Emerging markets: Worth a look?

Todd Mattina, PhD
Senior Vice President, Chief Economist,
Portfolio Manager, Team Co-Lead
Mackenzie Multi-Asset Strategies Team

Jules Boudreau, MA
Economist
Mackenzie Multi-Asset Strategies Team

Highlights

- In 2021, emerging market (EM) equity indices were weighed down by China's regulatory crackdown and EM currency weakness, but some individual EM stock markets still posted solid gains.
- With China now easing its macro policy stance, and with persistently strong global demand for both manufactured goods and commodities, EM equities are well positioned to outperform developed market (DM) equities over the next decade.
- We also expect major EM currencies to strengthen, adding to the attractiveness of typically unhedged investments in EM equities.
- EM asset classes have historically performed well in periods of strong global growth. In the near term, a key macro risk for the EM outlook is tightening global liquidity conditions as major central banks hike interest rates.

2021 was a year to forget for EM equities with the benchmark MSCI EM index returning -2.5% in USD terms, compared to 28.7% for large cap US stocks. But those gloomy returns hid some bright spots for EM stocks. In local currency terms, seven of the world's top ten-performing equity markets last year were in developing countries.[1] The EM underperformance at the overall index level was mostly explained by the drag from Chinese stocks, which lost ground due to the double whammy of a regulatory crackdown and slower growth. Chinese stocks are a key driver of EM stock returns, making up around 30% of the benchmark MSCI EM index. However, EM stocks excluding China returned 12.3% for a currency-hedged investor. In addition, the depreciation of many EM currencies further weighed on returns for unhedged investors.

This pattern was flipped on its head in the first month of 2022, as EM stocks outperformed DM stocks except for the energy-heavy UK equity index. Fourteen of the fifteen top-performing individual stock markets in January were in the developing world, a pattern that may be set to continue given the current macro backdrop and relative equity valuations.

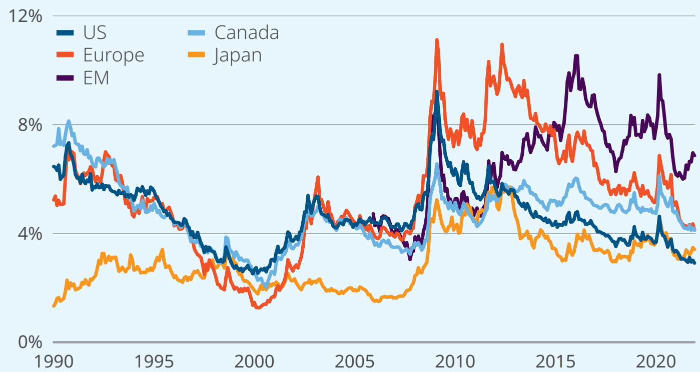
The Chinese government has begun to ease macro policy, strengthening an economic rebound. China's growth slowdown in 2021 had likely bottomed before the Omicron variant forced renewed lockdowns in late December. The Li Keqiang index, a real-time proxy for Chinese growth, has begun to inch up, while an inflection in the Chinese credit impulse may indicate easier credit (see circled area in Figure 1). In January, the People's Bank of China cut its benchmark lending rates for banks for the first time since April 2020. Retail sales and imports – proxies for the strength of domestic consumption – rebounded in November 2021 after slumping in the early Fall amid a real estate crisis. The arrival of Omicron dampened domestic demand in December, but this headwind should fade if the variant follows a similar "boost-bust" pattern in China as it did elsewhere. But more importantly for ex-China EM firms, it is Chinese production, not household consumption, that drives earnings. And production has remained solid, as the government relies on the manufacturing and exports sectors to compensate for sluggish consumption to reach its growth target.

1 We restrict the universe to those equity markets with a market cap above US $25 billion. Of those 51 markets, 26 are in emerging economies.

Figure 1. Chinese stimulus could be one of the triggers for EM stocks to realize their potential

Credit expansion has begun in China

Wide valuation spread between EM and US stocks (cyclically-adjusted earnings yield)



Notes: Left chart: Data via Bloomberg as of January 24, 2021. Right chart: The cyclically-adjusted earnings yield divides the 10-year average of real earnings by the current real index price, following Robert Shiller's methodology. Underlying data via Bloomberg as of January 19, 2021.

