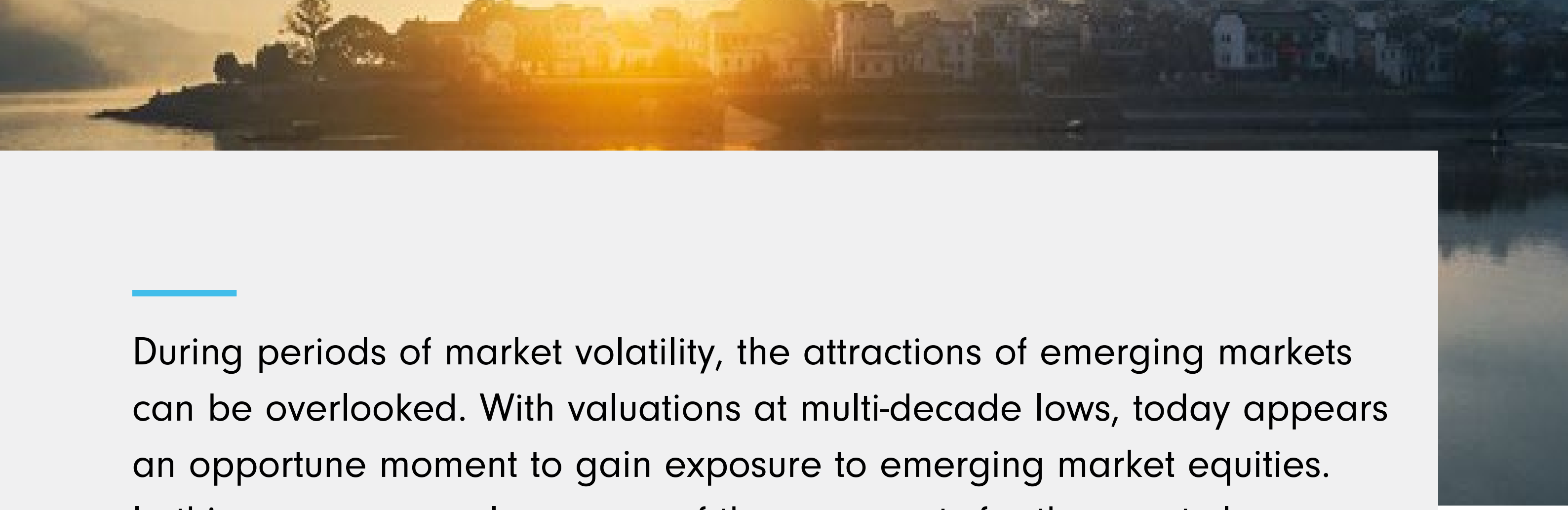
July 2023

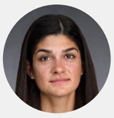
The case for global emerging market equities

- The value of investments and the income from them can go down as well as up and investors may not get back the amount invested.
- Reference to specific securities should not be construed as a recommendation to buy, sell or hold these securities and is included for the purposes of illustration only.
- Investors should note that the views expressed may no longer be current and may have already been acted upon.

Fidelity INTERNATIONAL



During periods of market volatility, the attractions of emerging markets can be overlooked. With valuations at multi-decade lows, today appears an opportune moment to gain exposure to emerging market equities. In this paper we explore some of the arguments for the asset class.

