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Warakirri ASSET MANAGEMENT

# Global Emerging Markets Outlook 2023

Despite the pressures of 2022 on Emerging Markets, we continue to find compelling opportunities to invest in resilient, growing companies in sovereign nations with attractive demographics and sound ESG and governance practices. The set up for good returns for patient investors appears to be in place as we head into 2023. Here we share our perspective on what lies ahead for the asset class.

*This information has been prepared by Northcape Capital, the underlying investment manager for the Warakirri Global Emerging Markets Fund.*

## Recap on key themes of 2022

The main drivers of Emerging Markets (EM) over 2022 have been the impact of higher central bank policy rates (to limit inflation becoming entrenched), Russia's expulsion from the EM equity asset class (and ensuing energy crisis), and China's persistent zero COVID policies and the reappointment of President Xi Jinping for an unprecedented third term in power. The combination of these factors meant the EM asset class has been under pressure for most of the year.

## Central bank policy weighs heavily on global growth outlook

As we head into 2023, we sense predicting outcomes is fraught with inaccuracy risks. Who would have thought at this time in 2021 that the outcomes of 2022 would manifest?

That said it seems the impact of material central bank policy tightening in 2022 will undoubtedly have a negative impact on global growth in 2023, increasing the risks of a global recession. However, given EM central banks have been by far the most aggressive in raising rates, EM appears to be in a good position to start easing when inflation eventually ebbs.

The Russia-Ukraine war appears set to become a stalemate, with Russia retreating to the Donbas region. This may have potential positive consequences for energy pricing, and the overall inflation pulse. The impact of Xi's leadership reappointment will become clearer, in our view posing risks to the downside for China.

## Cautious outlook for China

We remain very cautious on China due to excessive debt, poor governance, and highly challenged demographics. We continue to identify risks to the downside on China relative to our preferred EMs.

The largest immediate risk to China's capital markets would be the ongoing demise of the property sector which accounts for about 30% of GDP. This has negative consequences for the country's economic growth, and there are contagion risks from property price weakness to the solvency of the banking system, given property linked debt is close to 70% of China's GDP.

Additionally, although China appears to be relaxing its dynamic zero COVID strategy in late 2022, given the vast percentage of the population is not properly vaccinated, there are significant risks of a major healthcare crisis as the country's hospital system is overwhelmed with COVID victims. This could be a source of social and political instability.

Increased sanctions by the US and EU on technology transfer are factors that will inhibit China's ongoing growth and development as well.

The recent reappointment of Xi Jinping for an unprecedented third term and installation of his loyalists and "yes-men" to the *Politburo*, raises the risks of increased state intervention in private companies, more severe breaches of modern slavery with the Uyghur population and potential provocations against Taiwan. The latter two will potentially increase the level of financial and trade sanctions on China from the West.

With this overhanging China's international perceptions the pace of foreign direct investment pivoting away from the country is set to increase in 2023, benefitting countries like India, Mexico, South Korea, Indonesia, Thailand, and Malaysia.

## EM sovereigns well positioned going into 2023

The EM equity asset class is not homogenous, and as always, the risk profiles vary considerably across country, sector, and companies. At a high level we want to invest in EM countries with strong demographics. Essentially countries with large, young populations fuelling growth in the working population and associated salary mass and/or improving workforce productivity.

A focus on ESG in assessing sovereign risk is also critical in choosing our most preferred regions within EM. We place a large premium on countries with democracies, and independent judiciaries allowing corporate law to be prosecuted effectively. We also want to see freedom of assembly and press, independent central banks, responsible fiscal, human rights and environmental policies.

Taken together these provide the crucial checks and balances for the capital markets to function with integrity. When these factors are absent, capital loss risks become very high and almost inevitable over time – witness Russia!

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**Exhibit 1: Northcape EM Political & Governance Risk Scores**