In the past, EM asset valuations have been vulnerable to a tightening in global financial conditions, but the macro context is different in 2022. In 2013, the US "taper tantrum" – when the Federal Reserve effectively tightened global financial conditions by reducing its enormous bond purchases – exposed vulnerable developing countries to higher US dollar-based interest rates, capital outflows driven by risk averse investors and declines in EM asset and currency valuations. In early 2022, we are seeing a similar tapering of bond purchases by the Fed… but much is different this time:

- **Policy stance in China:** At the time of the 2013 taper tantrum, the Chinese government was wrapping up its credit expansion, rather than just starting to ramp it up. In 2022, Chinese financial conditions will be loosening – a tailwind for many developing countries – balancing out the tightening in DM countries.
- **Strong global demand:** The global economy was fragile and operating below capacity in 2013. Consumers and businesses were deleveraging rather than borrowing, and aggregate global demand was weak. In 2022, demand for manufactured goods and commodities is historically high, and it likely will take more than a few Fed rate hikes to dampen demand quickly.
- **EM equity valuations:** Ten years ago, EM stocks were not particularly undervalued relative to US stocks. Today, the historically wide EM-US valuation spread means that EM stock valuations could be relatively less vulnerable to a rise in risk-free interest rates (Figure 1).

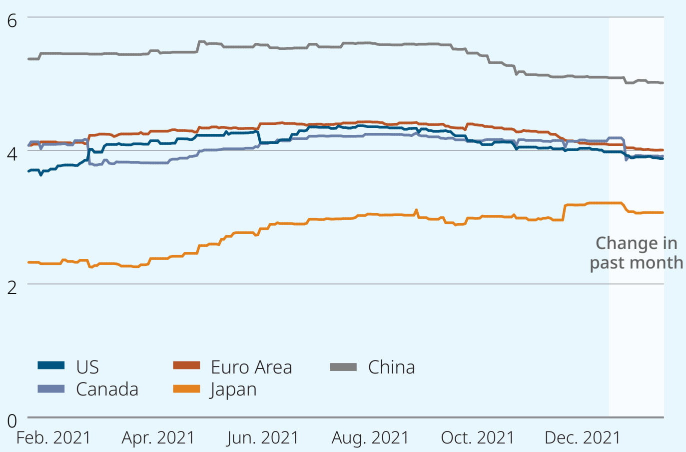
For EM stocks, currency moves can be an important component of total returns, especially over short investment horizons. Diversifying currency exposures by allocating to a basket of major EM markets can help reduce overall currency risk. From a tactical perspective, many EM currencies are well positioned to strengthen due to high commodity prices and strong demand for manufactured goods. We previously focused on the strong tailwinds to commodity currencies in our November commentary, and the Brazilian real and South African rand have been two of the best performing currencies to start the year. We also expect the Indian rupee to gain over the next few months. 70% of the Indian population could be vaccinated by the end of Q1 2022, one of the highest rates among EMs. Inflation is high but contained, and the Reserve Bank of India is expected to hike its policy rate by 100 basis points in 2022. One notable exception to the generally positive outlook for EM currencies is the Mexican peso, which we expect to remain weak in 2022, given the Bank of Mexico's reticence to push back against inflation by raising rates.

Notwithstanding a strong start and promising long-term outlook, EM stocks remain more volatile than many of their counterparts in developed markets. But for investors with a long-term horizon and who are able to bear volatility, EM stocks offer attractive expected returns.