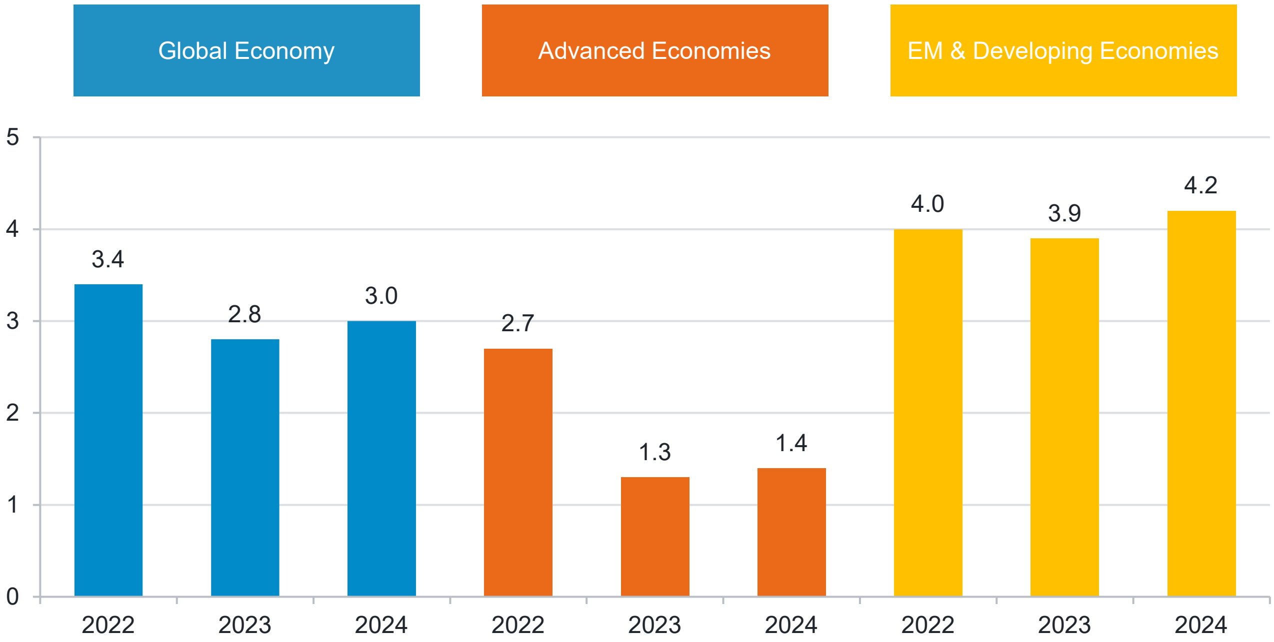


Amber Stevenson
Senior Investment Specialist - Emerging Market Equities

Growth premium re-emerges, but dispersion will be high

Emerging markets have historically offered an attractive economic growth premium to developed markets. This growth story has been more lacklustre of late, but China's economic reopening and higher commodity prices suggest that brighter days maybe round the corner, as do stronger fiscal positions, peaking interest rates, and a weaker dollar.

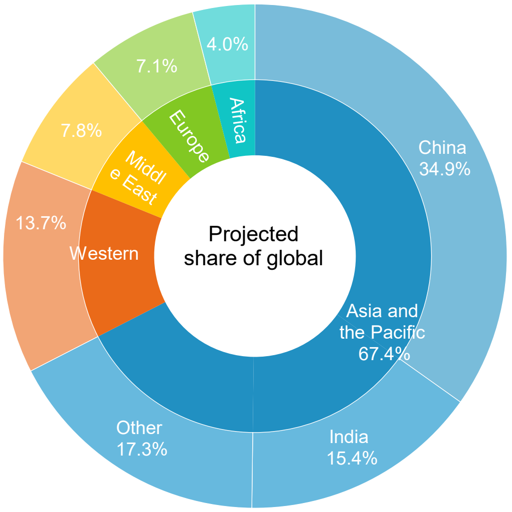
Chart 1. IMF forecasts indicate that emerging markets will lead global growth in 2023



Source: IMF, World Economic Outlook, April 2023.

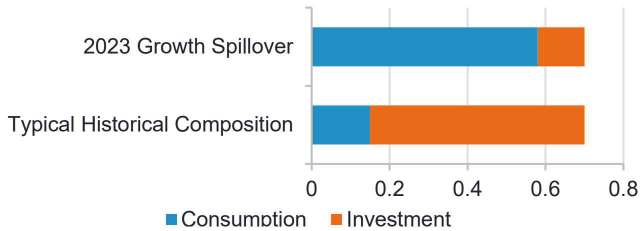
The IMF thinks that Asia will generate 70% of global growth this year. Consumption will be key as a recovering Chinese consumer offsets weaker demand elsewhere.

Chart 2. Projected share of global growth in 2023



Source: IMF, World Economic Outlook, April 2023. 'Asia poised to drive global growth, boosted by China's reopening', 1 May 2023. Note: Groupings based on IMF Regional Economic Outlook classifications.

