

Emerging Markets: Looking Ahead



Emerging markets (EM) equity and debt suffered along with other assets when the COVID-19 pandemic set off a global economic shock. Now, a year after the virus emerged, we share our thoughts about how EMs are likely to fare in this ongoing global crisis.

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As we look ahead, it is important to understand where we are—a global economy in the midst of a pandemic, but also one with significant opportunity and hope.

In 2020, the human race faced substantial obstacles but also showed resilience, ingenuity, and agility. In physical isolation, we celebrated the power of human connection. Those of us who believe that sitting across a table from decision-makers, embedding ourselves in economies, and visiting company operations are critical to solid decision-making look forward to these experiences again. But perhaps 2020 was also a lesson: our physical stillness allowed us to connect in new ways. Individually and together our teams did just that. It is at the height of uncertainty when experienced teams can prove their mettle, looking for opportunities to use volatility to their advantage, leaning in when others are running away, and relying on time-tested investment frameworks and expertise.

While the investment world concentrated on vaccines, Brexit, trade wars, and the economic implications of the stop-start lockdowns, the Chinese equity market¹ quietly outperformed, rising 40% for the calendar year. Led by Asia, EM equities² more broadly rose by approximately 18%, outpacing developed market equities. With the pandemic, developed market monetary policy became even more accommodative, bolstered by substantial fiscal policy support, both of which are expected to continue in the intermediate term. This environment has made the search for yield even more focused, and EM debt³ was the natural beneficiary, yielding 4.53% with a historical default rate of less than 1% (compared with U.S. high-yield credit⁴, which yielded 4.18% and had a historical rate of greater than 3%).

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Stephanie G. Braming, CFA

Regardless of 2021's trajectory, one 2020 theme will undoubtedly persist. Concerns about sustainability—of our planet, infrastructure, societies, and institutions—will endure long past this year. The importance of these concerns cannot be overstated, as they affect both growth opportunities and risk. A focus on sustainability underpins our investment processes at William Blair, which includes strong and/or improving governance expectations of companies and countries. Central to the dialogue is a focus

¹ MSCI China A Onshore Index (net)

² MSCI Emerging Markets IMI Index (net)

³ J.P. Morgan EMBIGD yield to worst as of 12/31/20; historical default rate is since 1983 and is estimated by Moody's.

⁴ Bloomberg Barclays U.S. Corporate High Yield Index yield to worst as of 12/31/20; historical default rate is since 1983 and is estimated by J.P. Morgan)

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Stephanie G. Braming, CFA

on a wider array of stakeholders, increasing pressure for more diversity in leadership and boardrooms, and an accelerating emphasis on climate issues. This is not news to European investors and pockets of investors elsewhere, but we expect adoption and engagement to accelerate globally with significant investment implications in emerging and developed markets alike. As investors, we must dig deeper and engage to understand intent, execution, and trajectory.

In the following pages, our teams discuss both the opportunities and risks for EM equity and debt, with a specific spotlight on China, given its increasing market heft. We believe the EM equity opportunity is stronger than it has been over the past decade because of a confluence of internal and external factors. With the low-yield environment, EM debt, particularly the higher-yielding segment of the market, also provides unique opportunities for discerning, experienced investors. Over time, while new growth leaders will undoubtedly abound across markets, asset classes, sectors, and continents, uneven growth and disparities in economic opportunity across countries will remain a focus and potential risk.

As we turn our eyes to the months and years ahead, will developed market accommodative fiscal and monetary policy, improving economic fundamentals, and pent-up demand—underpinned by a global vaccine rollout with unprecedented speed and collaboration—lead to a new Roaring 20s? Perhaps, but regardless of what the next 12 months hold, what we do know is that while there are risks, EMs remain an exciting area for growth and provide significant opportunities for long-term investors.

Best,



Stephanie G. Braming, CFA

GLOBAL HEAD OF INVESTMENT MANAGEMENT



Olga Bitel
GLOBAL STRATEGIST

Charles Dickens’s timeless quote—“It was the best of times, it was the worst of times”—may come to characterize the global economy of the early 2020s quite accurately.

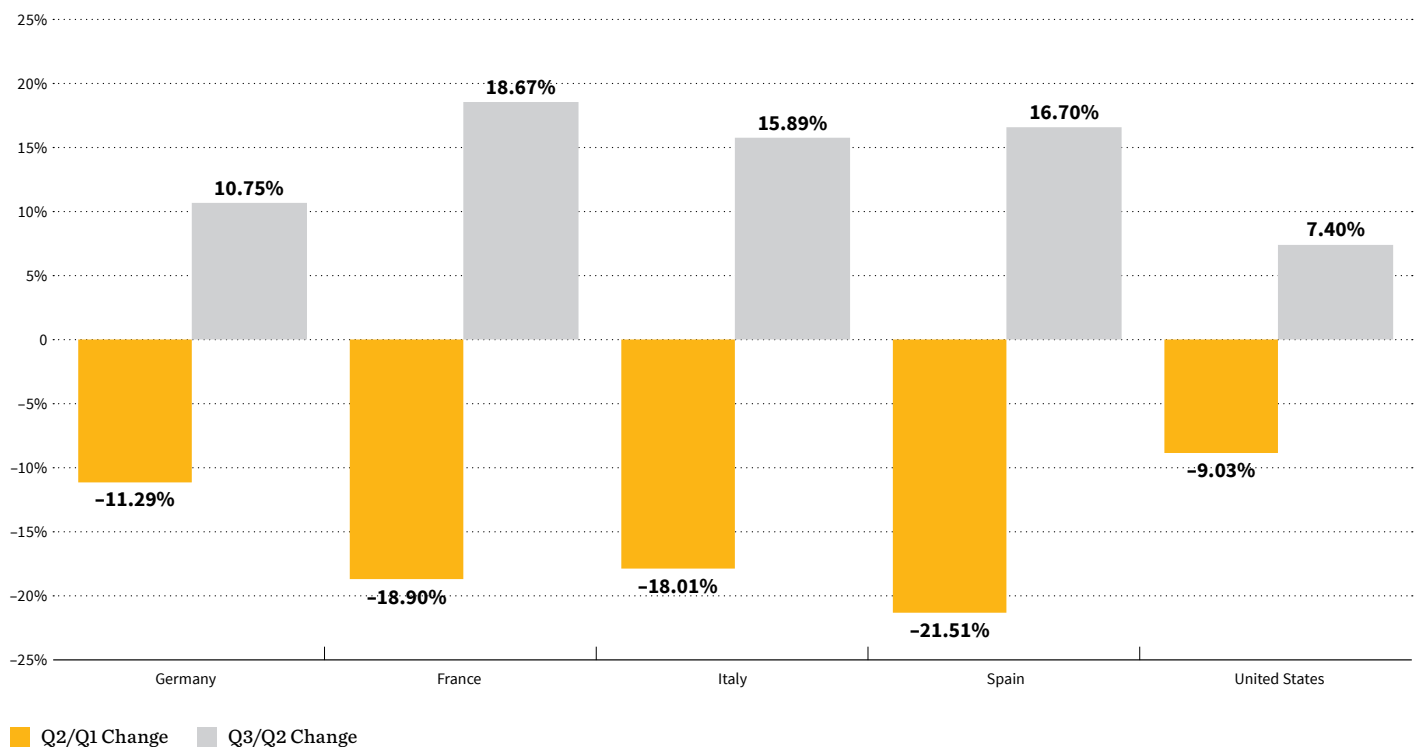
The COVID-19 pandemic wreaked havoc on the global economy. The brunt of the decline occurred in the second quarter everywhere except in China, where activity

declined mostly in the first quarter. However, the magnitude of the decline varied greatly, from 9.0% in the United States to 21.5% in Spain. By comparison, during the worst quarter of the Global Financial Crisis (GFC) recession, the U.S. economy lost 4.0% of output, annualized.

What is remarkable is that the subsequent snapback in activity in the third quarter of 2020 was commensurate with the second-quarter contraction: those countries where output declined the most in the second quarter posted the strongest growth in the third. Exhibit 1, which shows gross domestic product (GDP) growth in both quarters, illustrates.

EXHIBIT 1

Real GDP Growth in Select Countries



Sources: Macrobond and WB analysis, as of January 2021.

EM Growth Depends on Three Developed Demand Centers

The vast majority of EMs are small, open economies whose fortunes depend on what happens in the world's three principal demand centers: the United States, Europe, and China. Put another way, EMs are a high-beta play on developed market growth. Interest rates, exchange rates, and commodity prices are largely set by the economic and liquidity conditions in the three global demand centers. At the same time, these prices—interest rates, exchange rates, and commodity prices—set binding constraints on economic outcomes in most EMs.

Through the third quarter of 2020—the latest data available at the time of writing—the U.S. economy lost 3.9% of output relative to the end of 2019, and the EU-27 lost 7.0%.⁵ This previews the magnitude of pent-up demand and economic force that is likely to be unleashed once the pandemic is finally behind us.

Last year was also one in which science came together with focused funding and state-of-the-art logistics and distribution to produce not one, but a series of vaccines in less than 12 months, a feat deemed all but impossible in February. The first quarter of 2021 is likely to prove challenging, with COVID-19 infections and deaths hitting new highs on both sides of the Atlantic and the subsequent curtailment of high-contact services provision.

At the same time, mass inoculation programs that are now being rolled out in Europe and the United States point to a decisive turning point in the fight against the COVID-19 pandemic. Specifically, the United States aims to have approximately 100 million adults, about 30% of its population, vaccinated by the end of the first quarter of 2021. The European program is similar in scope and timing. If successful, more than 70% of the adult population in developed market economies may be vaccinated in the first half of 2021.

The experience in the third quarter, together with the vaccination rollout, points to the world economy starting out slowly, with growth remaining challenged in the first quarter of this year. However, this will likely be followed by strong sequential acceleration in economic activity as we head into the seasonally low period of respiratory infections and as mass inoculations further reduce whatever fear of vaccinations remains.

Consumer spending is likely to grow smartly across many developed markets as pent-up demand and high aggregate savings rates work in tandem. Indeed, retail sales volumes already surpassed their prior peak. At the same time, industrial production, which enables the consumption of these goods, remains some 7% to 10% below pre-COVID recession levels. So, even in the absence of further fiscal support—already approved in Europe and quite likely in the United States—major developed market economies may be firing on all cylinders come spring of this year.

Even with the strongest synchronized growth in at least three decades, major economies, with a notable exception of China, may not return to pre-crisis output levels before 2022. However, current forecasts of economic growth fall well short of regaining pre-crisis output levels on a multiyear horizon. Exhibit 2 provides a snapshot of the latest consensus estimates and the implied output trajectory for 2021 and beyond.

