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Emerging Markets: A Bright Spot for Investors?

While high inflation, monetary policy tightening, and global recession risks could cloud the first quarter of 2023, we expect market conditions to improve in the second quarter as inflationary pressures dissipate, particularly in the United States. In this environment, emerging markets (EMs) could be a bright spot for investors. The bear market in EM equities is long in the tooth in terms of time, price, and multiples, and EM debt appears attractively valued. On the following pages, our portfolio managers share their thoughts about what to expect in 2023.

December 2022

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Emerging Markets: A Bright Spot for Investors?

Stephanie G. Braming, CFA, Partner

We began 2022 with an increasing inflationary impulse and expectations of developed-market central-bank tightening, which cast a pall over risk assets. This chilling effect was amplified in February, when Russia invaded Ukraine—a move that had substantive implications for energy and food prices and security. These increased geopolitical tensions and persistently high inflation caused an abrupt shift in market leadership and were significant headwinds to economic growth and market performance overall.

There was no place to hide for investors, with risk assets down substantially in 2022. Even fixed income, which is meant to serve as ballast for portfolios amid uncertainty, was down. As of early December 2022, EM equities were down approximately 18%; EM local-currency bonds were down about 17%; developed-market equities were down more than 14%; and global investment-grade bonds were down about 15%.[1]

> "It is at the height of such 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."

Stephanie G. Braming, CFA, Partner, Global Head of Investment Management

As we turn to 2023, central banks in developed markets are seemingly nearing the end of an aggressive tightening cycle, albeit with considerable investor concerns about a recession—or at best lackluster growth, which has global implications. In comparison, developing economies are generally further along in their monetary cycles, although there is variation depending on country. China is one example. Given the heft of the Chinese economy globally, as macroeconomic policies begin to ease and the country makes strides to reopen its economy, there are substantive implications for domestic supply and demand across industries and economies.

1 Index representation is as follows: EM equities, MSCI EM Investable Market Index (IMI); EM local-currency bonds, J.P. Morgan EMBI Global Diversified; global investment-grade bonds, Bloomberg Barclays Global Aggregate Index; developed-market equities, MSCI World Index.

More broadly, EM corporate earnings expectations have fallen substantially, and equity-market valuations have already derated, which may bode well for future equity performance. EM debt is also attractively valued, in our opinion, on both an absolute and relative basis. Sovereign high-yield spreads are particularly attractive relative to U.S. high yield, while in the distressed credit space we believe that prices underestimate restructuring and recovery values and overestimate negative credit events.

While we do not know with certainty the trajectory of global growth and risk assets in the coming 12 months, we believe the most sizable headwinds could moderate as the year progresses. Regardless, it is at the height of such 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.

Best,

Stephanie G. Braming, CFA, Partner
GLOBAL HEAD OF INVESTMENT MANAGEMENT

Olga Bitel, Partner
GLOBAL STRATEGIST

As we look out to 2023, the U.S. Federal Reserve (Fed) has reached its "neutral" monetary policy stance, and the European Central Bank (ECB) is not far behind. Europe has moved fast to secure fossil fuel supply away from Russia, even at higher—but stable—prices. U.S. consumer price inflation is moderating. Asynchronous reopening, with China's consumers set to rejoin the post-COVID economy, is likely to mean more inflation volatility next year. Even so, if we can avoid geopolitical pressures escalating meaningfully from current levels (which are already uncomfortably high), can the world's biggest demand centers pivot toward a multiyear cycle of modest but sustainable growth? If so, equities may not be a bad place to be in 2023.

Slowflation—economic slowdown combined with rapidly rising inflation fueled by energy supply disruptions—proved a tough backdrop for financial markets in 2022. In the past two decades, only 2008 recorded worse returns for equities, while fixed-income investors have not had to contend with the likes of the year's declines even in the depths of the Global Financial Crisis (GFC). On an absolute basis, both equities and fixed income were down about 14% to 18%.

"Economic observers do not expect major economies to regain pre-COVID levels of output next year."

Olga Bitel, Partner

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.

