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Emerging Market Opportunities – Delayed but not Cancelled

Adam Sparkman: Welcome to another episode of Away from the Noise Thornburg Investment Management's Podcast on key investment topics, economics and market developments. I'm Adam Sparkman. Client Portfolio Manager for emerging markets at Thornburg. And I'm joined today by Josh Rubin, portfolio manager of the firm's emerging market equity strategies. Welcome, Josh.

Josh Rubin: Adam, it's great to be in the studio with you today.

Adam Sparkman: Thank you. Josh, just as the global economy seemed to be getting back to normal following COVID, Russia's invasion of Ukraine has sparked another large-scale humanitarian crisis and carries a wide range of geopolitical and economic implications. What was your base case for emerging markets in 2022 prior to the Russia-Ukraine uncertainty, and how has it changed in light of recent events?

Josh Rubin: Adam, the good news and the bad news is our base case entering the year was pretty similar to our base case entering the last several years, and that is emerging markets structurally have a lot of tailwinds and emerging market central banks and many of the governments have learned a lot of lessons over the last 20, 30, 40 years of economic development.

But at the same time, the reason they're emerging markets is there are always surprises or there are always a few curveballs thrown at you and so when we entered this year, we did think that the nature of a recovering global economy, the fact that China had not yet reopened and therefore that would provide an incremental cyclical tailwind to the global economy and the emerging markets economies, along with the fact that commodity prices were stabilizing at a higher but not too high level, all would create attractive tailwinds for emerging markets economies, stability for emerging markets currencies, and consequently a lot of investment opportunities in emerging market stocks.

Given the unfortunate situation between Russia and the Ukraine, we've essentially had to evolve or adjust our base case in a similar way to what we've also had to do over the last several years. If you think over maybe 2016 through today, in many of those years, we've had material surprises either to the global economy or to different emerging markets over time.

And that might be political dynamics, the US-China trade war, that might be COVID, that might be when OPEC made the decision in 2014 to really increase production and crush oil prices. Or most recently, you know, now it's this situation which obviously is impacting emerging markets but very clearly has had an impact on developed markets also. When this happens the nature of a base case usually turns into thinking instead about the different types of outcomes you could see.

And so today we really don't have a base case instead we have a better type of case and a worse type of case, not a disaster case per se, and not a terribly rosy case. But more just what if things get a little bit better? What if things get a little bit worse? And the way that we really think about that is there is a sooner rather than later political solution to the Russia Ukraine conflict.

And consequently, the world gained some comfort that Russia will be reintegrated over time into the global economy. And the other side of it would be this is a conflict that persists for a much longer period of time than was initially expected. And that increases the friction in the global economy in a lot of different ways, from commodities to global trade to economic growth.

When we think about both of those outcomes, we tend to think there are a few commonalities and a few things that are different. The commonalities are commodity prices remain elevated. They're higher under the situation where the conflict continues for longer than expected. But even if the conflict resolves, commodity prices still probably look like they did as we exited 20 21, which was much higher than they had been for the prior several years.

And then there's some additional tailwinds from a global economic re-acceleration that would continue with greater global confidence. If the conflict continues, commodity prices stay higher because There are probably challenges to the supply situation from Russia, which is a key supplier of many commodities used around the world.

Adam Sparkman: So, considering a spectrum of outcomes as opposed to homing in on just one basic case is an interesting perspective to hold during what's been, you know, now a prolonged period of heightened volatility in emerging markets. You mentioned thinking about a better and worse outcome right now. When you look across emerging markets, are there any countries or regions you think are particularly defensive or vulnerable under the current scenario?

Josh Rubin: Absolutely. Maybe just to set the stage emerging markets has over 20 countries, and within that grouping there are certain countries who because of their import or export surplus or deficit or because of their fiscal budget situation, are more prone to currency strength or currency stability or some that are more prone to currency weakness. And we tend to refer to the currency weakness. Countries as being fragile currencies. So, in these scenarios where commodity prices are higher, commodities are generally a challenge for countries that need to import those commodities. An interesting element, again, of emerging markets, given their diversity, is that doesn't really mean one particular region it usually means just certain countries in different regions.