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⁵ The EU-27 refers to the 27 European Union (EU) countries after the United Kingdom left the EU.

The top baseline in exhibit 2 reflects a conceptual output path for developed market economies, assuming a 2% annual growth rate—which is consistent with recent economic experience—in the absence of a COVID-19 recession. This assumed level of output indicates how much supply and labor is on hand. Since the COVID-19 recession was short and fiscal measures provided the support necessary to keep supply more or less intact, this theoretical level of output is a reasonable approximation of the levels of activity developed market economies need to generate to truly recover from the 2020 recession.

As can be seen in exhibit 2, current economic growth projections not only do not imply any convergence toward a pre-crisis growth trajectory, but actually imply further declines in output levels in select euro area economies in 2021. The third quarter 2020 economic rebound—together

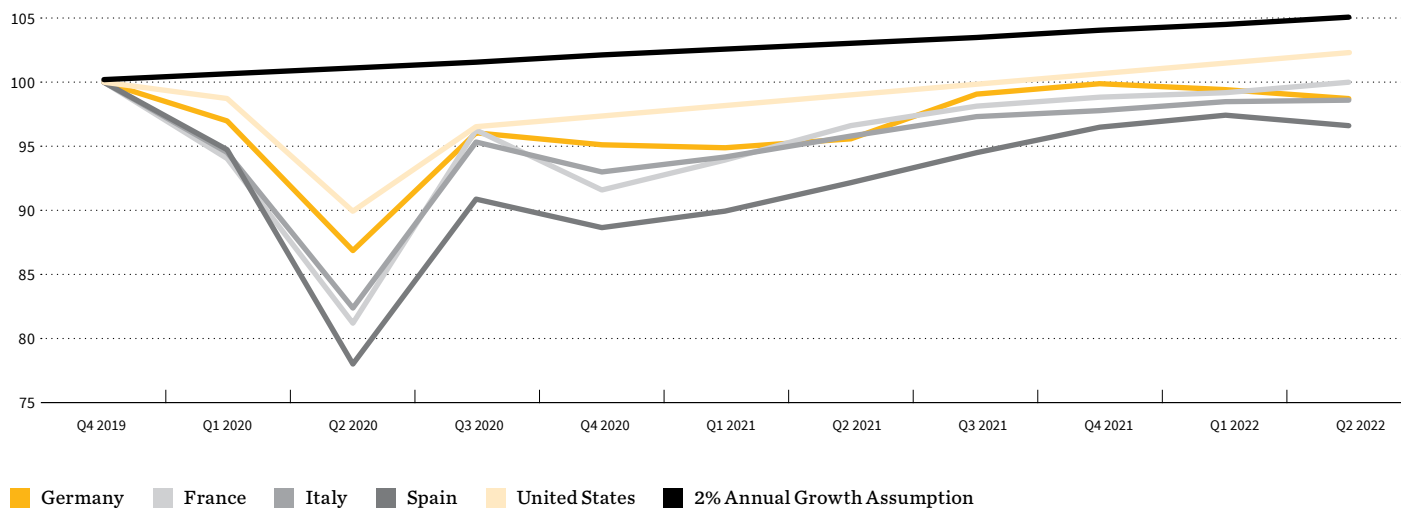
with ongoing concerted efforts of policymakers across developed markets—suggests that current forecasts are likely too pessimistic.

In short, high aggregate savings rates and strong acceleration in consumer spending, especially on services, together with still-depressed levels of industrial production, suggest that economic growth in 2021 is likely to be the strongest in many decades, and visibly above current forecasts.

If economic growth is to trend higher this year, so is inflation. The bulk of consumer spending in developed markets is concentrated in services, and the overall inflation baskets broadly reflect these weights. As with economic growth, 2020 provided a glimpse of what we might expect in 2021.

EXHIBIT 2

Actual and Forecast Output Levels for Select Economies (Q4 2019=100)



Sources: Bloomberg and WB analysis as of January 2021. Forecasts begin with Q4 2020.

As exhibit 3 highlights, during much of the summer, goods prices accelerated strongly while production was constrained by lockdowns and physical limits on personnel reduced supply and stretched logistics. As activity normalized and the supply side of the economy adjusted to the new, temporarily constrained work environment, goods inflation began to ease. This episode highlights the elastic nature of developed market supply and logistics, both of which should adjust relatively quickly to the normalization of economic activity through 2021. Inflation of goods prices is likely to return to more subdued rates.

By contrast, services inflation declined sharply in 2020 as activity was largely curtailed. High-contact services inflation in recreation, travel, and related activities looks set to rebound strongly as pent-up demand is robust and consumers have plenty of income to support it, while supply can be delayed and in some cases is, by definition, finite. (It takes a while to return

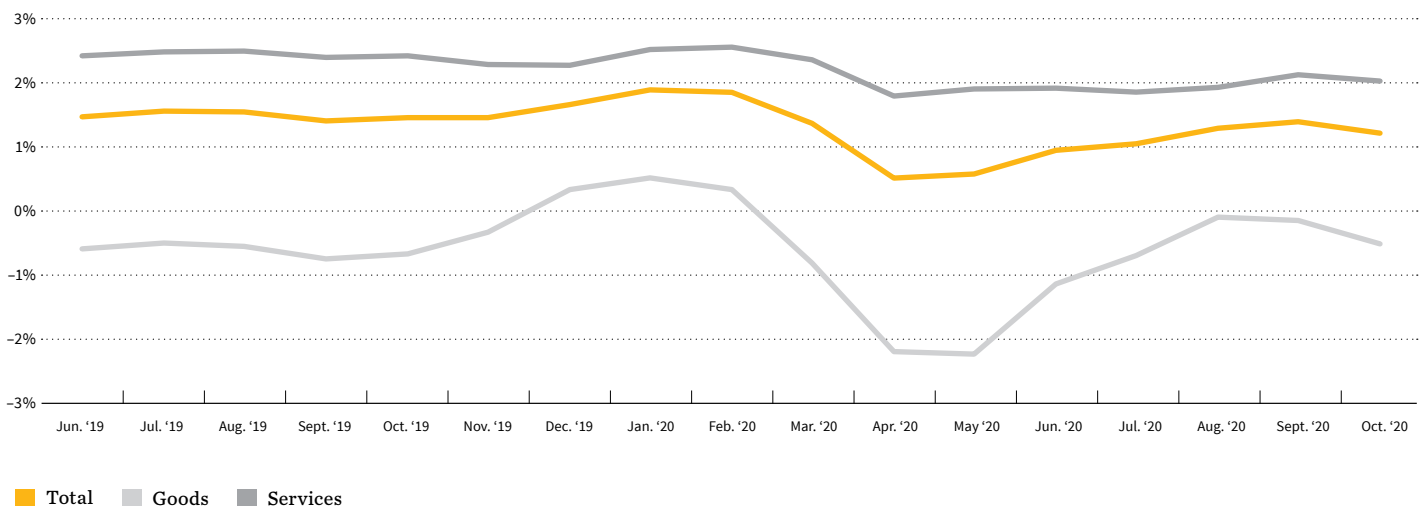
planes into service, and hotels once full, are, well, full. And, of course, they will adjust prices in response to surging demand.) Since the overall inflation rate is driven predominantly by services, inflation is going to be higher just due to base effects, precisely at a time when growth is getting stronger.

For now, any inflation “spike” beyond a 3% annual rate in 2021—if that can even be called a spike—looks likely to be transitory. Even if growth surprises to the upside and developed markets grow at well above the current consensus rates, our economies are unlikely to regain the pre-crisis trajectory of output until 2022 at the earliest.

For this reason—and to support domestic economies and fiscal authorities—central banks in developed markets will likely be in no rush to raise rates. Although 10-year U.S. rates have been inching up since the second half of 2020, at 1.12% they may not reach pre-COVID levels until well beyond next year.

EXHIBIT 3

Annual U.S. Inflation Rate



Source: Macrobond, as of January 2021.

EM Equity | Multiple Factors Create a Bullish Outlook for 2021



Todd McClone, CFA
PORTFOLIO MANAGER, EM EQUITIES

As we head into 2021, we are more bullish on EM equities than at any point in the past decade. After bouts of volatility in early 2020 caused by disruptions related to the COVID-19 pandemic—and a subsequent rapid recovery—we see room for strong growth in developing markets in 2021.

Despite our favorable view overall, the market is highly differentiated, and regions are recovering at disparate rates. As a result, we see a large but varied opportunity set full of high-quality growth companies that requires in-depth analysis to identify the most attractive opportunities. In short, we expect

EMs to provide ample opportunities for investors seeking to identify companies exhibiting sustainable value creation in 2021 and beyond.

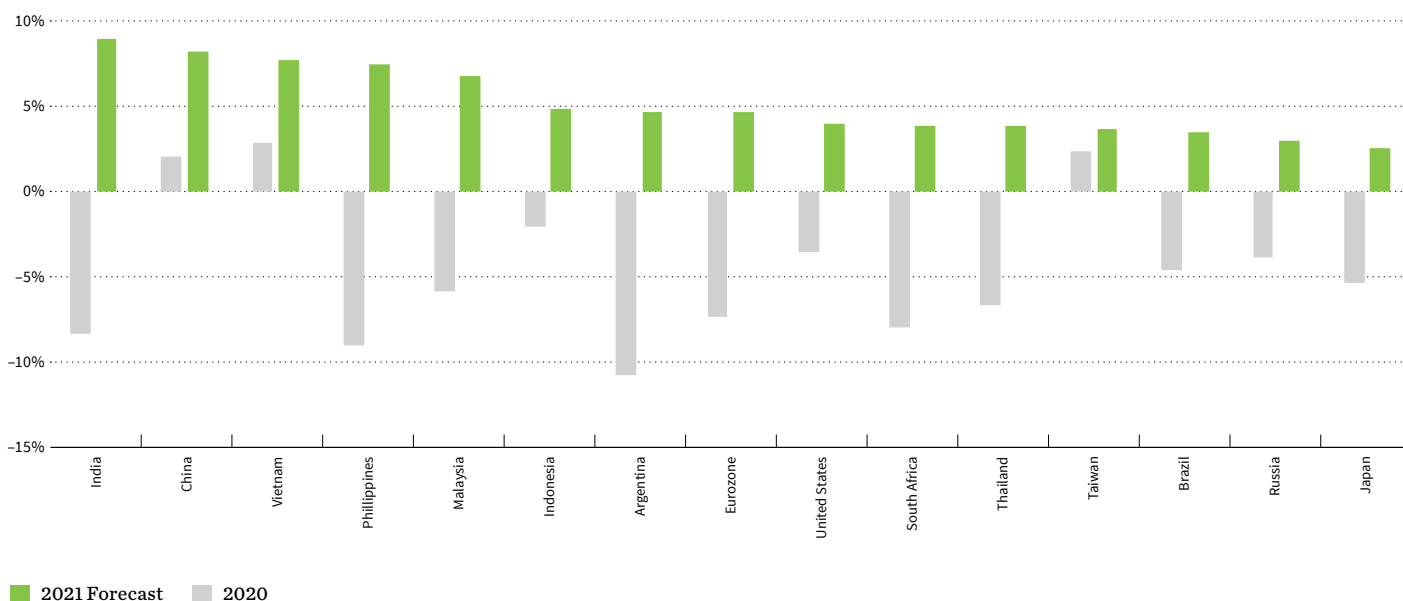
Dynamics Driving Our Bullish Outlook

Several factors are driving our optimism for the asset class as whole, including a range of fundamental and geopolitical tailwinds.