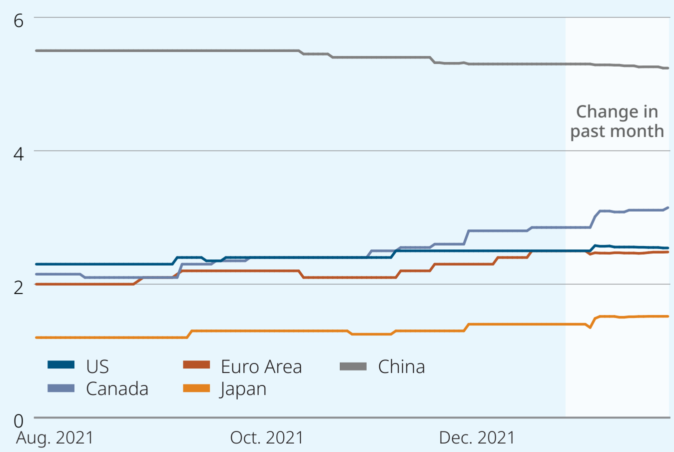
Global macro update

- Forecasts for 2022 **Canadian growth** dipped in January, as strict lockdowns were enacted in most provinces. We expect any strain on the economy to be temporary and we are looking for Canada to revert to its growth path from the Fall as soon as lockdowns are eased, which has already happened in a few provinces.
- **Annual GDP growth in China** for 2021 came in at an estimated 8.1%, in line with consensus expectations. Solid industrial production and high growth in exports partly compensated for weak domestic consumption in the second half of 2021. This is a pattern we expect to persist into 2022. Producers and exporters will benefit from easy credit more than consumers, especially if Covid restrictions linger, resulting in a widening of the current account surplus as export growth outpaces import growth. This would do nothing to weaken a strong Chinese yuan.
- **CPI inflation** for December clocked in at 7.0% in the US and 4.8% in Canada, year-on-year. Both readings were in line with the average economist's forecast. Month-on-month inflation slowed in Canada from previous months, but we shouldn't put too much stock into the dip. Disruptions from Omicron, combined with a temporary drop in oil prices, caused most of the slowdown. The average economist still expects 3.3% annual inflation in 2022.

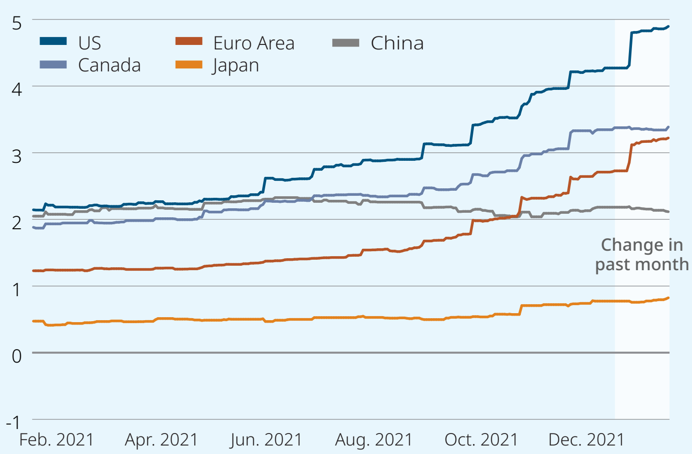
2022 real GDP growth forecast (%, consensus)



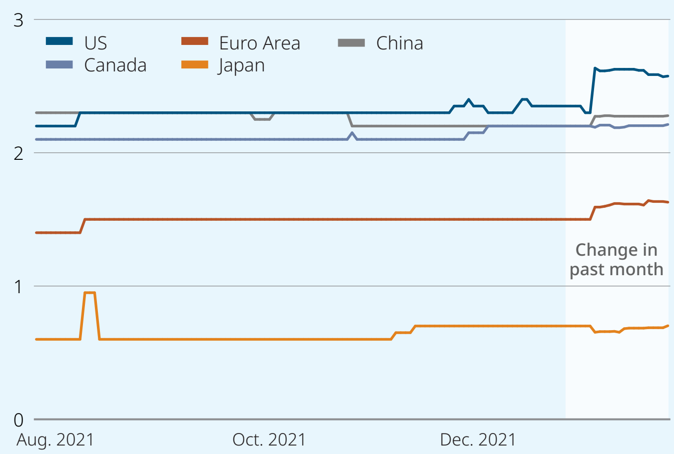
2023 real GDP growth forecast (%, consensus)



2022 inflation forecast (%, consensus)



2023 inflation forecast (%, consensus)

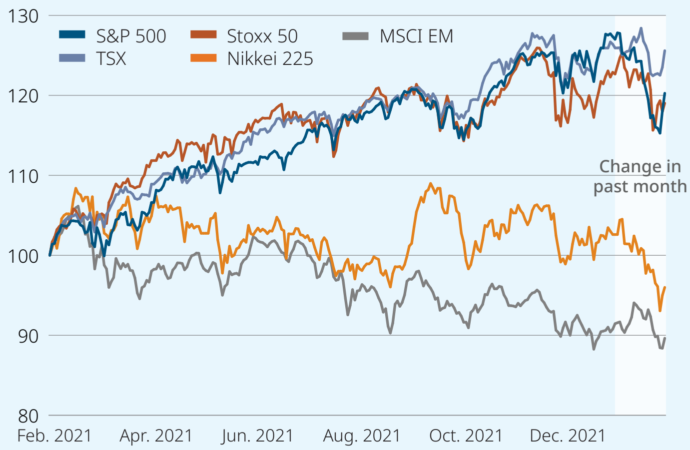


Notes: Forecasts from Consensus Economics as of January 31, 2022.