Chart 3. Boost to Asia Pacific GDP growth from China



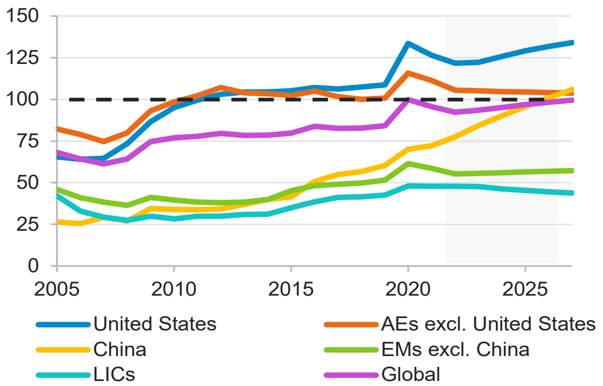
Source IMF, World Economic Outlook, April 2023. 'Asia likely to see dynamic economic growth, but with policy challenges', 13 April 2023. Asia-Pacific Regional Economic Outlook October 2022 and IMF staff calculations. Note: Typical composition bar is based on the historical (2001-Q1 to 2019-Q4) average spillovers from private consumption and investment. Chart is for illustrative purposes only.

The $1.5trn of excess savings accumulated by Chinese households during prolonged lockdowns can help to bolster spending. This rebound in consumer confidence and economic growth will not be linear, however, and could take some time to fully play out. We could also see a K-shaped recovery given the distribution of excess savings in China is unevenly spread. There will likely be a heightened focus on quality characteristics such as brand proposition and competitive advantage, as consumers demand better value for money in a more challenging macroeconomic environment.

Solid fiscal positions and inflation under control

Although the economic recovery in China may not follow a linear trajectory, we do broadly see much greater resilience among emerging market economies than in previous cycles. The fiscal positions of emerging market countries have strengthened since the 2013 taper tantrum, with better current account balances, less dollar-denominated debt, and more significant foreign exchange reserves. Here, again, differentiation is apparent, with flatlining debt in the emerging markets ex China region countered by a more negative picture for China.

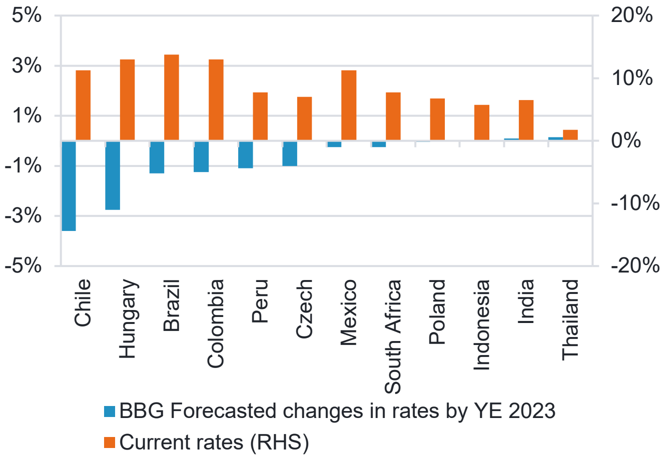
Chart 4. Public debt flatlining in emerging markets ex China



Source: IMF, World Economic Outlook, April 2023. 'How to tackle soaring public debt', 10 April 2023. IMF staff calculations. Note: Averages weighted by nominal GDP. Shaded area denotes forecast period. Sample comprises a balanced panel of 32 advanced economies, 45 emerging market economies, and 12 low income countries. AE= advanced economies; EM= emerging market economies; LIC= low income countries.

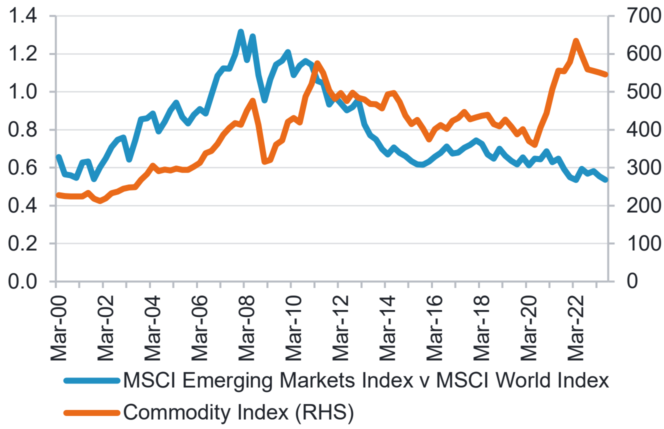
Borrowing among emerging market economies has largely shifted from dollar-denominated debt to local currency, reducing the vulnerability of emerging markets to dollar strength and higher US interest rates. There has also been more discipline from emerging market central banks this cycle, which have been ahead of the curve in raising rates. With inflation under control, rates should start to come down this year, acting as a tailwind for the emerging consumer.