Growth acceleration: The gap in GDP growth between EMs and developed markets narrowed in recent years, but that gap seems poised to begin widening again. As shown in exhibit 4, the 2021 GDP growth forecasts for India, China, and several other prominent EMs are significantly higher than developed markets. Historically, EM equities have significantly outperformed developed markets when the GDP growth gap has been widening. Moreover, economic growth is a significant driver of strong corporate performance; as a result, we expect earnings growth to accelerate in EMs.

EXHIBIT 4

GDP Growth Forecasts for Emerging and Developed Markets



Source: Bloomberg, as of January 2021.

U.S. dollar weakening: One tailwind for growth in EMs is ongoing weakness in the U.S. dollar, which appears to have entered a weakening cycle after an extended period of strength. A 1% decline in the U.S. dollar typically boosts global trade by 75 basis points (bps) and, according to J.P. Morgan, has added approximately 3.4% to EM equities performance, compared with just 2.1% for developed markets. J.P. Morgan has also observed that EM equities have outperformed developed markets in approximately 90% of the instances of U.S. dollar weakness.

Another important aspect of the weaker U.S. dollar is that many EMs have dollar-denominated debt, so a weaker U.S. dollar decreases their liabilities. The weak U.S. dollar also allows more flexibility for central bankers in EMs to engage in looser monetary policies without worrying about harmful effects on their currencies. This ability to provide additional stimulus will likely be extremely valuable as countries continue to recover from the pandemic. As central banks in developed markets continue to provide massive amounts

of global liquidity, this should perpetuate conditions that are favorable for EM equities.

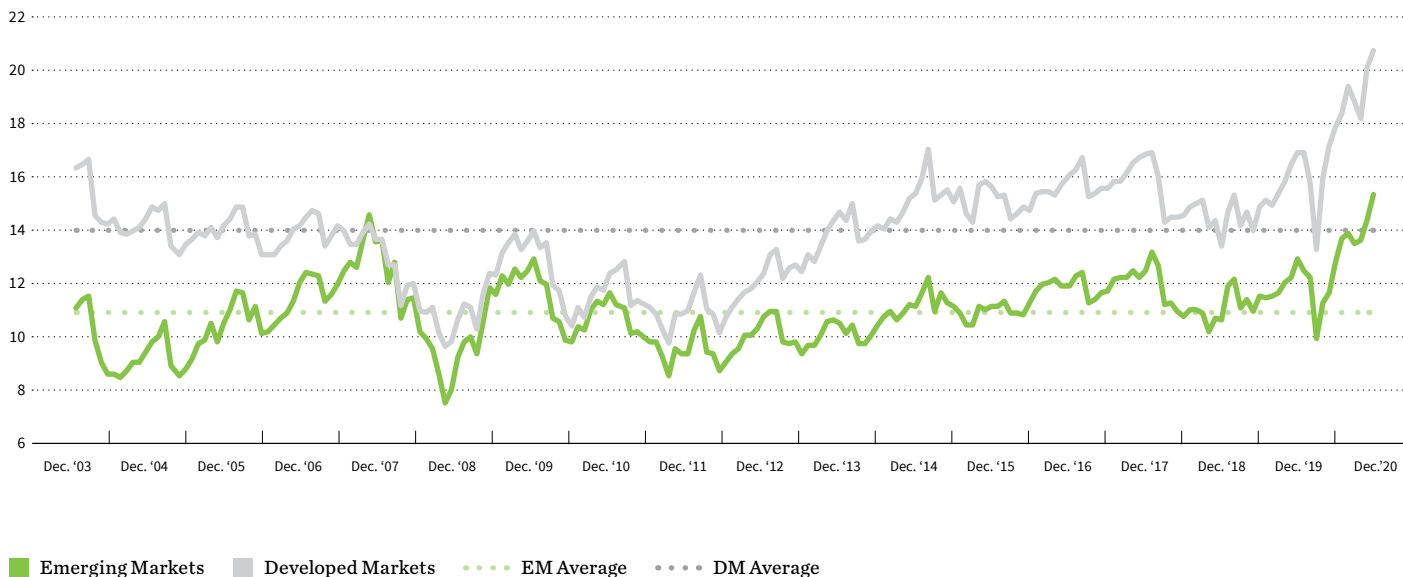
Valuations that do not reflect EMs' growth focus:

In terms of long-term price-to-earnings (P/E) levels, EM equities appear historically cheap versus developed markets, as shown in exhibit 5. We see EM equities as trading about 15% cheaper relative to their long-term average discount compared to developed markets. While EM equities typically trade at a discount, this level offers significant upside for EMs from a valuation perspective, in our view.

EM valuations appear even more attractive when considering how the MSCI EM Index has evolved since the GFC. In 2008, low-valuation sectors (energy and materials) were about 40% of the index, and more growth-oriented, higher-valuation sectors (IT, consumer, retail, and media) were about 10% of the index. Now, those proportions are reversed, but today's valuations do not appear to reflect this shift.

EXHIBIT 5

Historical Valuation Differences Between Emerging and Developed Markets



Sources: MSCI, as of December 2020. Shows MSCI emerging versus developed market P/E ratio for FY2.

Fund inflows driven by rebalancing: Technical factors should support EM valuations in 2021. Among global equity portfolios, the current average weighting for EM exposure (7.3%) is currently well below the long-term average (9%) and even further below the neutral allocation (11.5%). Moving from the current allocation to the long-term average would result in \$350 billion of inflows into EM equities, and we believe that this movement has already begun. Should the performance of EM equities continue to improve relative to developed markets, we believe that global funds will likely increase their allocations further, creating another positive catalyst for EMs.

COVID-19 vaccine: We believe that the AstraZeneca vaccine developed at Oxford University will be especially important to EMs. At \$3 to \$4 per dose, this vaccine is significantly cheaper than Pfizer's/BioNTech's (\$20 per dose) and Moderna's (\$32 to \$37 per dose) vaccines, and AstraZeneca's vaccine should be easier to distribute without the need for extreme low-temperature refrigeration. We acknowledge that the vaccine will take time for full distribution and economies around the world will not immediately return to a pre-COVID "normal." Nonetheless, after extended global health and economic pain, the proverbial light at the end of the tunnel is visible, with pent-up demand likely to lead to a potent economic recovery.

Changing geopolitical conditions: We believe that the U.S. political environment in 2021 will likely prove more supportive of EMs than in recent years. We expect the administration of President Joe Biden to be more predictable than the Trump administration in trade policy and international relations; this should offer more stability for EMs and investors. At the same time, we believe that Biden will continue to be tough on China, although we expect that Biden's China policy will be more orthodox and based on traditional diplomacy compared with the Trump administration.

Diverging Regional Growth Outlooks Create Localized Opportunities

While we are favorable on the overall outlook for EMs, there is a wide disparity in the pace and stage of their recoveries from economic disruptions caused by the COVID-19 pandemic. This is reflected in exhibit 4, which shows GDP growth forecasts by country for 2020 and 2021.

ESG Reaches an Inflection Point in EMs

EMs have historically been viewed as laggards in terms of ESG. Concerns about governance practices, as well as other issues including limited or inconsistent reporting of ESG data and policies, have caused ESG ratings providers to skew their ratings significantly more negative for EM companies than for developed market companies. These concerns have also tempered some investors' enthusiasm for EMs.

Efforts to close the ESG gap between emerging and developed markets, however, have been gaining momentum recently. EM countries such as India, Malaysia, Mexico, South Africa, and Taiwan have some of the world's highest levels of sustainable reporting, according to a recent study by KPMG. Many other EMs have also made notable progress as a result of increased regulatory requirements—from both stock exchanges and governments—and higher ESG focus and scrutiny from local and international investors.

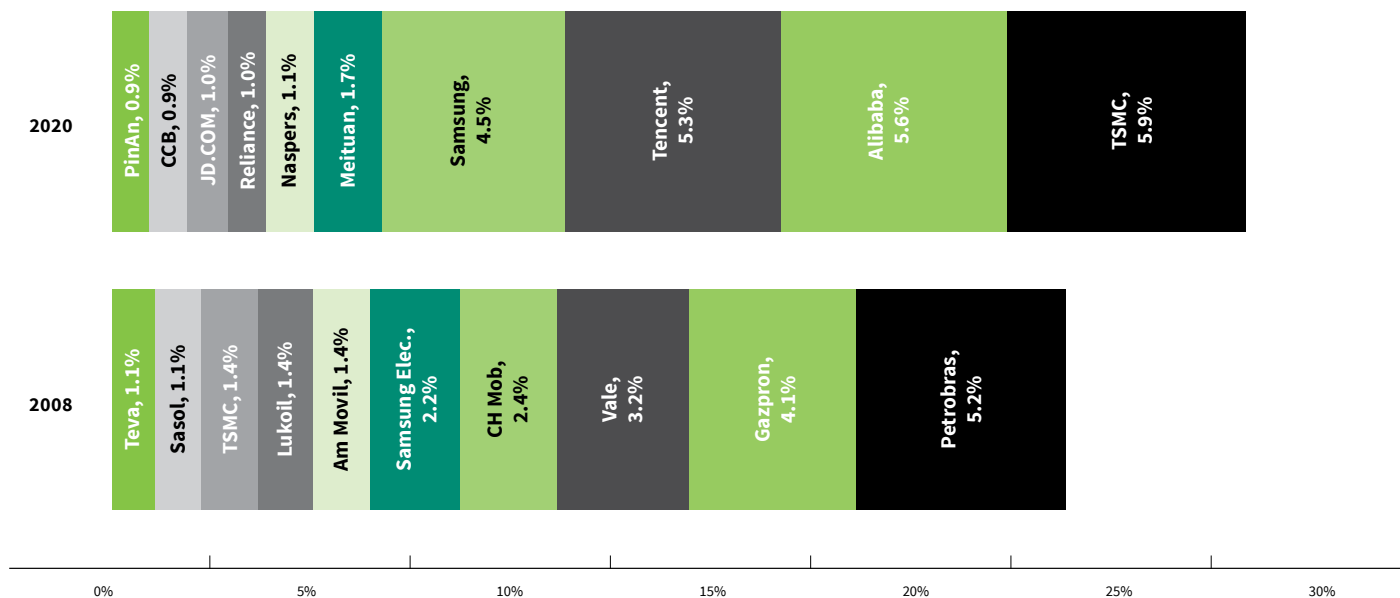
China has made significant strides as well. Stock exchanges in Hong Kong and mainland China have been ramping up ESG disclosure requirements, and companies have been encouraged to communicate on their contribution to sustainable development goals (SDGs). Moreover, the September 2020 announcement by President Xi Jinping of China's commitment to achieving carbon neutrality by 2060 brought climate change and ESG to the forefront of the government's policies, and Chinese companies are aligning themselves with these priorities.