| 3Q22 | Democracy? | Judiciary | Stability | Corruption | Policy Acumen* | Fiscal Resp | CB independence | Total | Overall Political Risk Assessment |
|---|---|---|---|---|---|---|---|---|---|
| China | 0 | 0 | 0.5 | 0 | 0 | 0 | 0 | 0.50 | High |
| Egypt | 0 | 0.5 | 0.75 | 0 | 0.5 | 0.5 | 0.5 | 2.75 | High |
| Hungary | 0 | 0.75 | 0.75 | 0.5 | 0.5 | 0.25 | 0.5 | 3.25 | High |
| Saudi Arabia | 0 | 0 | 0.75 | 0 | 0.25 | 0.25 | 0 | 1.25 | High |
| South Africa | 0.5 | 1 | 0.25 | 0.25 | 0.25 | 0 | 1 | 3.25 | High |
| Turkey | 0.25 | 0.25 | 0.5 | 0.25 | 0.25 | 0.25 | 0 | 1.75 | High |
| Colombia | 0.75 | 1 | 0.25 | 0.5 | 0.25 | 0.5 | 0.5 | 3.75 | High |
| Philippines | 1 | 0.25 | 0.5 | 0 | 0.5 | 0.25 | 0.25 | 2.75 | Medium |
| Brazil | 1 | 0.75 | 0.25 | 0.25 | 0.5 | 0.5 | 1 | 4.25 | Medium |
| Chile | 1 | 1 | 0.5 | 0.75 | 0.5 | 0.5 | 1 | 5.25 | Medium |
| Greece | 1 | 1 | 0.5 | 0.5 | 0.5 | 0.25 | 1 | 4.75 | Medium |
| Indonesia | 0.75 | 0.5 | 0.5 | 0.25 | 0.5 | 0.5 | 0.75 | 3.75 | Medium |
| Malaysia | 0.5 | 0.75 | 0.75 | 0.5 | 0.5 | 0.5 | 0.75 | 4.25 | Medium |
| Mexico | 0.75 | 0.5 | 0.75 | 0.25 | 0.5 | 0.75 | 1 | 4.50 | Medium |
| Peru | 0.75 | 0.5 | 0.25 | 0.25 | 0.5 | 0.5 | 1 | 3.75 | Medium |
| Poland | 0.75 | 0.75 | 0.75 | 0.5 | 0.75 | 0.5 | 0.25 | 4.25 | Low |
| India | 0.75 | 0.75 | 1 | 0.5 | 0.5 | 0.5 | 0.75 | 4.75 | Low |
| Czech Republic | 1 | 1 | 0.75 | 0.5 | 0.75 | 0.75 | 1 | 5.75 | Low |
| Korea | 1 | 0.75 | 1 | 1 | 1 | 0.75 | 1 | 6.50 | Low |
| Taiwan | 1 | 1 | 0.5 | 0.75 | 1 | 0.75 | 1 | 6.00 | Low |
| Thailand | 0.25 | 0 | 0.25 | 0.5 | 0.5 | 0.5 | 1 | 3.00 | Low |

Source: Northcape Capital. Factor scores range from 0-1 to indicate level of risk. Countries in green indicate Northcape's current preferred countries.

Through this lens, our current preferred EM sovereigns are India, South Korea, Taiwan and Indonesia due to generally better governance practices, and stronger capital market buffers and/or attractive demographics **(see Exhibit 1)**.

## Structural growth sectors with lower volatility stand out from the crowd

In terms of sectors, we continue to favour those with structural growth such as information technology, industrials, consumer, healthcare, telecoms, renewable technologies and infrastructure. These sectors tend to grow at the rate of underlying GDP (or even higher) but with relatively lower volatility.

Although the sector is benefitting from the current energy crisis, we remain cautious on oil and gas over the long-term for two reasons in particular: growing demand destruction risks on climate change constraints long-term; and political risks such as resource taxes and price control regulation. In the near term, a resolution of the conflict in Ukraine would also see potential for the premium in oil pricing to reduce.

We also believe that select quality financials/banks are well placed as a hedge against inflation should it remain higher for longer. This will be reflected in the ability of these banks to raise rates in step with higher central bank policy rates.

Quality EM banks have also been conservatively managed and as such have ample provisions for potential increases in bad debts and have higher levels of capital adequacy – well above regulatory requirements, and crucially above their main competitors. As such, these banks are in a strong position to grow market share over the long-term in the "underbanked" EM countries they service.

## In conclusion – Quality EM companies in good shape

We anticipate that, notwithstanding the prospect of a global recession in 2023, companies in our EM portfolio should in aggregate continue to post double-digit growth over the medium to long-term, underpinning returns for investors.

Quality companies within the EM equity asset class have been penalised by higher interest rates, on account of being long duration assets, but what is especially exciting currently is the clear evidence that these companies have arguably never been in better shape, and are trading at some of the most attractive valuations since the inception of the strategy in 2008. The set up for good returns for patient investors appears to be in place as we head into 2023.

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