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RICHARD SHEPHERD: Year of the Rabbit starts an emerging market bull run

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Global markets turned bullish in 2022's fourth quarter, rebounding from their October 2022 lows due to continuing dollar weakness, headlines on China's re-opening and the belief that global inflation had peaked and the US economy may well pull off a soft landing despite high interest rates.

Investors have been anxiously looking for evidence that a US Fed policy pivot is coming, but unfortunately the recent data releases will give them reason to think again. Evidence of the US economy slowing down significantly under the weight of restrictive interest rates came from the Institute for Supply Management's new orders index, a broad gauge of the health of the manufacturing sector, which fell to 42.5 points, the lowest reading outside of an economic recession in 72 years.

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Coupled with disappointing earnings among the mega-cap stocks such as Apple, Amazon and Alphabet, it points to an uncertain outlook for the US economy for 2023. Our base case remains that the US economy will enter a mild recession during the year.

While developed markets face headwinds of low growth and higher interest rates to combat elevated inflation, emerging markets (EM) are starting to see a tailwind with a return to growth for China, a main growth engine of emerging markets, as the Chinese Communist Party focuses on stimulating the economy and rolling back the restrictive zero-Covid policies that were in place for the past three years.

Institutions are notoriously slow to update their forecasts, but the IMF recently updated their global growth projections, showing that the growth differential between emerging markets and their developed counterparts for 2023 and 2024 is likely to rise to 2.8 percentage points from the 1.2 percentage points estimated in 2022.

Many emerging market central banks, that were ahead of the monetary curve in hiking rates as inflation rose post Covid, have now started the process of easing their monetary policy, ensuring emerging markets are well positioned to be a driver of investor returns this year.

Uncertainty will remain a part of the story, with geopolitical headlines such as the decoupling of trade between the US and China drawing investor attention. While diplomatic relations are likely to remain

strained, their trade relations recorded a new high in 2022. A recent US Bureau of Economic Analysis report shows that imports and exports of goods between the countries hit $690.6bn, breaking the previous high set in 2018, prior to the introduction of US trade tariffs.

China has historically been the largest consumer of commodities and the economy reopening, together with any fiscal stimulus, will see a significant increase in demand for commodities, specifically those related to energy. While western sanctions on Russian energy exports were a major proponent in an energy supply shortfall in 2022, returning energy demand from China is likely to keep the demand-supply curve tight. This will be driven by increased production from Chinese factories, normalisation of Covid-affected supply chains and the population cautiously returning to pre-pandemic consumption of goods and services.

The tight global energy demand-supply dynamic that was exposed by the Russian invasion of Ukraine, together with ongoing climate change policies are likely to further drive the demand for metals that are key to the global transition to renewable sources of energy.

China's "Common Prosperity" policy in 2021 coupled with it taking a heavy-handed approach to their technology sector, resulted in large outflows of capital as global investors underweighted China in their portfolios. China's decision to end its zero-Covid policy in December 2022, amid a weakening dollar environment, has seen investors allocating significant capital back into emerging markets and China. Funds tracked by EPFR Global show that 2023 has seen more than $30bn invested in emerging markets, a trend that we expect to continue.

The valuation of emerging market equities remains attractive compared to their developed market counterparts, despite the rally we have seen thus far. It is important to remember that emerging markets are not a singular asset class, but rather a collection of 24 countries, diverse in economic resources and geopolitical outlook.

Presently valuations of the underlying countries highlight that some, such as China and Brazil, are trading at a significant discount to their 10-year average. Our bottom-up investment approach leads us to invest in companies that are trading at a significant discount to our estimate of their intrinsic value. Companies such as Alibaba, JD.com,

Sands China and Wynn Macau are some of the names in our portfolio that will benefit from a Chinese consumer eager to spend and to travel again.

Geopolitical events were a significant cause of volatility in 2022 and are likely to be disruptive in 2023. Understanding these events and their likelihood of occurring form an important part of our risk management process, and we continue to closely watch events relating to China, the US, Brazil, SA and Chile.

It has been 10 years since emerging markets saw their last bull market. Today, they are ideally positioned to start a new run, as we are seeing the foundations for these markets' outperformance re-establishing itself. These include a positive GDP growth differential; attractive valuations; a weakening dollar environment; and the underweight positioning of China by global investors.

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