Increased ESG awareness is facilitating engagement with company management teams on these issues across EMs. We have seen an increased number of companies proactively reaching out to investors to explain what they are doing or seeking advice on how to report in a way that is meaningful to investors. We believe that this is an encouraging development that should lead to positive value creation.

While GDP expectations for all EMs decreased significantly because of the pandemic, this delta is significantly smaller for countries such as China that were among the first to experience widespread infections and implement measures to control the pandemic. China's path to economic recovery provides somewhat of a roadmap for what recoveries in other EMs that are later

EXHIBIT 6

Tech Has Transformed the MSCI EM Index (Top 10 Weights, 2008 vs. 2020)



Sources: MSCI, as of December 31, 2020. References to specific companies are provided for illustrative purposes only and should not be interpreted as recommendations to buy or sell any security.

in the outbreak/shutdown/recovery cycle could look like. As a result, we are seeing increasing opportunities in laggard countries such as India, Indonesia, and Brazil that are just now coming out of the pandemic and moving more significantly into their recovery phases.

Seeking Sustainable Growth Opportunities Amid the Evolution of EMs

While some EMs are still heavily dependent on commodities and exports, technology has become as central to EMs as it has to developed markets. This evolution underpins much of our portfolio positioning and where we are finding opportunities for sustainable value creation in EMs.

Growth and Asia are more prominent in EMs: The drivers of value creation over the past decade have shifted, transforming the shape of EM equities as an asset class. The MSCI EM Index has gone from being highly dependent

on energy and commodities to being driven by IT, media, and consumer companies. This shift is reflected in exhibit 6, which shows that the four largest components of the index in 2020—Alibaba, Tencent, TSMC, and Samsung—account for nearly a quarter of the index weighting. As noted above, we find that current valuations in EMs do not fully reflect the index’s shift toward higher-growth sectors.

The transformation of Reliance Industries is a microcosm of the shift in EMs broadly. Reliance was originally an oil and gas infrastructure and energy company, but in the past decade the company has invested heavily in telecommunications and other less commodity-driven areas. As part of that change, Reliance has built a wireless and fiber optic network in India and then moved to capitalize on e-commerce, fintech, and social media opportunities from the broad consumer base it built through that rollout.

Country weightings in the index have changed significantly as well, shifting toward Asia at the expense of Latin America and the Europe, Middle East, and Africa (EMEA) region. In particular, China’s weighting is poised to increase. In addition to China’s strong economic recovery from the pandemic, companies such as Alibaba and Tencent continue to have significant potential for expansion. China A-shares have become far more important and provide what we see as a massive opportunity for both fundamental and technical reasons. The inclusion of China A-shares in the MSCI EM Index should lead to additional inflows as both active and passive investors gain broader access to mainland Chinese stocks.

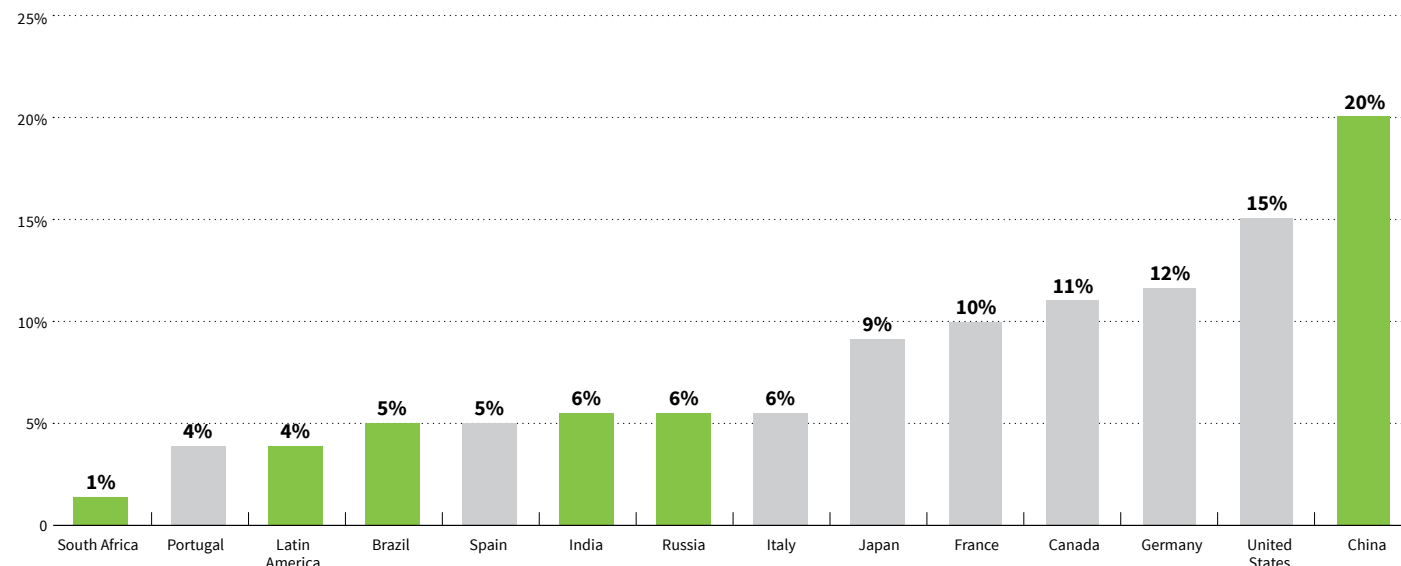
Sectors and themes offer compelling opportunities for growth investors: The increased importance of technology and rising consumer spending dominate the growth investing landscape in EMs. Looking beyond these mega-trends, we are particularly focused on the

following sectors and themes in our search for high-quality companies offering sustainable growth.

The first sector/theme is e-commerce. The growth of e-commerce is one of the most compelling trends shaping EMs. Fueled primarily by Alibaba, China shows the potential for e-commerce penetration in other EMs. As shown in exhibit 7, e-commerce penetration in non-China EMs significantly trails developed markets, but major investments in digital infrastructure have expanded mobile data coverage and increased smartphone adoption in EMs. In addition to these longer-term drivers, the pandemic has spurred more consumers to purchase online in both emerging and developed markets. In our view, part of the appeal of investing in e-commerce companies in EMs is that many EM governments create barriers to Amazon and other foreign players; this reduces price competition and supports the development of “local champions,” such as Reliance Industries in India and Magazine Luiza

EXHIBIT 7

E-Commerce Penetration by Country (Online Sales as a Percentage of Retail Gross Revenue)



Sources: Bank of America, as of September 2019.

Another sector/theme is healthcare. We have found attractive investment opportunities in the healthcare sector for many years, and the pandemic has only enhanced our conviction in healthcare as a long-term quality growth sector in EMs. We see healthcare expenditures as an extension of an overall increase in consumer spending in EMs. As shown in exhibit 8, healthcare spending per capita is still very low in EMs relative to developed markets. As disposable incomes grow, we expect to see significant increases in spending on health and wellness by consumers in EMs.

Lastly, we see opportunities in consumer and financial technology (fintech). We believe that the consumer sector will continue to experience structural growth, fueled by rising disposable incomes in EMs. We also like that the sector provides exposure to fintech, which we see as the most attractive aspect of financials. Tapping into the tremendous potential of digital payments and other aspects of fintech are the only paths to sustainable growth in EM financials, in our view. We are selectively adding

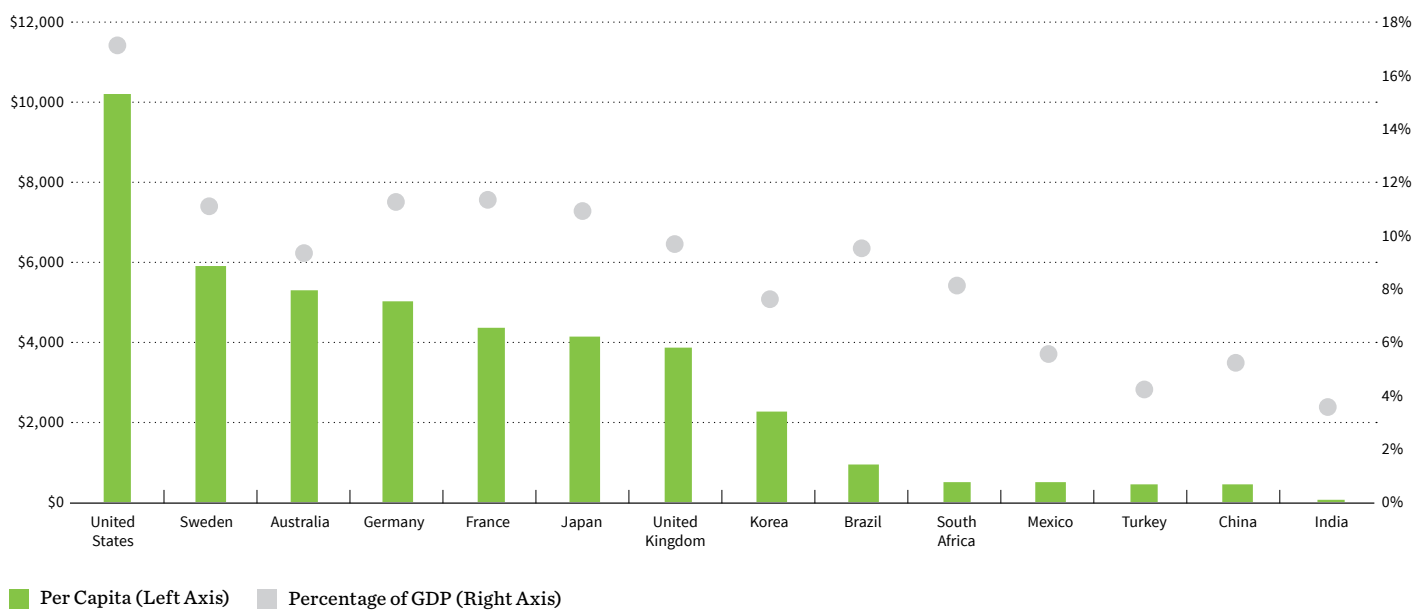
to our broader financials exposure in India as we seek to capitalize on the country’s improving economic conditions.