So certain Latin American countries are commodity exporters, others are commodity importers. Same thing across Southeast Asia, North Asia and so on. So rather than sort of walking you through each of the individual countries, that has a greater risk, maybe a different way to think about it would be the blocs that are more stable or have more opportunity. North Asia is an area that does tend to import commodities, but because of the trade situation in China or Korea or Taiwan, where they do have net trade surpluses that allows them to import commodities without straining their economy.

Because of that, we do look at North Asia as being a situation where rising commodity prices are not a positive for them, but they're able to handle it and maintain economic stability, currency stability. And so, we think those have attractive underlying growth drivers, even in this environment. There are some other countries, whether it's in the Middle East, parts of Southeast Asia or Latin America, that are also commodity exporters, Brazil or Indonesia. Saudi Arabia tend to come to mind. Those do have a positive cyclical tailwind from higher commodity prices because they're exporters and then there are sort of this mix of other countries that are kind of in between. They might be importers but have nice export dynamics the same way the North Asian countries do or just they have a strong enough fiscal situation that they can navigate it.

But India might be the one country that's sort of a poster child of risks and that's simply because it is a commodity importer and it doesn't have natural trade surplus characteristics. So, its currency does tend to weaken when it needs to be importing higher priced commodities.

Adam Sparkman: So, for investors, who's knee jerk reaction may be to naturally be bearish on EM during times of heightened global uncertainty, even in the less than rosy outcome you just outlined. It sounds like there's still pockets of EM that may offer durability. In aggregate, do you think emerging markets can keep pace with developed market equities even in a less than rosy scenario?

Josh Rubin: Right now, I think it's important to think about what's happening in Russia and the Ukraine, as being not only an emerging market situation but a global situation and actually having a bigger direct impact on developed countries as opposed to emerging countries. And there's a few reasons for this: N umber one, although Russia previously was in the emerging markets index, it's no longer in the index anymore.

The damage has been done on a backward-looking basis. Number two, Western Europe's dependance on Russian commodities or importing commodities is absolutely going to decelerate Western European economies right now. But Russia did not have the same relationship with many of the other emerging market countries. So, the direct connection economically between Russia and Western Europe is not the same as between Russia and other emerging market countries.

A final thing is emerging markets do have certain underlying growth drivers, which are just different from developed markets. So, population growth, the growth of the middle class within emerging markets, these are longer term trends that do have a shorter term impact.

But these are the types of dynamics that are more sustainable in spite of what's happening in the Ukraine. If you think of the United States, Hurricane Katrina was a real shock to the system, but the U.S. GDP continued to grow all the way through it. Right now, we have a situation where Americans and Western Europeans are absolutely watching the news, shocked by what's happening in the Ukraine.

But that doesn't mean it's going to have the same impact as the global financial crisis or COVID. Because general daily behavior seems to be continuing, particularly in emerging markets.

Adam Sparkman: Okay. So let's consider a more positive resolution of the Russia situation. What's the outlook and which countries or regions do you think maybe the biggest beneficiaries in emerging markets? Are there certain segments of equities that you think still may struggle even in, you know, a better outcome?

Josh Rubin: That's an interesting question. I actually don't know that there's one particular part of emerging markets that benefit most from a positive resolution. The reason I say that is I think the benefits would be extremely broad based. The biggest challenge for investors was in emerging market stocks over the last decade has not been earnings growth. It's been valuation, it's been global equity investors perception of risk in emerging markets, equities compared to develop market equities.

The United States has been the big outperformer simply because of a valuation rerate, not only because of earnings growth. The elimination of worry about European or Eastern European conflict on the global economy, definitely has the chance to reset expectations or improve investor perceptions. That would probably benefit stocks across regions, across sectors, simply because valuations are already so low.

Secondly, any moderate decline in commodity prices, again, although not perfectly positive for some of the commodity exporting countries, is going to be a positive tailwind for emerging market consumers across the world. And because the emerging market consumer and especially the emerging market middle class is the biggest secular driver of the emerging markets opportunity, lower commodity prices should be benefiting all of the countries around the world, but not just in the consumer sector.