Chart 5. Policy rates in emerging markets forecast to come down in 2023



Source: Fidelity International, Bloomberg, 30 April 2023.

Chart 6. The relationship between emerging markets and commodities has decoupled



Source: Bloomberg and Fidelity International, 26 June 2023. Commodity Index = CRB CMDT Index

Emerging market currencies have also performed well, which may not be appreciated. The strength of the dollar last year and prominent headlines on the Turkish lira's depreciation masks how emerging market currencies have held up well relative to developed currencies more broadly, largely because the Fed started raising rates later than emerging market central banks. Although interest rate cuts could be a headwind for emerging market currencies, falling inflation should result in real rates staying high, which should support currencies even if nominal rates decline.

Higher commodity prices are a tailwind

The improved fiscal backdrop for emerging economies will be supported by a buoyant commodity price environment. Commodity prices are a key driver for economies such as South Africa, Mexico, and Brazil, supporting their exports, foreign exchange reserves, and current account balances. Historically, emerging markets have moved with commodity prices, but this relationship has decoupled due to weakness in China. There is scope for this relationship to be restored and valuations should start to recover as commodity prices remain elevated.

We have a positive outlook for commodity prices over the longer term, with decarbonisation set to drive prices higher as increased demand for energy and raw materials is coupled with a lack of political will to invest in new mines and energy sources. This comes on top of ten years of underinvestment in the commodity complex, with the move to decarbonise the global economy only set to bolster demand given how commodity intensive clean energy technologies are. By some estimates, demand for copper could double from 2020-2050.

A positive outlook for earnings and returns, at attractive valuations

Our estimates for next year indicate that the emerging market index should see better net income growth, sales growth, and return on invested capital (ROIC) than the global index, as well as lower levels of debt.

Chart 7. A positive fundamental outlook for emerging markets

2024 estimates	MSCI Emerging Markets	MSCI World
Net income growth, %	16.8	7.0
P/E, x	12.1	17.0
ROIC, %	15.5	14.9
Net debt/EBITDA, x	0.50	1.1

Source: Fidelity International, July 2023. Fidelity analyst estimates.

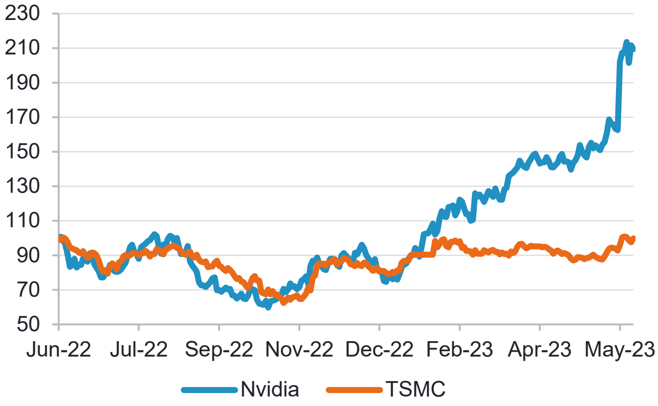
This favourable picture is not reflected in valuations, however, with the emerging market index trading at a 30% discount to the global index. We think that the extent of this discount is unwarranted, especially given the worsening outlook for the US, where unsustainable profit margins, elevated debt levels and a weakening currency are headwinds.

Geopolitical risk requires scrutiny, but is reflected in valuations

The geopolitical environment warrants close attention and will result in greater dispersion between emerging countries. However, the past few years have shown that developed economies are not immune to headwinds such as the rise of populism and the impact of elevated inflation. Much of these risks are priced into emerging markets, and there is a sense that some of the headwinds appear to be easing. For example, US-China tensions are still a key area of focus, but our investment team's recent trip to China indicated that many companies are starting to adapt and are proactively coping with restrictions on business activity.