Risks Facing EM Equities

Despite the overall attractiveness of EM equities today, there are certainly risks that investors should consider. Given that China is further along in its economic recovery from the pandemic than practically any other country, China could enter a monetary tightening phase defined by slowing credit growth sooner than expected, which could result in market volatility. The speed at which COVID-19 vaccinations are rolled out in EMs poses another potential threat for investors. If the pace of vaccinations in EMs is significantly slower than the pace in developed markets, developed economies could rebound faster than EMs; this, in turn, could cause the post-COVID growth rebound in developed markets to outpace that of EMs, thereby attracting capital flows away from EMs and back to developed markets. Finally, the continued weakening of the U.S. dollar, which historically has been a major tailwind for EM equities, could be reversed if ongoing

EXHIBIT 8

Healthcare Expenditures Per Capita by Country



Source: World Health Organization, as of July 2020.

fiscal stimulus measures in the United States cause interest rates there to rise, which would increase the relative attractiveness of the U.S. dollar.

Expanding Opportunity Set for Quality Growth Investors

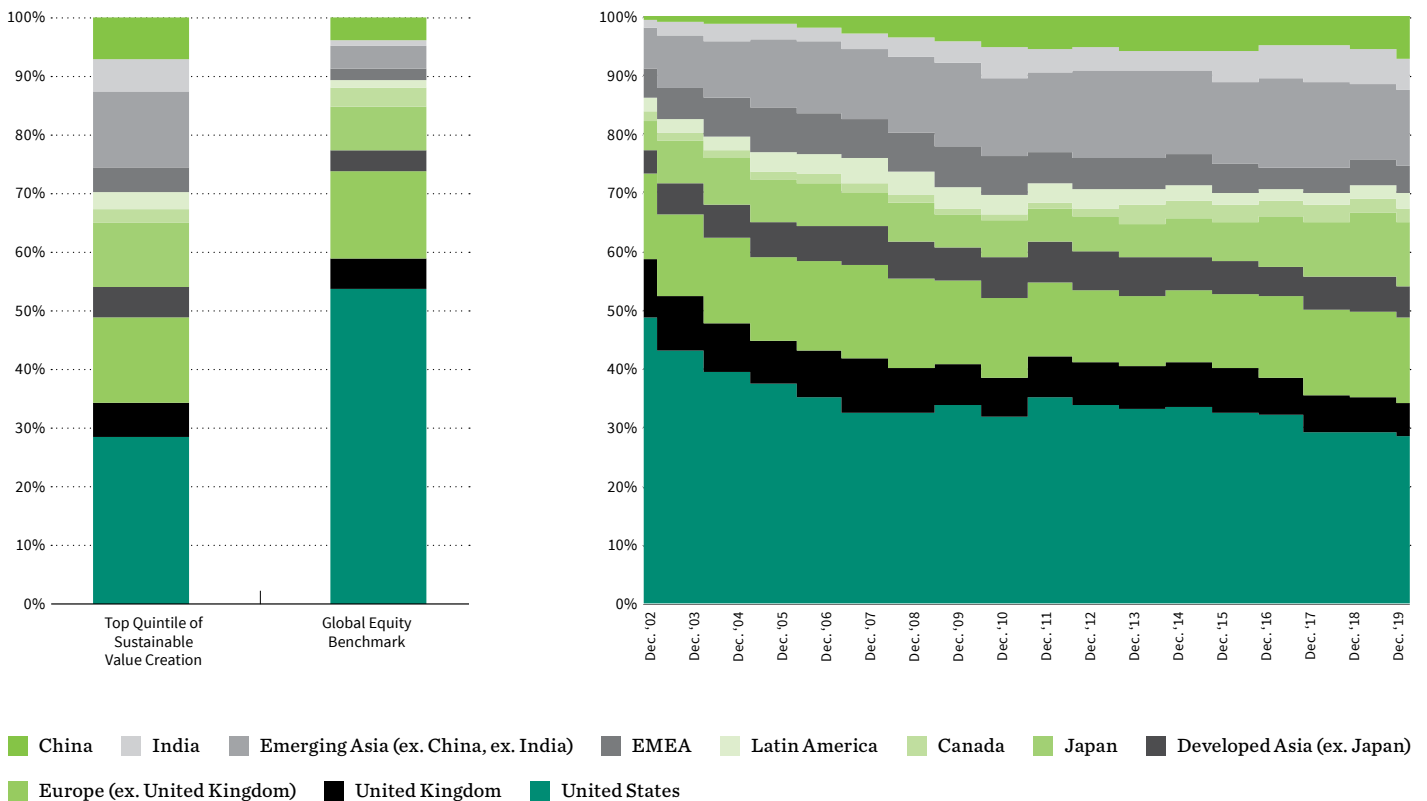
As we evaluate the longer-term landscape for EM equities, we see an expanding opportunity set full of leading companies with tremendous growth potential. Our investment approach centers on identifying companies with sustainable value creation characteristics, including those with industry-leading return on invested capital (ROIC) profiles and durable competitive advantages. Exhibit 9 shows that EMs include a disproportionate share of top-quintile companies in terms of sustainable

value creation. Moreover, the share of top-quintile companies domiciled in EMs has increased over time—a trend that we expect to continue.

Given the widely diverging outlooks for sectors, countries, and companies in EMs, we believe active management is paramount. While the asset class as a whole appears attractive now, passive exposure would force investors to own the less attractive sectors, countries, and companies with more perilous economic growth prospects. We believe the ability to successfully navigate EM equities requires extensive experience and bottom-up research to capitalize on the opportunities and manage risks in this dynamic asset class.

EXHIBIT 9

Top Quintile of Companies Exhibiting Sustainable Value Creation by Region



Source: MSCI and William Blair, as of December 2019. Global benchmark is the MSCI ACWI IMI. Top quintile of sustainable value creation is equal weighted. Sustainable value creation is an aggregate measure of corporate returns on capital. Several quantitative financial statement factors are used to measure profit and cash flow relative to invested capital as well as operating efficiency.



Marcelo Assalin, CFA
HEAD OF EM DEBT

After an extremely challenging 2020—a year that will go down in history as one of the most difficult periods in modern times—we expect a strong global economic recovery in 2021, as already indicated by the rapid rise of Purchasing Managers’ Indices (PMIs). While the recovery has been led by robust economic growth in advanced economies and China, EMs should also benefit from improving global trade, rising investments, and higher commodity prices.

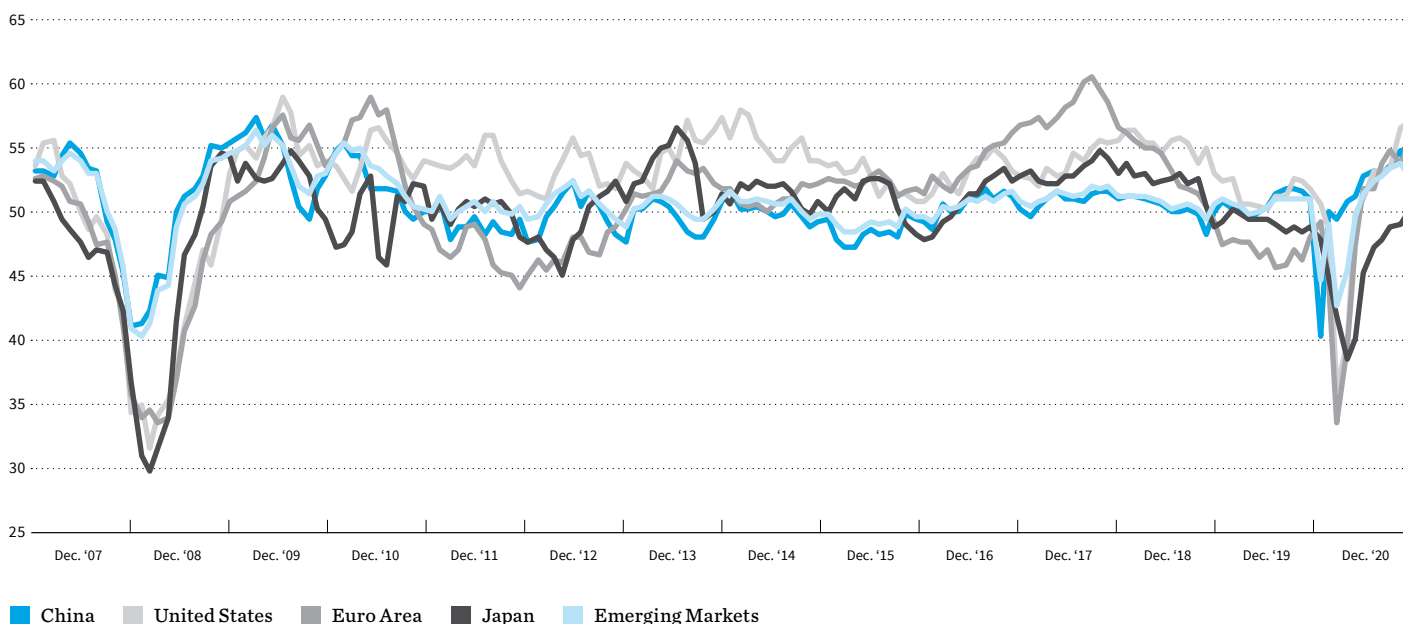
However, the path to economic normalization is more uncertain and will most likely be more uneven than in developed markets.

Vaccine production constraints and distribution challenges mean rollout programs should be delayed in many of the smaller, less wealthy EMs. As a result, virus containment measures will have to remain in place for longer. This could delay the economic recovery. However, there are nuances. Countries with younger demographics, for example, have been able to soften lockdowns as hospitalization rates have not spiked.

Asian, Central European, and Eastern European countries should lead the recovery, driven by better management of the pandemic and stronger fiscal buffers. Middle Eastern, African, and Latin American countries are likely to be the laggards, affected by structural headwinds and lack of additional fiscal capacity.