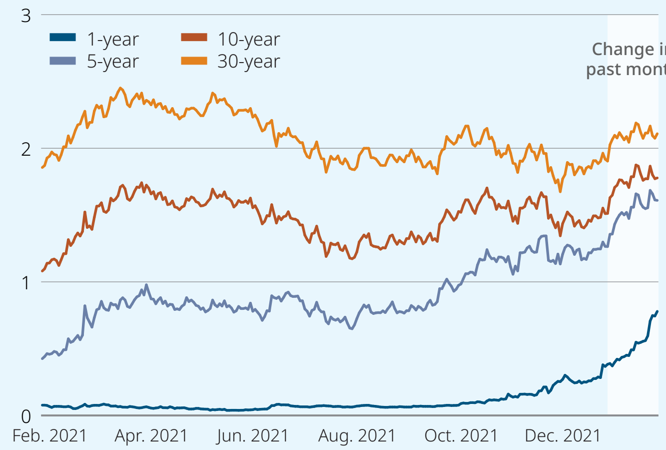
Capital markets update

- **Short-term US Treasuries** sold off aggressively in January as the market pulled forward expected rate hikes by the Federal Reserve. The pricing of interest rate derivatives now implies that investors expect the Fed to begin hiking rates in March, as soon as it has completed the tapering of its asset purchases. A 50bps March hike– twice the magnitude of a “standard” rate hike – is not outside the realm of possibility. After Fed Chair Powell took a hawkish tone in the press conference following the Fed’ monetary policy decision on January 26, markets began pricing in around a 20% probability of a 50bps March hike.
- After a slow start, **the US dollar (USD)** appreciated sharply in the aftermath of the Fed’s policy-setting meeting. But prior to the Fed event, the USD was uncharacteristically tepid given the equity sell-off. Typically, the USD outperforms in “risk-off” periods, especially ones where interest rates are rising in the US. Why did the USD behave differently this time? One reason could be that the sell-off in equities in January was heavily concentrated in US markets, leading to outflows from the country’s capital markets. And while bond yields did rise in the US, they rose even more in many other countries, including Canada.
- In January, **WTI oil prices** topped US $90 for the first time since 2014. Given low inventories, capped output from the largest producers, and a possible boost to already-strong demand from the waning of the Omicron wave, prices have further room to rise.

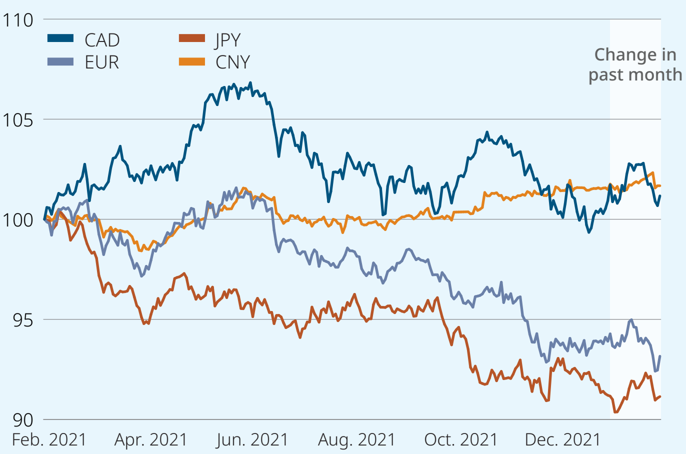
Equity indices (one year ago=100)



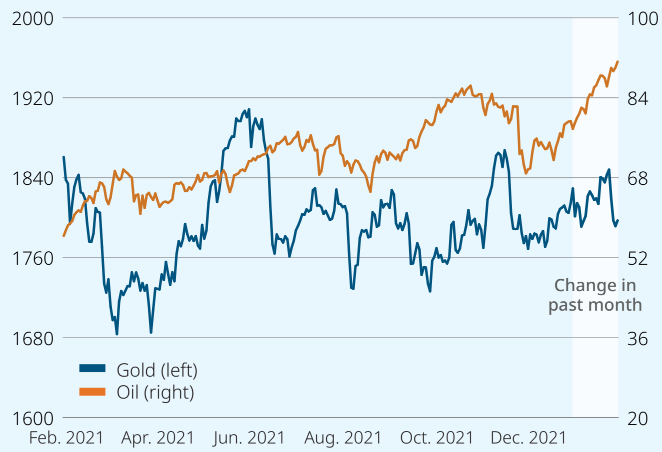
US Treasury yields (%)



Currencies (relative to USD, one year ago=100)



Commodity prices (in USD)



Notes: Financial data from Bloomberg as of January 31, 2022. Total return equity indices are in local currencies, except MSCI EM, which is denominated in USD.