Geopolitical tensions have depressed the valuations of many high-quality companies. A comparison of Nvidia, the US fabless chipmaker, and TSMC, Taiwan's pureplay chip foundry is one example. Nvidia outsources the manufacturing of its chips to companies like TSMC and could not exist without the Taiwanese chip maker. But while hype around AI means Nvidia's share price has accelerated by around 100% over the past year, pushing it to a P/E multiple of over 200x by the end of June, by contrast, TSMC has been broadly flat over the same period, and has a P/E multiple of 15x. This is largely due to the market's perception of geopolitical risk, rather than any fundamental issues with TSMC's business.

Chart 8. Negative sentiment has impacted TSMC's share price



Source: Bloomberg, Fidelity International, 31 May 2023.

Deglobalisation and nearshoring will also drive dispersion

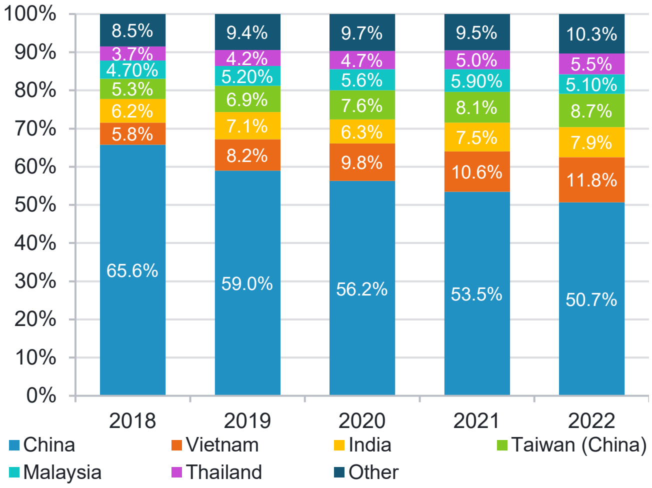
Rising geopolitical tensions and disrupted supply chains are hastening the end of the era of globalisation and the process of decoupling. Companies are increasingly looking to move their supply chains both closer to home (the trend of nearshoring) or to friendly partner countries (that of friendshoring). Apple moving its manufacturing to India and Tesla moving its factories to Mexico are just two well-known examples.

The China +1 strategy is a key driver, as developed-market companies redirect production previously outsourced to China to other countries with low-wage, high-skilled economies. This trend of deglobalisation will also drive greater dispersion in returns among emerging economies. Although some countries will lose out, others such as India, Indonesia, Vietnam, and Mexico will benefit.

Data from the consultancy Kearney show how the US is increasingly importing goods from other Asian low-cost countries at the expense of China, while its imports from Mexico have also risen.

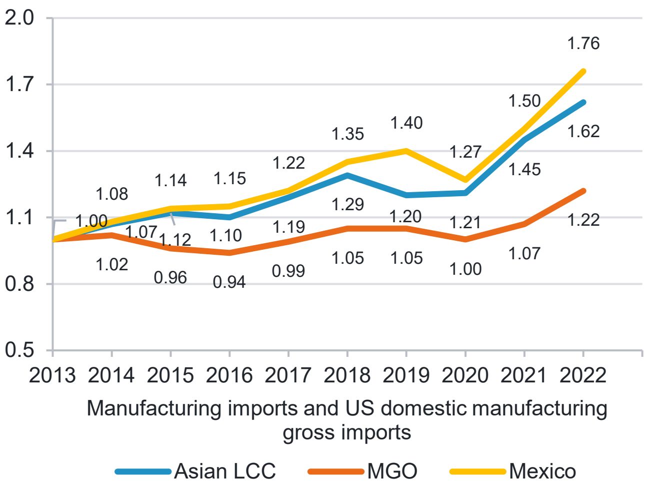
This will boost not only those industries directly impacted, such as industrials, logistics, materials, and railroad companies, but also consumer and financial businesses as shifting supply chains prompt migration and growing demand for goods and services in these countries.

Chart 9. Countries like Vietnam are gaining from deglobalisation



Source: Kearney, April 2023. United States International Trade Commission, Kearney Analysis. '[America is ready for reshoring. Are you? 2022 Reshoring Index]'.