EXHIBIT 10

Manufacturing PMIs Indicate Recovery



Sources: Macrobond and Markit, as of January 12, 2021.

“Asian, Central European, and Eastern European countries should lead the recovery, driven by better management of the pandemic and stronger fiscal buffers.”

Marcelo Assalin, CFA

Signs of Stabilization Despite Fundamental Deterioration

While we expect the average real GDP growth in EMs (as represented by the countries in the J.P. Morgan EMBI Global Diversified) to rebound to 4.7% in 2021 from -4.8% in 2020, overall levels of output should remain below those of 2019. On the other hand, large output gaps should help keep inflation subdued over the near term.

The severe impacts of the COVID-19 crisis on economic activity and fiscal revenues will likely continue weighing on fiscal accounts, most notably in countries that also implemented fiscal stimulus. Although we expect the average fiscal deficit-to-GDP ratio to improve to 6.3% in 2021 from 8.5% in 2020, we believe it will remain significantly above the 3% level seen in 2019.

This significant fiscal deterioration has led to increased debt. The average total public debt-to-GDP ratio is expected to increase to about 62% in 2021, from 60% in 2020 and 48% in 2019. Even though credit metrics have clearly deteriorated in most EMs, raising the need for fiscal consolidation and structural reforms in many places, overall debt levels remain significantly below those of advanced economies. Importantly, although debt levels have increased, the debt burden should be offset to a large extent by lower financing costs.

On the external balance front, the average basic balance-to-GDP ratio should improve to -0.6%, from -1.5% in 2020. Improving prospects for a pickup in foreign direct investment (FDI) flows, remittances, and tourism later in the year should improve the outlook for EM external accounts over the next few years, eliminating any concerns about EM external accounts.

No Systematic Crisis Brewing

While we acknowledge a decline in sovereign credit quality and view aggregate EM fundamentals with a degree of caution, it is important to emphasize that we do not believe there is a systemic crisis brewing in EMs as a whole.

Historically, EM crises have been driven by unsustainable debt dynamics, currency crises, and/or financial sector disruptions. This is not the case today. Until recently, EM debt levels have grown only moderately and have been generally concentrated in the corporate sector, primarily in China. Most EM countries have rebalanced their external accounts since 2013's “taper tantrum” and many are now running basic balance surpluses, with improved external accounts, rising international reserves, and undervalued currencies indicating strong external resilience. Importantly, the EM financial sector is generally well capitalized and regulated.

Fundamentals in the EM corporate sector remain strong, especially when compared to those of developed market credit, with net leverage levels significantly lower in EMs. The effects of the events of 2020 varied by sector.

The vast majority of non-financial issuers in the EM corporate debt universe were flexible enough to reduce cost structures and defer investments to adjust to this year's lower cash flows. EM non-financial corporates experienced their trough in fundamental metrics in the second quarter of the year, followed by a significant rebound in the third quarter led by the industrial and commodity sectors. Although aggregate credit metrics deteriorated in 2020, they appear to be on their way to return to pre-COVID-19 levels in the first half of 2021 given current growth expectations, stringent cost controls, and limited capital expenditures.

For financial corporates, we expect loan growth to accelerate in most major EMs, with the exception of China.

Overall, financing conditions should remain favorable for EM countries and corporates in 2021. Ample global liquidity conditions, low financing costs, and strong support from multilateral and bilateral organizations should limit the scope for defaults.

Still, we also see risks on the horizon, albeit with a low probability of disrupting the secular trend. Hiccups in vaccination rollout programs are a significant risk because they could delay the economic recovery. Conversely, a stronger economic recovery in the United States, triggering a rapid and persistent increase in inflation, could in turn lead the U.S. Federal Reserve (Fed) to start normalizing monetary conditions earlier than expected, potentially creating market instability. In EMs, we could see our estimates of default probabilities prove unrealistic, and a pickup in sovereign credit events could affect investor sentiment negatively. But these risks are not our base-case scenario.

Technical Conditions Supported by Strong Flows and Low Net Debt Supply

Improved investor sentiment and low global rates support investors' search for yield. That, coupled with attractive EM debt valuations, leads us to expect strong flows into EM debt in 2021.

In a world with close to \$17 trillion of government bonds trading with negative interest rates and approximately \$4.3 trillion invested in near-zero-yielding money market funds, higher EM debt yields should continue attracting sizable flows into the asset class.

EM debt has attracted, on average, \$47 billion of dedicated inflows per year over the past 10 years, according to J.P. Morgan, and current conditions—including favorable valuations relative to developed market credit—suggest that inflows could easily exceed that mark in 2021.

“Historically, EM crises have been driven by a combination of unsustainable debt dynamics, currency crises, or financial sector disruptions. This is not the case today.”

Marcelo Assalin, CFA

Bond supply dynamics should also remain supportive. This is particularly true in the hard currency sovereign space, where improving fiscal deficits should result in a decline of gross issuance. J.P. Morgan estimates net financing needs (gross issuance minus amortizations, buybacks, and coupon payments) will be about \$55 billion in 2021, significantly lower than the \$101 billion estimated for 2020. Meanwhile, for EM corporates, gross supply estimates of \$522 billion suggest the highest new issuance year on record, although when adjusting for the expansion of the asset class, yearly issuance is closer to average. In net terms, J.P. Morgan estimates 2021 financing needs of \$73 billion in hard currency corporate credit, similar to 2020 needs.

Hard Currency Valuations Compensate for Risk

Valuations in the EM hard currency sovereign space remain attractive, with spreads above long-term averages. EM hard currency sovereign credit spreads⁶ to U.S. Treasury yields of similar maturity ended 2020 at 352 bps, marginally above the 10-year average.

EM high-yield spreads, the segment of the market where we see most value, ended the year at 608 bps, approximately 55 bps above the 10-year average. The spread differential between high-yield and investment-grade ended 2020 at 455 bps, approximately 105 bps above the 10-year average. EM high-yield spreads also compare favorably to developed market credit, trading approximately 250 bps above U.S. corporate high-yield credit, which is 170 bps above the 10-year average.

Moreover, we believe the risk premia in EM hard currency sovereign credit overcompensate investors for default and loss-given-default risks. Historically, credit defaults have been rare in this space, affecting less than 1% of the investable universe per year on average since 1983, according to Moody's. Furthermore, recovery values have historically been high, with investors recovering approximately 50% of their original investments, on average, during this period.

⁶ Represented by the J.P. Morgan EMBI Global Diversified.

To be sure, 2020 was an exceptional year. A large number of countries decided to either restructure their debt (Argentina and Ecuador) or stop debt services altogether (Belize, Lebanon, Suriname, and Zambia). Although default rates increased materially during the year, recovery values remained about 50% of their initial investments, on average.

Going forward, we expect EM hard currency sovereign default rates to converge back toward their long-term average, supported by favorable financing conditions and strong support from multilateral and bilateral organizations. And if our conservative estimates materialize, the performance of the J.P. Morgan EMBI Global Diversified should be hurt only modestly.

Meanwhile, in the EM hard currency corporate credit space, the availability of financing led to a lower-than-expected default rate of 3.5% and historically high recovery values of 43% in 2020. We expect the default

rate to improve in 2021, falling to 2.5%. Comparatively, U.S. high-yield credit experienced a 6.7% default rate with a 16% recovery rate in 2020, and we expect the default rate to be 3% to 4% in 2021.

Undervalued Currencies Should Drive Flows in Local Currency Sovereign Debt

In the EM local currency sovereign space, attractive valuations should be one of the more important drivers of inflows.

Our longer-term currency valuation metrics show Europe, Middle East, and Africa (EMEA) and Latin American currencies undervalued by approximately 10% on average, while EM foreign exchange (FX) in Asia tends to be fair to slightly overvalued. While we do not expect these valuation imbalances to fully adjust in the near term, they provide additional scope for appreciation before EM policymakers feel the need to lean against inflows through increases in foreign reserves or other measures.

EXHIBIT 11

EM High-Yield Spreads Are Attractive



Source: J.P. Morgan as of December 31, 2020. Shows J.P. Morgan EMBIGD high-yield sovereign spreads.

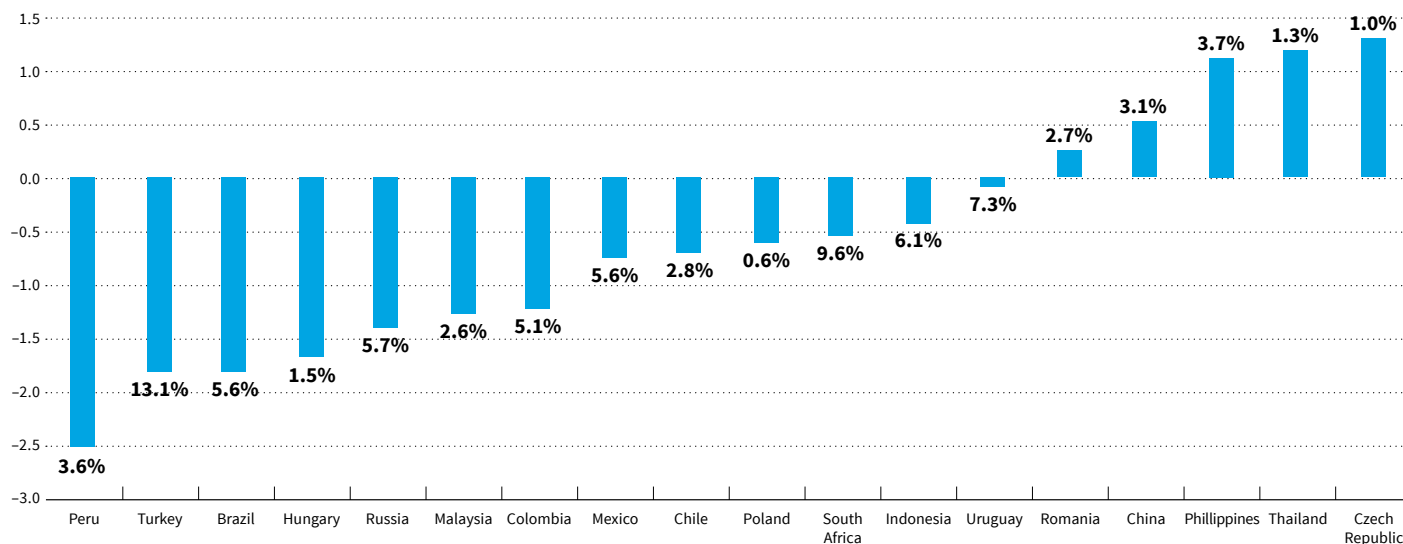
The valuation picture in local rates is more balanced, with the low-beta segment of the J.P. Morgan GBI-EM Global Diversified ending this year with flat, low-yielding curves. Particularly in emerging Europe, real rates have moved further into negative territory on the back of deep monetary policy cuts but surprisingly sticky inflation. On the other hand, the higher-beta markets in Latin America and Africa still offer a considerable degree of excess term premium, while the carry available in frontier markets is also quite high.