The post-COVID economic transition back to something "more normal" proved volatile and is complicated further by rising geopolitical conflicts. None of the major economic powers have surpassed their pre-COVID output trajectories. The U.S. economy is the closest: by the end of the third quarter of 2022, its output was about 1.5% lower than it might have been in the absence of the pandemic. Euro area and Japanese output is more than 3.5% lower. And in larger EM economies, such as China, Brazil, and Indonesia, output ranges from about 5% to 7% lower. Latest expectations, as embedded in consensus estimates, suggest that economic observers do not expect major economies to regain pre-COVID levels of output next year.

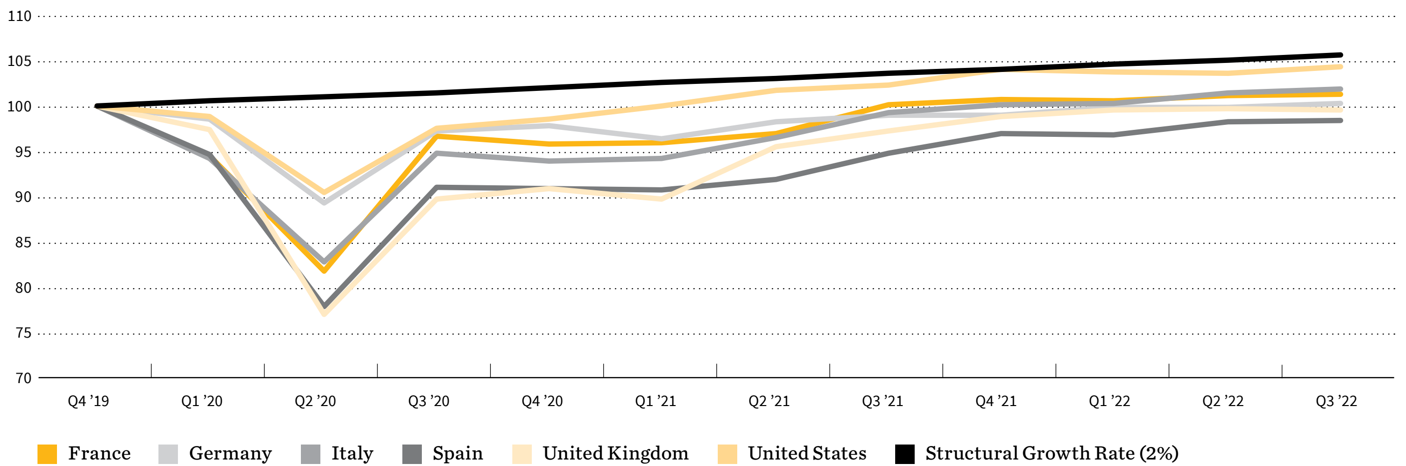
Energy Prices Should Ease

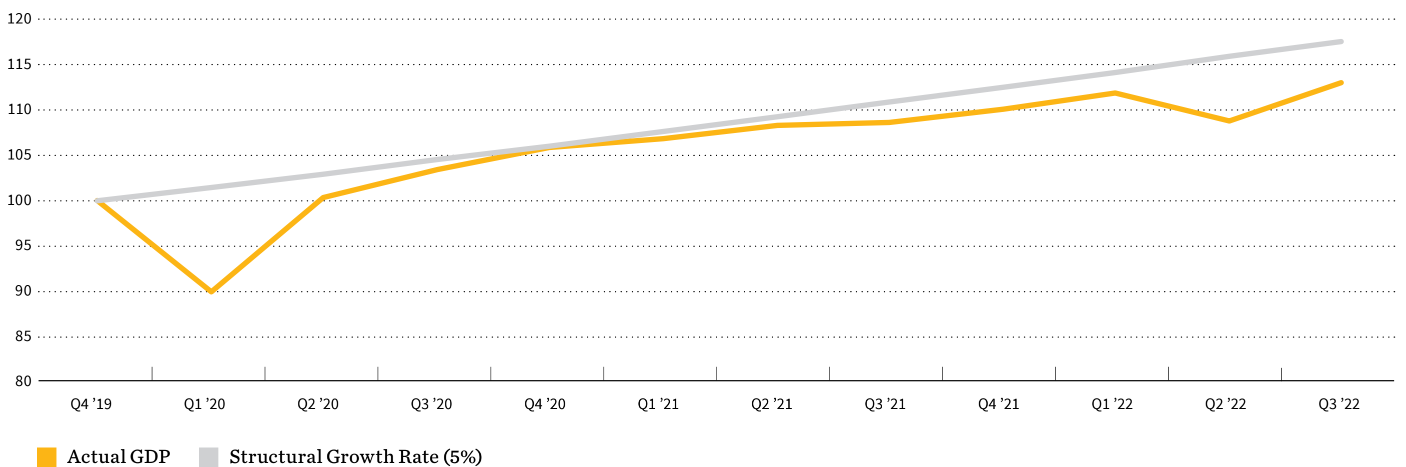
Open warfare between Russia and Ukraine amplified tensions between the world's largest consumers of fossil fuel energy and its producers. Although the world has plenty of oil and gas, natural gas spot prices in Europe spiked to about seven times higher in 2022 compared to just one year prior. No economy can adjust to a cost shock of this magnitude in the space of a few quarters. Indeed, purchasing managers indices were already suggesting in the autumn of 2022 that the European economy is likely to enter a recession.

EXHIBIT 1

Actual Output Levels for Major Economies

No major economy surpassed its pre-COVID output trajectory in 2022. The charts below show gross domestic product (GDP) compared to structural growth rate (a 2% annual growth assumption for the United States and Europe, and 5% for China).





Sources: Macrobond and William Blair analysis, as of November 2022. Q4 2019 = 100.

"Today's high prices may well lead to tomorrow's low prices, and tomorrow may arrive sooner than many feared."

Olga Bitel, Partner

Although the outlook for fossil fuel energy supply in Europe remains unusually volatile, the risks are balanced. The Organization of the Petroleum Exporting Countries (OPEC) sought to limit crude supply by cutting daily production by 2 million barrels, just as Europe and the United States are implementing the next round of sanctions on Russian barrels (in part by barring Western firms from insuring Russian cargo).

