

Exchanges at Goldman Sachs

Is it time to invest in emerging markets?

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Allison Nathan: As the global economic backdrop continues to improve, is it time to invest in emerging markets?

Hiren Dasani: Under the hope that a lot of different dynamics are playing out. But the key message I want to leave is that the quality of the earnings is going to be much better in '23.

Allison Nathan: I'm Allison Nathan and this is Exchanges at Goldman Sachs.

[MUSIC INTRO]

Allison Nathan: Emerging markets stocks and bonds

suffered steep losses in 2022 but have started to rebound in recent months. To help us understand whether that rally can continue, and the outlook for emerging market assets this year, I'm sitting down the Goldman Sachs Kay Haigh and Hiren Dasani from the Asset & Wealth Management business. Kay is co-CIO of Fixed Income and oversees the Emerging Markets Debt Team. And Hiren is the co-head of Emerging Markets Equity. Hiren and Kay, welcome to the program.

Kay Haigh: Thank you.

Hiren Dasani: Thank you, Allison.

Allison Nathan: So, emerging markets certainly did not escape the downturn in markets last year. They suffered very heavy losses. There were tons of headwinds. We had rising rates, a strong US dollar, lockdowns in China, the war in Ukraine. The list goes on and on. But this year, emerging market assets are turning in a better performance. And in some areas, outperformance.

So, what's driving this better performance? Hiren, maybe you can start us off?

Hiren Dasani: If you think about last year, other than the macro [?] factors such as US Fed aggressively hiking rates and the [UNINTEL] strength of the US dollar, you had two EM specific issues which were impacting the EM equities market. The first was the China economic slowdown, which was a function of the Zero COVID strategy being pursued throughout 2022. And also, the default by the Chinese real estate companies. And the general sense that China is going to be less friendly to private entrepreneurship going forward.

The second reason impacting the EM equities last year was the semiconductor cycle. Coming out of COVID, there were significant [UNINTEL] of demand across the value chain of semiconductors. And starting around the second half of last year, we are witnessing significant [UNINTEL] stocking of the inventories of the semiconductors. So, these were the two EM specific reasons for, let's say, the underperformance of the EM equities last year.

The good news, we are seeing silver linings on both of these issues. China, as we all know, has abandoned Zero COVID strategy. And has opened up the economy starting in

December. The pace of reopening is far better and has been a surprise to almost all the investors.

Along with that, there have also been significant [UNINTEL] on the real estate sector, as well as a clear signal that private sector is very much welcome in China.

On the semiconductor side of it, also we are seeing early indicators that the cycle will be close to bottoming out. We are no longer seeing significant decline in the end market applications of semiconductors such as smartphones or computers or the other communication products. The fact that China and the semiconductor cycle both are turning around make us much more positive on the EM equities for the next year.

Allison Nathan: And Kay, Hiren mentioned the impact of rising rates. I'm sitting here in the US. There's a newfound concern that the rate hiking cycle isn't over. It will last longer than maybe was previously anticipated. We're seeing the dollar resurge again. What does that mean or what would that mean for EM, sovereign, and corporate debt?

Kay Haigh: Typically, most EM spreads in countries are

driven by a lot of idiosyncratic factors. But of course, you've just mentioned two or three of the most important exogenous drivers behind emerging market performance, which is the strength of the dollar, global liquidity, and global growth.

And as we saw last year, when there was a deterioration from the point of view that emerging markets, when rates were going up and people worried about growth and inflation was high and people feared that central banks had to continue to hike, EM didn't perform very well. That was last year's story.

I think when you look at it today, a couple things are different. The first one is just to pause a little bit and think about why our US rates' where they are. Are they going much higher? Or are they higher for longer? I think that typically has a negative impact on emerging markets. But this year, interest rates are rising, not because of global inflationary fears, but because economic activity in the United States is a little bit stronger. So at the margin, that's a good reason for why rates are where they are and likely to stay where they are.

The second point is just worth thinking about is when we look at emerging markets, of course not every country is affected by higher rates in the same way. So, some are much more resilient. Some corporates are much more resilient. And it's really figuring out the sensitivity that these countries have, either because of their debt gearing or because of their lack of liquidity that we can very quickly see which countries are likely to perform better than others in this particular environment.

So, although the market has rallied, it's been supported at the beginning of the year, we've been actually quite differentiated in the way we look at EM. And there are clearly countries, let's say Mexico, that are much more resilient than others. For example, Ghana, Sri Lanka, Zambia, etcetera.

And the final point very quickly just to point to the obvious which is that when we look at EM debt, the opportunity set is actually very heterogeneous. So, there's corporates, IG, high yield. And if you look at the kind of deterioration in sovereign debt dynamics as a response to higher rates, it's actually not been that dramatic. It's been relatively modest.