A consumer is buying something at a retail store, but whatever they're buying was produced across the industrial supply chain. So, it really can have broad based positive tailwinds not just in one sector.

Adam Sparkman: Some investors are drawing parallels between Russia's actions in the Ukraine and a potential approach that China could take with Taiwan. I'd love to get your thoughts on what kind of lesson China might be taking from Russia's invasion of Ukraine and what, if anything, may be next for China.

Josh Rubin: Well, this could take many hours, so I'll give you my shortest and best shot at this. I think what's very important about the global economy is an idea that economic integration is a way to reduce war or military conflict because the cost of breaking economic ties is higher than the cost of starting a war to get what you want out of it.

The global response to Russia's invasion of the Ukraine in terms of sanctions, in terms of trading relationships definitely is a signal to China. There are a lot of indications China has internalized that seeking a military solution for Taiwan does not achieve China's broader aims of economic strength and stability. So, it does appear that it's far more likely China will continue to seek a political outcome for integrating Taiwan into mainland China rather than feeling emboldened by the Russian invasion that it should go ahead and try the same thing in Taiwan.

But with that said, we don't think there's a near-term solution.

We don't think Taiwan is resolved in the next two or three years or by 2030. China has often spoken about Taiwan becoming reintegrated by the 100th anniversary of the People's Republic of China when Mao and the Communist forces won the civil war. That puts it at around 2050.

And really what it appears is that China wants to set a precedent for Taiwan that makes the Taiwanese people interested in being integrated. And that probably means quality of living and proof of success. So today there are a number of Chinese cities where the quality of life or living standards is just as high as Taipei. And China would like to continue to do that so that by 2050 Taiwanese look at China and say wow, there's several hundred million Chinese living better than we are.

We just think we're leaning towards political integration rather than military an attempt for military integration in China.

Adam Sparkman: So, shifting gears for one final question. Investor sentiment, valuation and earnings, all matter for stock returns. What is your outlook for EM earnings given the current situation?

Josh Rubin: It's interesting. There's a real important balance taking place right now. Often, particularly over the last decade, local currency earnings in emerging markets have been very attractive. But the difficulty has been currency depreciation at different points in time that have eaten up the local currency earnings growth for U.S. or European based investors where currencies have been more stable.

Today, there's this big question around the world, which is, is the Fed behind the curve? Is the European Central Bank behind the curve in relation to inflation? And often when major central banks are raising rates, that causes emerging market currencies to depreciate. But today, we would actually say EM central banks have been ahead of the curve and that enables greater currency stability across most of these countries.

So, take Brazil, for example. Normalized inflation in Brazil might be three or 4% today. It's absolutely running hot. It's high single digits, maybe 10%. But Brazilian interest rates are already at 12%. So, compare that to the United States, where inflation is six to 8% and interest rates are two and a half percent or less. It's a very different scenario.

We think it's similar across emerging markets where interest rates really are appropriate. That enables currency stability. And so, because of these secular growth drivers in emerging markets, we do have the chance for earnings growth to be pretty attractive in 2022 to 2023 and beyond. Generally, sort of consensus across the industry. Expectations today are that U.S. earnings growth could still be 10% or more in 2022, while European and emerging market earnings growth could be mid to high single digits, I would argue that there could probably be a higher chance that emerging markets earnings growth is stronger while U.S. earnings growth or European earnings growth expectations need to be dialed back bit due to what we've seen in terms of the shock from the Russia-Ukraine situation.

Adam Sparkman: Well, thanks, Josh. It was great to get your thoughts today. It sounds like the case for equities is delayed but not canceled.

Josh Rubin: I think I agree. Adam, thanks a lot for taking the time with me.

Adam Sparkman: Also, I want to thank you for listening. You can find this and other episodes of Away from the Noise at Thornburg.com/podcasts as well as on Apple Podcasts, Spotify or wherever you prefer to listen to podcasts. Please rate subscribe and review us. You can also visit Thornburg dot com to see all of our market commentary. Thank you.

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2300 North Ridgetop Road | Santa Fe, New Mexico 87506 | 505.984.0200 tel | 800.533.9337 toll-free | 505.992.8681 fax | thornburg.com