Chart 10. US imports shifting to Asian low-cost countries and Mexico



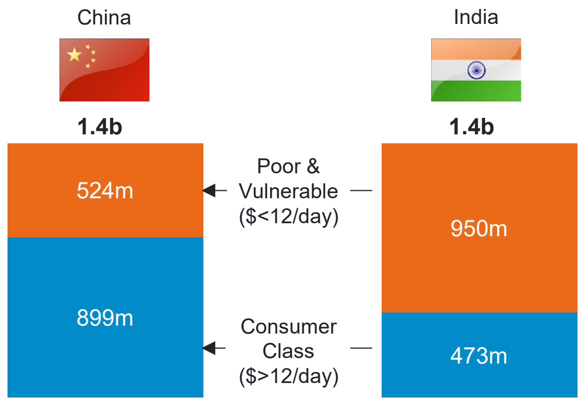
Sources: Kearney, 2023. United States International Trade Commission, United States Department of Commerce Bureau of Economics Analysis, Kearney analysis. [1]Asian LCCs are low-cost countries and regions. [2] MGO is UD domestic manufacturing gross output. '[America is ready for reshoring. Are you? 2022 Reshoring Index]'.

Strong demographic drivers, but nuances emerge

A recent report by Brookings Institute highlighted how although India and China's populations are now the same size, they have very different demographic drivers.

Growth in India's consumer class will predominantly be among young people and those living in rural areas, while in China, growth in this consumer class will mainly be driven by those over the age of 45 and city-dwellers.

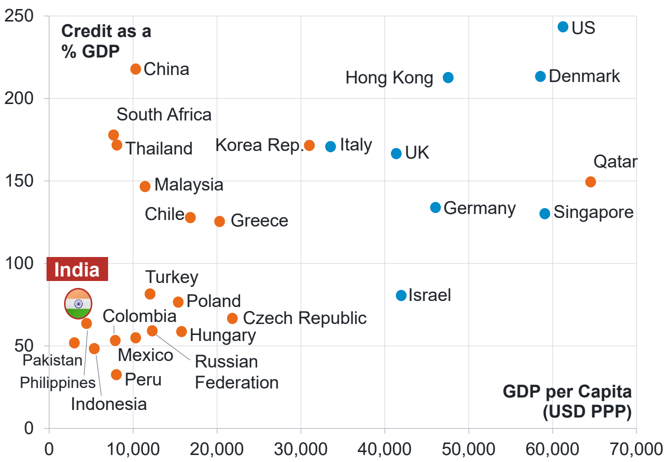
Chart 11. India and China both set to drive consumption growth



Source: Brookings Institute, 14 April 2023. '[China and India: The future of the global consumer market]'.

These differences mean that both countries have attractive but distinct growth drivers. India benefits from the under penetration of both consumer goods and financial services, which will drive demand for everything from trainers to credit cards. The ratio of credit to GDP in India is half the level of that in other emerging economies and has scope to grow considerably in the coming years, driving demand for the banks and financial services firms offering savings and insurance products.

Chart 12. Underpenetration of credit in India represents a growth opportunity



Source: World Bank, 2019. Note: Icons in orange denote countries regarded as being 'EM' – in line with the classification determined by MSCI.

China on the other hand is often deemed a more negative demographic story given its ageing population. However, the country has the largest middle class in the world, and one that still has scope to grow. Estimates from the Boston Consulting Group forecast that China could add 80m to its middle and upper classes from 2022-30. This expanding middle class in China will continue to drive the trend of premiumisation as wealthy consumers spend their rising income on quality products.

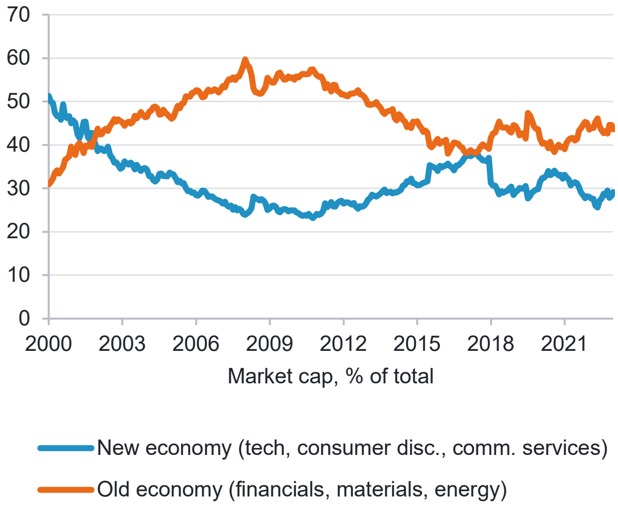
A diverse universe creates a broad opportunity set

This shifting demographic picture in emerging markets is accompanied by a constantly evolving equity market. The region's stock market is home both to innovative companies in the technology, media, entertainment, and consumer discretionary sectors, but also the commodity and financials businesses that should do well in an environment of higher commodity prices and interest rates.