Interest payments as a percentage of GDP have increased by only 0.3 percent since 2019. So, why is that? Well, because a lot of these countries or corporates also fund themselves in local currency. And here, it's really real rates that matter. And they've been negative. So, the backdrop is much better looking forward than it was over the last year.

Allison Nathan: And just a quick follow up to that because we are also seeing emerging market central banks respond. Can you talk a little bit about how they have responded to these developments in the US and the other developed markets? And how that's feeding into some of the differentiation you've talked about?

Kay Haigh: Yeah. So, they've responded. I think here also it's very interesting to break it down by the long-term and the shorter-term response. On the shorter-term response on monetary policy, EM central banks started hiking before developed market central banks hiked. And they probably reached a peak in rates at some point in the second half of last year. There are, obviously, exceptions. China and Tokyo are exceptions. But they're very idiosyncratic.

Number one.

Number two. On the fiscal side, ever since COVID, so now for the last three years, EM countries have actually been on a fiscal tightening path [UNINTEL] overspend that took place back in 2020, that needed to come out of the system. And actually, those countries that having tightened their fiscal are, in fact, the ones that are the most vulnerable going forward. So, they were very incentivized to tighten fiscal. And that's what they've done.

So, in a cyclical sense, liquidity conditions have probably reached their tight for emerging markets given fiscal and monetary policy responses. But I wouldn't expect this to change dramatically. So, I don't think there's a dramatic kind of loosening of policy.

And then the more structural points, and that pertains to the dollar and how a stronger dollar links into kind of emerging market vulnerabilities, absolutely a stronger dollar on average has not been good for emerging markets.

But it's really worth pointing out that for long periods of time now, ever since the 2008 crisis, actually, emerging markets have done a number of things to make themselves more resilient. First of all, they've moved away from having

formal pegs to the dollar. Not in all instances, but in a lot of instances. So, they haven't built up these imbalances. They've been much smarter about how they fund themselves. So, they haven't built up a lot of dollar debt or less dollar debt than they used to have in the past.

So, you know, the whole dollar effect, although it's still there, it's actually weaker than it has been in the past. So, EM countries have actually done quite a lot of work on that front.

Allison Nathan: And I just wanted to spend one more moment on China. Hiren mentioned the importance of China reopening to the outlook. I think there is a lot of discussion in the market about how temporary that may prove to be though. So, what are you hearing? What are you seeing? And how are you expecting China to feed into the outlook this year?

Kay Haigh: So, China reopening, and reopening more quickly is generally considered to be a positive thing because it's positive for economic growth in China. And if China grows more, there are very clear channels through which that has a positive impact at the margin on emerging

markets. So, they import more. So, that's good for exporters. Probably better for Asia. Good for Latin America. There's another channel which is services. The biggest service is actually tourism. So, people traveling. Also good for emerging markets. Good for Asia.

And then the third channel would be higher commodity demand and higher commodity prices. So, that's good for a large number of emerging market countries that export commodities. So, the obviously ones here are Brazil, South Africa, Chile, Peru, etcetera. So, at the margin, this is positive.

I would just calibrate it a little bit. We're talking about growth at the margin. So, we're not talking about a dramatic economic expansion like we saw in 2009 post financial crisis where growth rates went double digit numbers. We're really talking about whether Chinese growth is going to be 5 percent or 5.5 percent for the year. Or that's the range the confidence interval.

So, I think it's positive. China reopening is positive combined with a number of other positive things that China has done as Hiren mentioned earlier. But I was say

investors should view it as something that is good at the margin. It is not something that will, by itself, drive returns in emerging markets going forward.

Allison Nathan: And Hiren, India was a big beneficiary of money moving out of China in 2022. So, if we think about the reopening of China this year, how is that affecting India at this point?

Hiren Dasani: Yeah. It's interesting that people think India and China are going to compliment or, if one works, the other will not work, or something like that.

The fact that China reopening is going to be positive for the global economic growth, obviously, India is going to benefit because of that as well. Now, if you think about why Indian equities significantly outperformed Chinese equities in the broader emerging market equities in the prior two years, which is 2021 and '22, and specifically India had more than 50 percent of [UNINTEL] outperformance over a two year period compared to the MSCI emerging market, or MSCI China, there were a few India-specific factors. First and foremost, the recovery of economy coming out of COVID from the second half of '21 was very strong. And

last year, India had more than 7 percent real GDP growth.