On average, real (inflation-adjusted) rates across the J.P. Morgan GBI-EM Global Diversified universe have fallen but remain positive. This trend also reflects improvement in aggregate index credit quality that came with the inclusion of Chinese government bonds earlier this year and the overall increase in market weight in Asia more broadly.

EM local rates really shine, though, when compared with their developed-market counterparts. Countries most closely linked to the Eurozone have seen their yield curves pushed to historical lows. Compared with U.S. Treasuries, the overall J.P. Morgan GBI-EM Global Diversified spread is approximately 4%, which puts it very closely in line with the long-term average of 4.3%. This occurred despite a significant narrowing of the inflation differential between EM countries and the United States.

EXHIBIT 12

EM REER Valuations Most Attractive Among Higher-Yielding Currencies



Sources: Bloomberg, J.P. Morgan, and William Blair estimates, as of December 31, 2020. Bars show 10-year Z-score of real effective exchange rates (REERs). Negative = undervalued, positive = overvalued. Bar labels are local currency sovereign bond curve average yield to maturity.

Important Themes for 2021 and Beyond

As we look ahead, we believe several themes will likely unify the landscape for EM debt.

The Dollar Weakens

The positive global macro backdrop Olga described should be conducive to risk-taking that encourages a rotation away from safe havens such as the U.S. dollar. Consistent with Todd's view, this would lead to a weakening of the dollar, which could be exacerbated by any political dysfunction.

Still, the market consensus is short the U.S. dollar, so there is room for it to recover at the margin as the year progresses. EM currencies remain undervalued on a real effective exchange-rate basis, and we expect some catch-up to the majors as global economic conditions normalize.

“EM currencies remain undervalued on a real effective exchange-rate basis, and we expect some catch-up to the majors as global economic conditions normalize.”

Marcelo Assalin, CFA

U.S.-China Tensions Continue Under a New Geopolitical Order

In the United States, the Biden administration will likely have a more conciliatory approach to China, especially regarding trade. It is likely to adopt a predictable multilateral approach to foreign policy, engaging allies in a more coordinated response to China's rising global influence.

However, we see scope for continued bipartisan backlash against China on issues related to technology, industrial policy, growing militarism, climate change, human rights, and aggressive nationalistic diplomacy.

While a less protectionist stance on trade would benefit the global economy (EM countries in particular) in the near term, a potential ideological divide between China and the Western world may lead over time to a more bipolar, less efficient global economy, as well as heightened geopolitical risks. This, in turn, could have significant implications for EM countries, from supply chain integration to trade to financing, while also providing investors with investment opportunities. These dynamics require constant monitoring.

Oil-Price Uncertainty Continues

Commodity markets experienced significant volatility in 2020, with unprecedented fundamental dislocations affecting oil in particular.

Economic shutdowns reduced demand by more than 20% at its trough. This made higher-cost production uneconomic, and markets did not stabilize until the OPEC+⁷ supply curtailment agreement was enacted in April. Although increased mobility and economic activity has since led to a demand rebound, the market is still supported by lower supply from OPEC+. Current demand appears to be 5 million to 8 million barrels per day lower than in 2019.

With a further demand recovery likely in the second half of 2021, we expect prices to be supported, but they are unlikely to spike, as a result of still-high inventory levels, supply restoration, and uncertainty about how behavioral changes will affect longer-term demand.

With approximately 60% of crude oil refined for transportation use, oil markets will likely continue to be hurt by the growing use of electric vehicles (EVs), as detailed below.

Chinese Demand Drives Metals Markets

While metals markets are diverse, they are unified by a single theme: Chinese demand.

⁷ Many of the largest oil-producing countries in the world are part of a cartel known as the Organization of Petroleum Exporting Countries (OPEC). In 2016, OPEC allied with other top, non-OPEC, oil-exporting nations to form OPEC+.

Copper prices troughed in March and have since risen by more than 50%. That rise in demand was driven, in great part, by China's 14th five-year plan and a global manufacturing rebound, which created conditions for a steady rise in prices. We believe prices will remain elevated given that a supply response will take time.

While the same demand factors affected iron ore, supply played a bigger role, driving prices to their highest levels in the last decade. With limited large projects in the pipeline, recent downgrades to production guidance from a major producer in Brazil have created a market imbalance as we go into 2021, and pricing should remain elevated.

New Demand Factors Transform Commodity Markets

Some commodity markets are also experiencing new demand factors—related to environmental, social, and governance (ESG) concerns—that are likely to be transformative in the medium term.

The popularity of electric vehicles (EVs) is driving substantial demand for lithium, nickel, aluminum, and copper. As we transition to a more sustainable future, these metals will likely play an important role. The rise of EVs will also likely affect electric energy demand and transportation fuel consumption.

Renewable energy sources will provide a growing part of electric generation, but the energy demands of a growing world are high, and natural gas should also see increasing electric demand as a cleaner alternative to coal generation.

Increased Focus on Sustainability

In recent years there has been an increased focus on the application of ESG indicators to EM debt investing.

The concept is not new to us. The analysis of ESG factors has been integrated into our investment process for many years because we believe analyzing ESG factors is critical to properly assessing risks and risk premia in EM debt. Moreover, we find evidence of a strong long-term relationship between ESG factors (particularly governance indicators) with the evaluation of risk premia measured by credit spreads. In the long run, positive changes in

governance indicators tend to lead to positive changes in environmental and social factors and macroeconomic indicators. Therefore, clearly understanding how a country's ESG factors evolve is critical to assessing that country's present and future creditworthiness, which is ultimately reflected in the ability to service its debt.

In addition to being critically important to the fundamental analysis of EM credit, asset owners' rising interest in sustainable assets has also had significant implications for the supply and demand dynamics of EM debt. Strong flows into sustainable investment products have resulted in strong demand from asset managers for ESG (particularly green-labeled bonds). Demand for green-labeled bonds far outstrips supply, creating a positive technical factor for lowering financing costs for countries and companies that have the ability to demonstrate strong compliance with ESG factors. This creates a positive feedback loop as lower borrowing costs incentivize issuers to adopt appropriate ESG factors more readily and quickly. As best practices evolve, countries improve productivity, increase potential growth rates, and enhance their citizens' living conditions. Similarly, economic and business models that are built on a more balanced and sustainable framework both improve working conditions for employees and potentially raise profitability levels.

As the momentum for ESG investing continues to grow, it is clear to us that issuer adherence to these factors will help issuers create value through an improvement in fundamentals that leads to lower borrowing costs and increased investor demand. Our process seeks to identify these opportunities early, assess the associated risks appropriately, and create value on behalf of our client base by recognizing these positive powerful changes.

As the world evolves, we remain flexible to ensure that we are well positioned to continue identifying and investing in this exciting trend on behalf of our clients.



Vivian Lin Thurston, CFA
PORTFOLIO MANAGER, CHINA A-SHARES



Clifford Chi-wai Lau, CFA
PORTFOLIO MANAGER, EM DEBT TEAM

China led the world into the COVID-19 pandemic and was the first country to emerge. As we look ahead to the remainder of 2021, what does the Sleeping Giant have in store? We asked Vivian Lin Thurston, CFA, a portfolio manager on our China A-Shares Growth strategy, and Clifford Chi-wai Lau, CFA, a portfolio manager on our EM debt team.

China was the first country to go into the COVID-19 crisis, and was the first one coming out. How does its recovery look at this point?

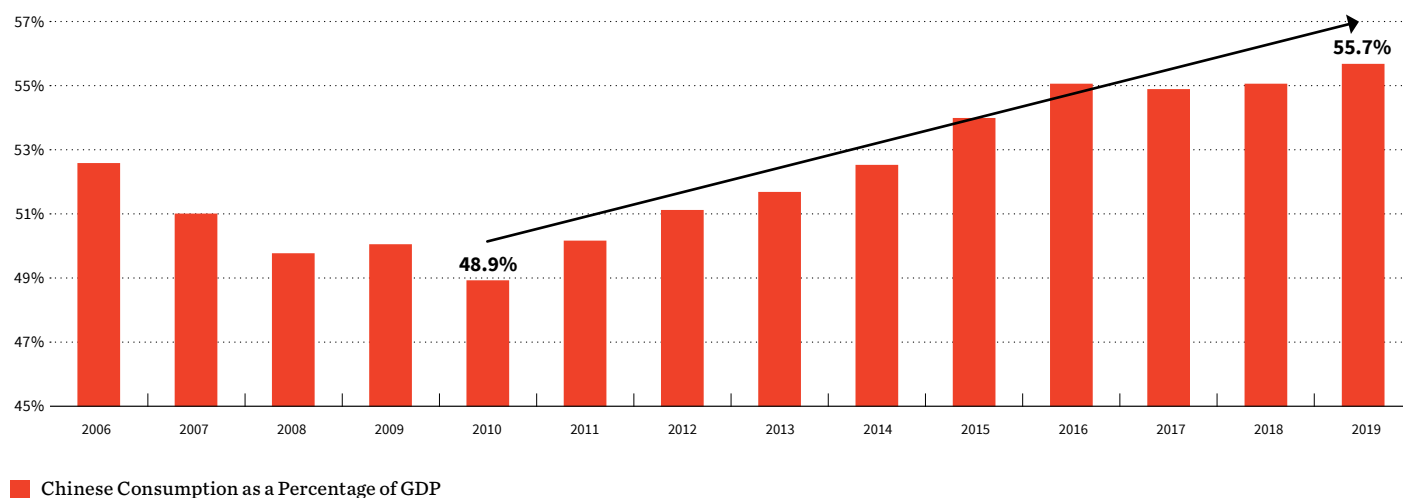
Vivian: Chinese GDP has continued to recover strongly after contracting 6.8% year-over-year in real terms in the first quarter, the height of the pandemic for China. It is the only major economy in the world to post positive GDP growth in 2020 (2.3% in real terms). And that recovery should continue, with current consensus estimates putting 2021 real GDP growth at 8.2%.

Are we seeing any changes as a result of COVID-19?

Clifford: I think COVID-19 has created a stronger impetus for China to make the changes needed to address the past few years of U.S.-China trade frictions. The idea of dual-circulation strategy was invented exactly to cultivate those changes, de-emphasizing globalization and focusing more on domestic and regional growth.