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What we'll be watching in February

February 10: China Q4 current account balance

- We expect the Chinese quarterly current account surplus – grossly defined as the difference between the value of exports and imports – to have increased in 2021Q4. While domestic consumption struggled in the wake of the real estate crisis and Omicron lockdowns, exports were unperturbed, in part due to the government's use of supply-side stimulus to hit its growth target.

February 15: Eurozone Q4 GDP

- Eurozone growth exceeded forecasts in 2021Q3, with real GDP surging by 9.4% (annualized) in the quarter.
- The emergence of Omicron late in 2021, which forced many Eurozone countries into lockdowns, will certainly ding growth for the 4th quarter. But Purchasing Managers' Indices – leading economic indicators – have remained strong for most European countries, even as Omicron hit. This suggests that the momentum of growth in Europe is mostly intact, which should support the value of the euro over the medium term.

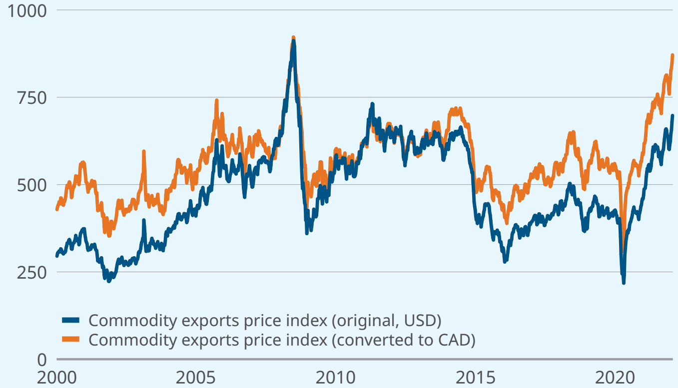
February 19: US January retail sales

- Retail sales dropped by 1.9% in December, coming in well below the consensus forecast of -0.1%. It's clear that retail sales – which have been well above trend since the summer of 2020 – will eventually need to drift down as consumers rebalance their spending from goods to services. But a 2021Q1 slump in retail sales without equivalent growth in services would be a negative sign for US growth in 2022.

Emerging theme

- The Bank of Canada's **commodity price index** – a weighted average of the price of Canada's commodity exports – surpassed its 2014 level, before the mid-2010's negative oil price shock. The BoC's index is expressed in US dollars. If we convert it into Canadian dollars, the index is almost above its all-time peak from 2008, given the CAD's depreciation in the interval.
- **Oil prices are still below their pre-2014 range**, but other Canadian commodities have surged since the start of the pandemic, buoying the overall price of commodity exports: agricultural exports prices are up 52% since January 2020, while lumber has spiked by 140% over the same period.
- **Canada's trade balance turned positive** in 2021Q3 for the first time since 2008. The recent surge in the value of Canadian exports suggests this surplus will widen further. The priciness of Canadian exports partly explains why even though the quantity of Canadian economic production (real GDP) is below its pre-crisis level, the value of production (nominal GDP) is at trend. Nominal growth often matters more than real growth for short-term economic dynamics, notably for the labour market, which is tighter in Canada than other developed countries. It also explains why the BoC is justified to hike rates even with real GDP still well below its trend.

The prices of Canada's commodity exports have been surging



Notes: Bank of Canada and Bloomberg as of January 20, 2021.

