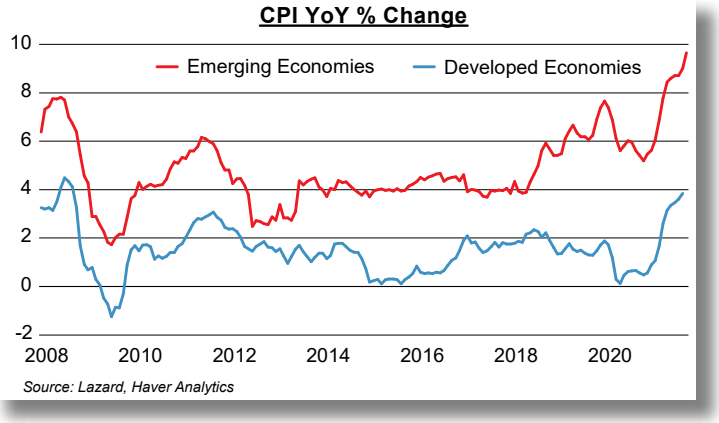
Foreign Equities: Emerging Markets

Quicktake: Emerging markets (EM) are facing more headwinds than developed markets. If we are correct in our view of a mid-cycle slowdown, emerging markets are unlikely to post outsized relative returns due to weaker support from developed market demand. The slowdown in China, hawkish central bank activity, inflation, rising US interest rates and a stronger US dollar, along with precarious risk sentiment, are all hurdles facing emerging market economies. We expect opportunities to be more idiosyncratic in the asset class this year, and recommend tactical exposure to individual regions and countries, rather than broad based EM exposure. Our outlook for EM would improve if inflation subsided, China surprised to the upside, and developed market central banks pull back on policy tightening measures. Clarity on these factors is unlikely to occur until Q2 or later, and volatility in global markets will likely cap demand for this risky asset class. Take an underweight position relative to developed markets to begin the year while remaining abreast of potential individual opportunities in commodity producing countries where exposure can be added during periods of risk-on sentiment.

The return outlook for emerging markets is overly sensitive to consistent growth in developed economies, inflationary pressures, and both domestic and foreign interest rate risks. Each of these factors will support or curb volatility throughout the year. Because EM is a high-risk position in many investors' portfolios, it is also one of the first allocations to be sold during periods of uncertainty and rising risk-off sentiment.

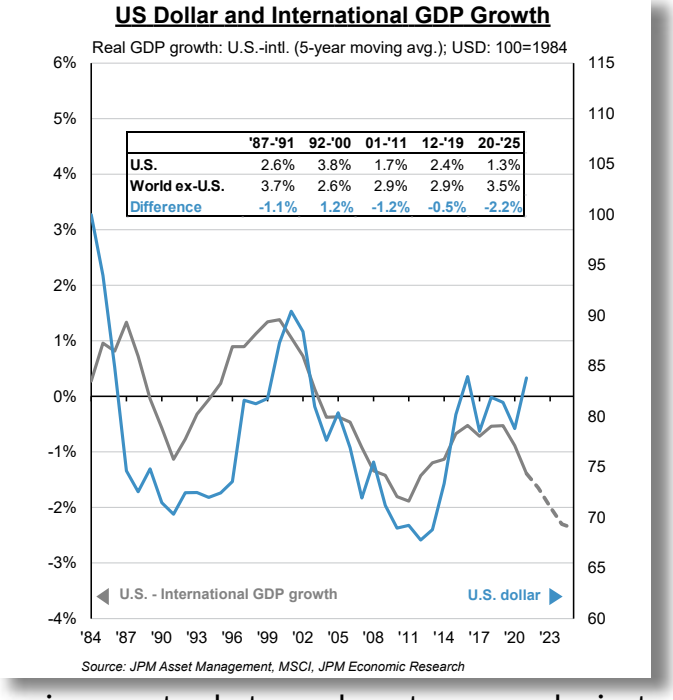
Inflation is rising faster in EM economies despite aggressive central bank activity



EM central banks have been working hard to battle inflation, but so far, they are losing the fight. Fourteen EM central banks have been raising rates over the past year to try and get back ahead of the curve. The moves have strengthened some currencies, but we could see that trend reverse as the Fed begins to raise rates in the US which will lead to a stronger US dollar. Currencies have a much greater impact on EM stocks than on developed stocks. A stronger US dollar typically leads to weaker local spending power and higher debt costs which ultimately weighs on EM GDP growth. Also, PMIs in emerging markets are lagging developed market economies. The data shows multiple countries flirting with the line between expansion and contraction. Consistent reports showing expansion have been encouraging, but as we have said before, the direction of the trend in the data is more important than the absolute level. The longer we see the data stuck in a tight range, the lower the probability of a sustainable breakout. Finally, new covid strains could lead to a disruption in the pace of EM economic growth by lowering consumer spending expectations and negatively impacting supply chains and local production.

While many headwinds exist, we do see some green shoots. The supply and demand imbalance in commodities will be a major tailwind for multiple EM countries. Agriculture, mining, and energy production have significant demand gaps to close, and EM will play a key role in these markets.

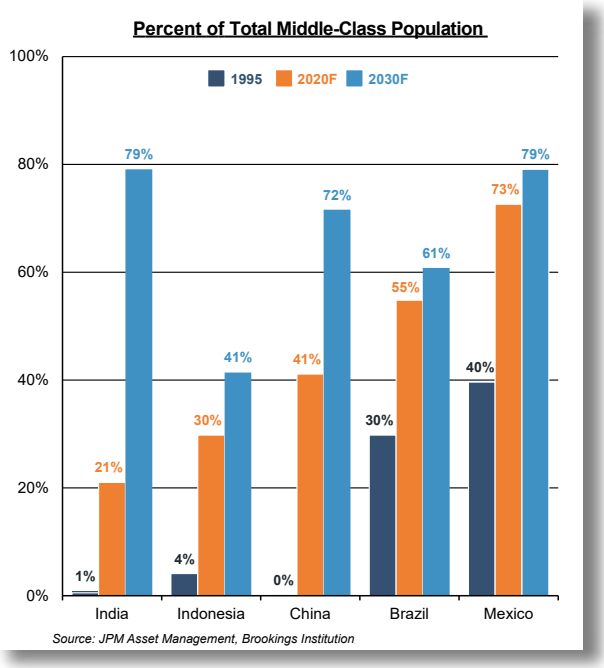
A stronger US dollar negatively impacts international GDP growth



Pricing power is high and demand will likely be strong throughout the year providing a solid baseline for higher revenues. We find many examples of these dynamics in Latin America where real asset production dominates local economies.

Additionally, a trend of deglobalization and China turning its focus inward could create opportunities for EM growth. This trend will also provide favorable prospects to countries which have been more open to outside investment and are working towards building a middle-income population. The ultimate benefits will likely take longer than twelve months to take hold, but companies willing to increase capex now stand to benefit from the future normalization of global supply chains. We think Asia-Ex Japan and India stand to benefit the most from this opportunity. The differences in return drivers for specific regions and countries will lead to wider distributions in emerging market returns this year. In this market environment, what you do not own can be just as important as what you do. We favor more concentrated exposure to trends which benefit from higher real interest rates and developed market demand rather than casting a wide net over the entire asset class.

Emerging market countries that are able to attract foreign investment and invest locally today can see a massive rise in future wealth.



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