their share of the overall market (65% and 51%, respectively) rather than them punching well above their weight as was the case through the previous six months.

Perhaps more importantly from a forward-looking perspective is that the factors that underpinned the strong and broad-based performance as 2020 drew to a close are likely to persist into the New Year.

Meet the new boss, different from the old boss

For starters, one of the most notable developments for EM was the outcome of the US election in November. The victory by former Democrat Vice President Joe Biden portends a return of much needed stability at the helm of the world's largest economy. The regime change resulted in a further unwinding of the political risk premium embedded in the US dollar over the last four years. Combined with expectations of less fiscal restraint in the US, this contributed to a broad-based weakening in the greenback and consequent lifting of EM currencies (the MSCI EM Currency Index, for example, rallied 5.3% in Q4 in its best quarter in a decade, to end the year 11% above its March lows).

Further, while it remains likely that the new White House Administration will maintain (or re-establish) pressure on some major EM competitors (namely, China and Russia), the approach to foreign policy is likely to be far less hostile and more diplomatic than its predecessor's, which increases the probability of establishing mutually beneficial trade agreements or otherwise easing trade tensions that have weighed on the global economy (and EM in particular) in recent years.

As well, the expectation of increased fiscal stimulus resulting from the now-unified and Democrat-led US government, particularly a projected emphasis on infrastructure spending, bodes well for the natural resource and industrial-focused areas of EM.

The implied boost from these geopolitical developments to the more cyclically-sensitive and traditional EM sectors that have been hard hit by the pandemic-induced collapse of economic activity through 2020, factored into the aggressive rotation away from Growth and toward Value in the closing months of the year and supported EM outperformance.

A knockout jab

Of course, the good news on the political front in November was not the biggest driver of the market narrative at the end of last year. By far the most important development for the macroeconomic outlook was with respect to vaccines with the potential to end the pandemic. November and December saw extremely positive final results of the phased trials of multiple vaccine prospects. The estimated high efficacy in stopping the spread of COVID-19, and negligible adverse side effects, resulted in the first wave of approvals and the start of vaccine distribution.

There have understandably been hiccups so far in the early stage of what stands as the largest global inoculation effort ever, but as it stands now the expectation is that the majority of the population in the DM will be vaccinated by the middle of this year. The EM faces additional logistical hurdles given their generally less developed transportation infrastructure and comparatively limited number of professionals available to actually administer the jab (particularly in Latin America and South Asia and Sub-Saharan Africa), but the expectation is that at least the bottom of the 50% to 70% vaccination threshold assumed necessary to establish herd immunity should be hit across EM around year-end.

This prospect — which would permit a rapid broad-scale reopening of economic activity and a return to something close to the norm of 12 months ago, when a global pandemic was simply an extreme and low probability scenario for risk models — is unambiguously positive for the global growth outlook and has resulted in a wholesale upgrade of economic projections across the forecast horizon, notwithstanding the expectation that the recovery takes a near-term step back amid the resurgence of contagion and the consequent reinstitution of lockdown measures.

Importantly, though, even if there do end up being significant issues and resultant lags in vaccine distribution across the EM, while clearly less than ideal and creating potential headline shocks and swings in investor sentiment, that is not outright negative for the grouping. Indeed, as long as DM are able to reopen to a material degree and unleash pent up demand that should provide a healthy tailwind over the coming months for the countries in EM where natural resources and goods production are the dominant economic drivers.

Hope is tomorrow's veneer over today's disappointment

The vaccine-induced clarity over the outlook has provided a relatively larger upgrade to the more cyclically-sensitive segments of the market and played a more significant role than US politics in driving the rotation away from those areas of the market that had outperformed earlier in the recovery toward the rest. There still remains scope for further catch up from these more traditionally EM-oriented sectors and as such, sets the stage for further fundamental strength in the broad EM over the coming months.

On top of that, the wide confidence intervals of forecasts and uncertainty-driven investor risk reticence means that EM equities continue to trade at wider-than-normal discounts to their DM counterparts on both a price-to-earnings and price-to-book basis. These disparities are even greater when taking earnings momentum and earnings growth expectations beyond just the coming year into account, which suggest that there is scope for further gains and relative outperformance should expectations be realized.

Add to that the prospect of a further broad-based weakening of the US dollar amid the sustained low interest rate environment (the Fed has committed staying behind the curve with respect to inflation and policymakers anticipate keeping rates at their current lower bound into 2023 based on the latest

Summary of Economic Projections) that sends yield-starved investor dollars seeking the higher coupons on offer abroad, and 2021 has the makings of a highly constructive year for EM assets — though the road to the next year-end is unlikely to be smooth, particularly over the coming months.