EXHIBIT 13

China Continues to Shift to a Domestic-Consumption-Driven Economy



Sources: World Bank and William Blair, as of December 2020.

How big of a role has fiscal stimulus played in China's recovery? Is it sustainable?

Clifford: Fiscal stimulus has certainly played an important role in China's recovery, though not to the extent we have seen in other countries. Many of China's export competitors have seen massive production disruptions, putting China, which emerged from lockdown much sooner, in a good position to fill the gap. That reduced pressure on the government to stimulate the economy via fiscal spending. The country's fiscal deficit of 4% to 4.5% in 2020 is manageable and below the global norm.

Vivian: The stimulus, in my view, was very sensible because countries facing a disruption event like a pandemic need a jumpstart. The stimulus was also well structured (with around 30% coming from tax and fee reduction, which directly benefits consumers and enterprises, and addresses structural issues at the same time). In addition, that amount of stimulus won't be necessary in 2021, once the economy gets back to normal growth.

Much of the fiscal support was focused on the corporate sector and infrastructure investments, leading manufacturing to outperform services. How do you see the transition from investment to consumption taking place in 2021?

Vivian: Inherently, after pandemics, manufacturing tends to recover sooner and respond to stimulus faster than services given their different natures. It takes longer for consumers to feel safe and comfortable consuming again, while manufacturing resumes immediately. But we have seen services catch up quickly in recent months, and even surpass manufacturing. Since May 2020, the average monthly Caixin China services PMI is up more than 7% year-over-year, ahead of manufacturing PMI, which is up around 4.0%. This indicates the recovery in services consumption is taking hold very nicely.

Clifford: The transition to consumption is already taking place as mobility increases and the servicing sector recovers more. The return of wage growth should also lend great help for domestic consumption in the coming year.

Vivian, what drove Chinese equity performance in 2020, and do you see the same factors continuing in 2021?

Vivian: There were two key drivers of Chinese equity performance in 2020: better-than-expected management of the COVID-19 pandemic, and swift and effective stimulus. Those drivers will likely decline in relevance in 2021. However, quality growth companies (which we seek out) tended to be the bigger beneficiaries of the recovery and stimulus, and outperformed the overall market 2020. We believe that has the potential to continue in 2021.

Clifford, what do you think will drive debt performance in 2021?

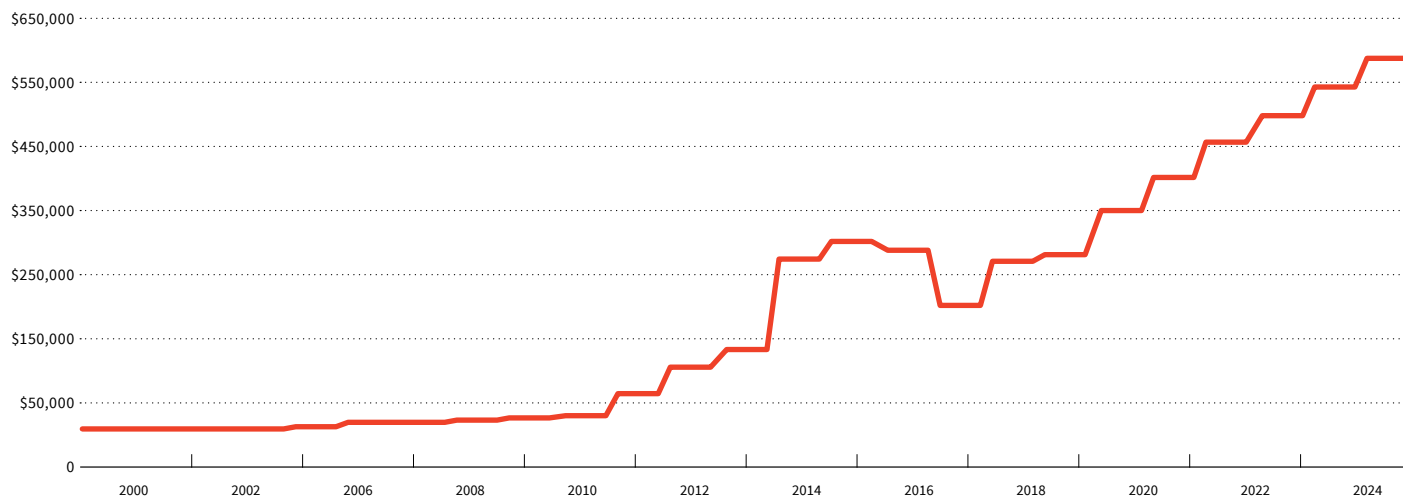
Clifford: The performance of Chinese government bonds in 2021 will likely be a balancing act. We should see continued offshore inflows as local bond markets gain more attention from overseas investors due to a high yield gap (versus other developed markets) on the valuation front and expected index inclusion on the technical front. But this healthy offshore demand will likely be tempered by expected strong Chinese growth and the potential for inflationary risk. This will likely cap rates.

“The performance of Chinese government bonds in 2021 will likely be a balancing act. Healthy offshore demand will likely be tempered by strong growth and the potential for inflationary risk.”

Clifford Chi-wai Lau, CFA

EXHIBIT 14

Chinese Debt Securities Held by Non-Residents (in Millions USD)



Source: Oxford Economics, as of December 2020. Data after 2020 is estimated.

Has your investment case for China equities and debt changed?

Clifford: Not on the government bond side. The Chinese government avoided large-scale monetary easing in 2020 to avoid the massive pent-up risk that inevitably occurs when unwinding becomes necessary. The Chinese government bond market also does not look overvalued, as economic resilience to the pandemic and supply from special issuance of local government bonds have been nudging the bond market to trade softer in 2020, which should preempt the bond market from a big sell-off in 2021.

Vivian: The investment case for Chinese equities hasn't changed; instead, it is enhanced, because the transition to a domestic-consumption-driven economy has accelerated post-COVID-19, which should further benefit the sectors in which we like to invest (including consumer, healthcare, and technology) and the companies we favor (leaders in those sectors). We're also finding more quality growth ideas in the cyclical industries with structural growth drivers, such as smart infrastructure and green-energy-related industries, in light of the stimulus and government's increased support to technological advancement and self-independence.

Clifford, where are you finding opportunities?

Clifford: China's government bond market may surprise on the upside given that valuations do not appear to be overstretched, supply risk could come down, and offshore demand remains strong. With inflationary risk remaining low and food prices likely to normalize further in 2021, there are opportunities in long duration in the cash bond market and curve flattening trades in the derivatives market.

“The investment case for Chinese equities is enhanced, because the transition to a domestic-consumption-driven economy has accelerated post COVID-19.”

Vivian Lin Thurston, CFA

Can the strength of the Chinese yuan renminbi (CNY) continue? Where is the line in the sand?

Clifford: Assuming the U.S.-China relationship normalizes in 2021, growth returns to a medium-term trajectory of 5% to 6%, and offshore investors remain enthusiastic about allocations to Chinese equities and bonds, the CNY could further strengthen. However, a strong currency does not always represent the best interests of the government and the economy (regarding export competitiveness, for example). Plus, with the risk of current accounts retreating back to borderline surplus and onshore diversification flows building up, the CNY may not have all the ingredients it requires for another strong year of outperformance. I think the best case is a strong resistance level of 6.35 to 6.40.

What impact do you think the new U.S. administration will have on the China investment case?

Clifford: At this point my best guess is no further escalation of what is the historically worst relationship between the two countries. But it will take time for both sides to reset the agenda. We should not expect the United States to immediately become reconciliatory given the bipartisan support to the existing approaches on both economic and political fronts.

Vivian: I agree with Clifford that the new U.S. administration does not fundamentally change the U.S. view of China as a strategic competitor. Conversely, the transition to a new U.S. administration should not alter the investment case for China, because China continues to shift to a domestic-consumption-driven economy and reduce its reliance on global trade and foreign technologies. We should see more Chinese companies get better and bigger at a faster pace than before, exhibiting accelerated growth, improved returns, stronger management, and better ESG attributes. From my perspective, this remains a key fundamental support for attractive investment opportunities in China. Perhaps on the margin, the new U.S. administration may lead to more structured and predictable policies toward China, which would benefit the investment case for China in the near term.

“The transition to a new U.S. administration should not alter the investment case for China because China continues to shift to a domestic-consumption-driven economy and reduce its reliance on global trade and foreign technologies.”

Vivian Lin Thurston, CFA

What’s your guess for how 2021 will play out in Chinese equities and debt?

Clifford: For China’s government bonds, my base-case guess would be a benign inflationary backdrop coupled with tailwind for the CNY supporting strong inflows from offshore investors, which would result in rates rallying.

Vivian: I expect earnings growth of Chinese companies—especially quality growth companies—to remain strong in 2021 if current consensus estimates for Chinese GDP growth take hold. The biggest unknown is valuation, especially after two consecutive years of strong bull markets. My base-case prediction is that price-to-earnings (PE) ratios of the markets overall should remain steady at current levels in the mid-teens. With that, we could still see solid appreciation in equities.



Marcelo Assalin, CFA

HEAD OF EM DEBT

We believe EM debt will benefit in 2021 from a favorable combination of factors, including improving global growth and global trade, rising investments, a benign inflationary environment, ample liquidity conditions, low financing costs, and higher commodity prices. Furthermore, stabilizing EM debt fundamentals, improving technical conditions, and still-attractive valuations should support the performance of the asset class in 2021.



Olga Bitel

GLOBAL STRATEGIST

The 2021 global economic recovery, propelled by domestic demand growth, is likely to be the strongest in several decades.



Clifford Chi-wai Lau, CFA

PORTFOLIO MANAGER, EM DEBT

Performance of the Chinese government bond market in 2021 will likely be a tug-of-war between persistent investor inflows (leading to lower yields) and a strong economic rebound (leading to higher yields). But we think the valuation of the Chinese government bond market is attractive and believe the first scenario—investor inflows driving market outperformance—will prevail.



Todd McClone, CFA

PORTFOLIO MANAGER, EM EQUITIES

As we head into 2021, we are more bullish on EM equities than at any point in the past decade. Tailwinds from a weakening U.S. dollar and valuations that do not fully reflect today's growth orientation in EMs are just two of the reasons for this optimism. We believe there are ample opportunities to find leading companies capable of sustainable value creation, but selectivity is paramount.



Vivian Lin Thurston, CFA

PORTFOLIO MANAGER, CHINA A-SHARES

We remain positive about the Chinese economy and Chinese equities, which are supported by an accelerated shift to domestic consumption and increased emphasis on technological advancement and independence.

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