The second also very important reason why India did very well was that the Indian government used the opportunity of COVID to push through some important structural reforms. Most specifically the labor law reforms, the incentivization of the manufacturing sector through the production linked incentive scheme. And also, some big ticket privatization such as debt of Air India, the national carrier, which was being talked about for a long time but had got finally consummated last year. So, there were some structural reforms. And there is a cyclical recovery, which are more India specific sectors. And obviously, the fact that Korea and Taiwan were impacted by the semiconductor drawdown and China had its own issues, that also helped India in relative terms.

And it's anybody's call how the markets will do in the near term. Valuations of India after two years of very strong performance did appear to be somewhat expensive compared to its own long-term average. And compared to the other emerging markets like China and north Asian markets like Korea/Taiwan. But you also need to realize that India is the only market which is going to help

compounded earnings growth of more than 15 percent for almost a period of four to five years starting 2021. And we are in the midst of this multi year corporate earnings [UNINTEL] cycle.

So, while it's tough to say what might happen to the markets in the very near term, we are far more positive on India from a long-term structural growth perspective. And there are very few large economies in the world that you can say that investors have visibility of 6 to 7 percent real GDP growth, not only for one or two years, but almost for the next decade or so. And India is one of them.

More importantly, India's growth is also driven much more by domestic consumption, investment in infrastructure, increasing manufacturing competitiveness. And these are the factors which will probably make India's growth less correlated, not completely uncorrelated, but less correlated with the [UNINTEL] growth. And that provides some real diversification benefits to the investors.

To cut the long story short, in India, we continue to be positive from a medium-term perspective.

Allison Nathan: And you're talking about a strong outlook for earnings in India. If we think about emerging markets more broadly, and this improving backdrop that both you and Kay have been discussing from a macro perspective, are we seeing that come through earnings across other parts of the EM universe at this point?

Hiren Dasani: Just as in many aspects of life, statistics can be misleading sometimes. And if you look at the headline EM Corporate Earnings Growth for year of 2023, it's likely to be tepid. In fact, EM earnings might see low to mid single digit decline for the year of 2023.

However, it is important to understand the drivers of the earnings growth. And earnings decline is going to be driven much more by sectors such as commodity, energy, and other global cyclical type of sectors, which had very strong earnings last year. Last year in the aftermath of Russia invading Ukraine, the commodity prices went up quite a bit. And all the commodity producers had very strong corporate earnings last year. And they are facing a very high base in the year of '23.

Having said that, the good news is that the structural

growth story is in the EM, such as consumer staples, consumer discretionary, financials, healthcare. These are some of the sectors which are going to witness very strong double digit corporate earnings growth in '23.

So, yes, the overall earnings may not grow that much in '23. But the quality of earnings for '23 is going to be far better than what we saw in '22.

And finally, if you look at geographically, China and India, the two largest emerging markets by market cap and by the weightages [?], they will see mid teens kind of corporate earnings growth in 2023. China more specifically about 14 percent. And India is likely to see about 16 to 18 percent corporate earnings growth in '23.

And on the other hand, semiconductor heavy markets like Korea and Taiwan are still going to see some decline in the earnings because in the first half of '23, the inventory [UNINTEL] cycle is still going on. So, under the hood, there are a lot of different dynamics playing out. But the key message I want to leave is that the quality of the earnings is going to be much better in '23.

Allison Nathan: And what about valuations, which you touched on in the context of India? But broadly across emerging markets, is there some potential for multiple expansion as we look ahead?

Hiren Dasani: Yeah, I can talk about the EM equities valuation as measured by one year forward P/E multiple, which is the most common way of looking at the valuations. The one year forward P/E multiple EM equities is today at about 11.5 times. Which is not very different from the long-term average multiple of, let's say, about 11.4 times. And you can say that broadly, valuations have fell in line with the long term averages.

However, if you think of EM from a price to book, which is another valuation metric, then EM equities are trading at about 1.6 times one year forward price to book multiple, versus a long-term average of about 1.8 times. That indicates some discount to its own long-term average.

The other way to think of EM versus developed markets, and more specifically US. So, obviously, EM equities have all traded at a discount per US. But the long-term average discount to US is in the range of 25 to 30 percent.

Currently, we are trading at about 35 percent decent per the US market compared to its long-term average of 25 to 30 percent.

Fair valuation, compared to its own average, but compared to the US and the developed market, there has been some room for valuations to improve for the emerging market equities.

Allison Nathan: And Kay, you mentioned liquidity very briefly. But when we think about investing in emerging markets, it's a topic that always comes up. It's a concern that always comes up. And given the outflows that we did see in the last year, has that problem gotten worse or better? Give us some update.