Although the weighting of 'new economy' sectors like technology and internet has expanded on a relative basis over the past decade, the importance of 'old economy' sectors has reasserted itself over the past few years as commodity producers, energy companies and banks continue to drive growth.

The importance of having balanced exposure to both new and old economy sectors is exemplified by the emergence of AI, which will be hugely disruptive not only for internet platforms such as Tencent and Alibaba and semiconductor companies like TSMC, but also the copper and lithium miners that will fuel the enhanced computing power required by AI.

Chart 13. 'Old economy' sectors are gaining in prominence



Source: Bloomberg, 22 June 2023

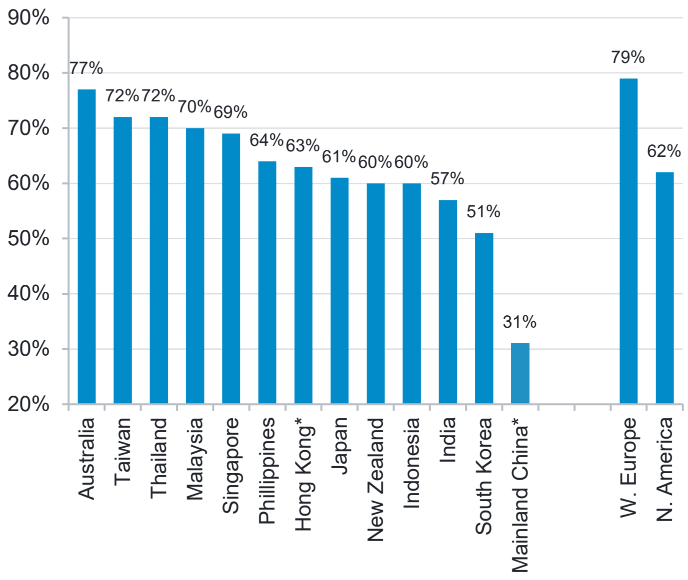
Weak disclosures mask improvements in ESG standards

While emerging market companies do broadly lag their developed market peers, sustainability practices in the region are improving and many companies are starting to catch up.

Latin America is one example of a region that is perceived to be home to companies that have weak sustainability credentials, including businesses operating in resource-intensive, high-carbon industries, or those that have underwhelming governance standards. In reality, we see many companies in Latin America - and the broader emerging market region - with improving corporate governance and environmental practices.

This is something that has been masked by the fact that disclosures within emerging markets remain weak relative to developed markets. As disclosures improve, we should gain a better understanding of how companies within emerging markets are approaching important sustainability issues.

Chart 14: Poor environmental and social disclosure rates hide improving practices



Source: Goldman Sachs Global Investment Research, 2023. Average corporate operational E&S disclosure rates in the GS SUSTAIN framework
E&S disclosure refers to the disclosure of the 50 most common E&S numeric and policy metrics identified by GS.

Concluding remarks: An attractive entry point for emerging market equities

With positive macroeconomic tailwinds, a more robust commodity price environment, and an improved fiscal backdrop, there are several positive short and medium-term drivers for emerging market equities, in addition to the long-term drivers of positive demographics, shifting supply chains, a fast-evolving universe and improving ESG practices.

On a price/book basis the emerging market index relative to the global index is at its cheapest since 2002. Although the war in Ukraine has emphasised the risks inherent with investing in emerging markets, we think the extent of this discount is at odds with what is an improved and more stable fundamental backdrop for many emerging economies.

Given that current valuations are at trough levels and seemingly out of sync with the improved fundamental environment, we think there exists today a particularly attractive entry point for the emerging market equity asset class.

Important Information

Fidelity INTERNATIONAL