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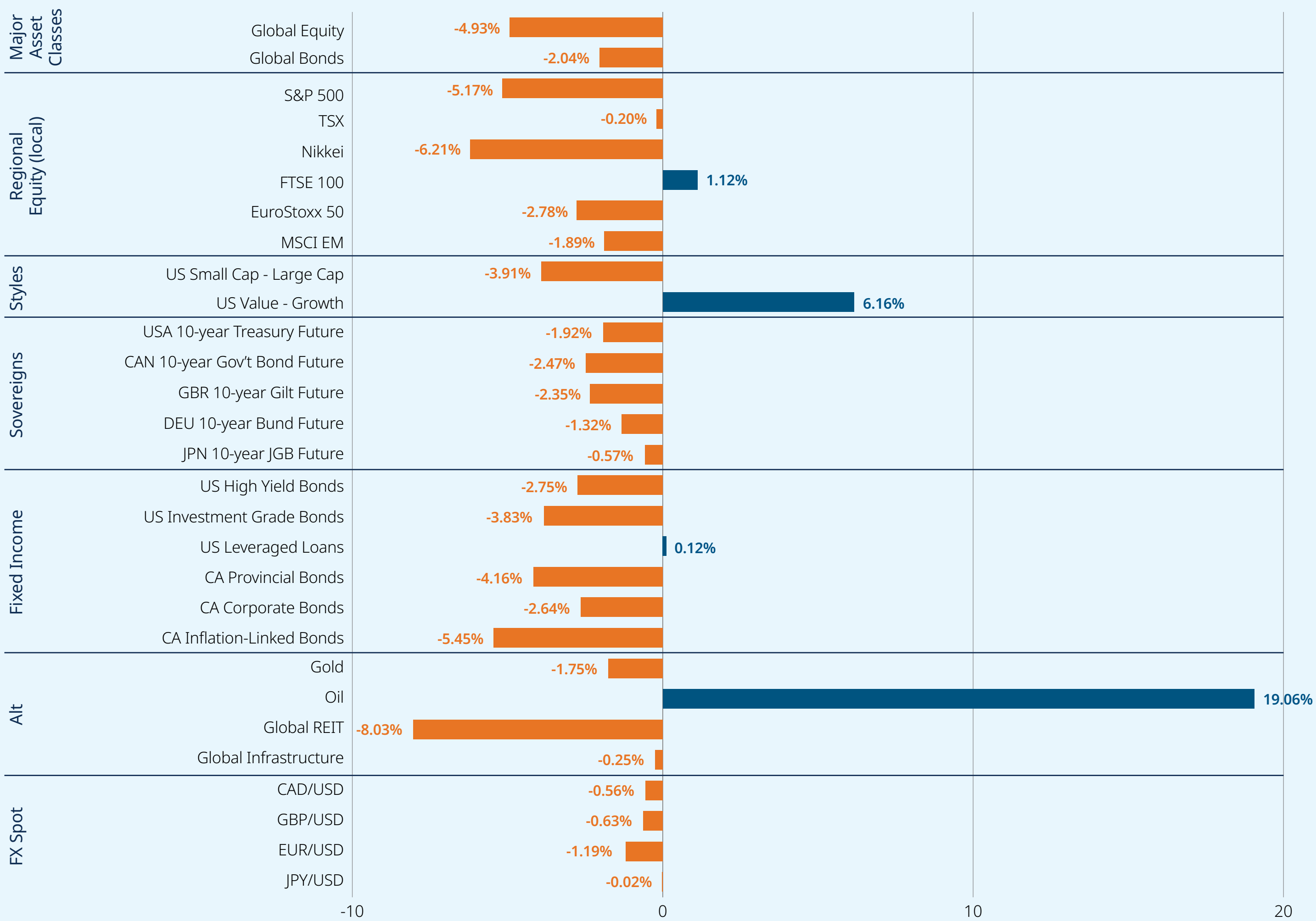
Capital market returns in January



Notes: Market data from Bloomberg as of January 31, 2022. Index returns are for the period: 2021-12-31 to 2022-01-31. In order, the indices are: MSCI World (lcl), BBG Barclays Multiverse, S&P 500 (USD), TSX Composite 60 (CAD), Nikkei 225 (JPY), FTSE 100 (GBP), EuroStoxx 50 (EUR), MSCI EM (lcl), Russell 2000 - Russell 1000, Russell 1000 Value - Russell 1000 Growth, USA 10-year Treasury Future, CAN 10-year Gov't Bond Future, GBR 10-year Gilt Future, DEU 10-year Bund Future, JPN 10-year JGB Future, BAML HY Master II, iBoxx US Liquid IG, Leveraged Loans BBG (USD), Provincial Bonds (FTSE/TMX Universe), BAML Canada Corp, BAML Canada IL, BBG Gold, BBG WTI, REIT (MSCI Local), Infrastructure (MSCI Local), BBG CADUSD, BBG GBPUSD, BBG EURUSD, BBG JPYUSD.

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