Kay Haigh: Yeah, indeed. The outflows last year were significant. But we've seen quite a significant reversal in the first few months of this year. Usually January is quite a heavy month for emerging market issuance, typically EM countries and corporates, they raise about 20 percent of their annual requirement in January. And this year's been no different. In fact, actually, it's been even bigger than. So, there is a lot of access now all of the sudden to liquidity in

the markets.

The first two months of the year, issuance has been around 50 billion, which is almost half the annual requirement. So, the market has opened up. Liquidity has been strong.

The market differentiates. That's important. A little bit along the lines of what we spoke about a little bit earlier, which is it differentiates around solvency and liquidity in emerging market [UNINTEL]. So, those that haven't done any heavy lifting and haven't improved macro fundamentals find it much harder to access. But liquidity is there. And it's been significant year to date.

Allison Nathan: And we are still feeling some implications for the ongoing war in Ukraine in terms of just how hard they've hit some of the poorest nations. Many of them are in talks of lenders. And we are seeing some negotiations over rescue packages from the IMF to restructured debt. So, how will that affect foreign bond holders?

Kay Haigh: So, you're right. It's been correlated with Ukraine in the sense that there was a wave of countries that started to restructure debt and not repay last year.

But I think a lot of the factors that drove countries to that point were actually already in play for much earlier in the sense that these were countries who had spent and borrowed beyond their means.

They are now in the process with the IMF. That is getting restructured in many cases. Negotiations are ongoing. But negotiations now include quite a large array of different lenders. You've got your multilaterals. So, IMF, World Bank, etcetera. You've got bilaterals. Which are countries lending directly. You've got China in the mix now.

Compared to past rounds of debt restructuring, China today is a far bigger lender to emerging markets than it had been in the past. And that is an interesting factor because China is not necessarily negotiating along with others. They're negotiating by themselves bilaterally. And that's tended to slow down debt negotiations. For instance, in Zambia.

So, how does it affect investors and countries, actually? The longer that these kinds of restructurings are ongoing and do not get settled, the longer the negotiations take, obviously, the worse it is for bond holders because it has a negative impact on their recovery. And it's also negative for

the countries themselves because they don't have access to markets. And they're probably unable to spend on some essentials.

To your question, the longer these negotiations go on, the more negative the impact both on bond holders and borrowers.

Allison Nathan: Let me end by asking both of you, given everything you've talked about, where you see the most value in emerging markets today, Hiren, on the equity side, and Kay, on the debt side? Hiren, maybe you can start.

Hiren Dasani: So, our investing philosophy is much more bottom up, looking for sound businesses trading at attractive valuations. And the way we define sound businesses, we want businesses which have strong competitive advantages run by the high quality management teams. And someone who'll treat minority shareholders as the [UNINTEL] owners of the business.

So, usually we tend to find such businesses in the area of consumer, financials, and information technology sectors within the emerging markets. If I can just give you some

flavor of what type of businesses we tend to like, these are the compounding growth stories in the areas of [UNINTEL] retail lending focused commercial banks. Or it could be the stock exchanges. It could be e-commerce and the food delivery type of businesses where the penetration levels are still much lower in the emerging markets. Or it could be hospital/health insurance type of businesses. So, these are some of the, I would say, businesses where we tend to find a lot of excitement of compounding opportunities over the years.

Allison Nathan: And Kay, on the debt side?

Kay Haigh: So, we're very constructive on emerging market corporate debt, the emerging market corporate index to a large extent, the IG rated. But it offers attractive yield pick up over comparable developed market corporate bonds. So, it's an interesting opportunity. Additionally, that segment gives you access to Asia and growth in Asia, which is something that on the margin we like.

And EM companies typically have been able to be quite resilient. They usually have more degrees of freedom when it comes to reducing costs and restructuring. So, we like

that segment, both in terms of access to Asian growth and valuation and its resilience.

Other than that, of course, if you think a little bit longer term, there's an energy transition that needs to take place in emerging markets. There's digitization as well. And there's an increasing kind of number of assets that are coming up. And we like that. We like those longer-term structural stories in the emerging markets as well. And there are some great opportunities there.

And on the sovereign side, I would say higher quality emerging market sovereigns that have run sensible economic policies, like Indonesia or Mexico, represent good value as well. Mexico is particularly interesting through its proximity to the United States, remittances, and maybe some kind of pivoting in terms of supply chains away from China towards Latin America.

Allison Nathan: Kay, Hiren, thank you so much for joining us.

Kay Haigh: It's been a pleasure. Thank you.

Hiren Dasani: Thank you.

Allison Nathan: Thanks for joining us on another episode of Exchanges at Goldman Sachs, recorded on Monday, February 27th, 2023.

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