Simultaneously, Germany has all but replaced importing capacity equivalent to its gas supply from the Nord Stream I pipeline. The government chartered five so-called floating storage and regasification units (FSRUs), which will be able to process 25 billion cubic meters of gas per year, roughly equivalent to half the capacity of the Nord Stream I pipeline. Meanwhile, the country's first liquified natural gas (LNG) import terminal, in the port of Wilhelmshaven, is expected to be completed in early 2023—commissioned and built in less than a year.

A glut of LNG-carrying vessels destined for Europe, together with rapidly increasing capacity to process this supply, suggests that the meteoric rise of LNG prices and its dramatic drag on European inflation may be a story left in 2022. What is more, within a few years, Qatar and the United States should expand their respective LNG export capacity, and Europe should build enough proper import terminals. Today's high prices may well lead to tomorrow's low prices, and tomorrow may arrive sooner than many feared.

But Central Banks Can't Wait

Yet the world's leading central banks have signaled that they will not wait. Perhaps one of the biggest surprises in 2022 was the speed with which the Fed moved its main policy rate toward a neutral stance. Assuming annual domestic inflation returns to a 2% to 3% range by the end of 2023, a neutral policy rate—where real rate is around 1.5%—is somewhere in the neighborhood of 3.5% to 4.5%. The federal funds rate—the Fed's main policy instrument—currently stands at 4.50%. Further rate increases tilt the U.S. monetary-policy stance toward restrictive.

When the Fed intends to stop lifting its benchmark rate is not only a matter of domestic economic concern. Rapidly rising interest rates impact global liquidity conditions. We have already seen macroeconomic stress in Sri Lanka, a near credit event of sorts in the United Kingdom, and a blowup in the cryptocurrency markets. So far, these stresses have not spilled into broader markets, but interest-rate increases impact financial conditions non-linearly. Debt payments of all sorts, and especially housing payments the world over, are linked directly to prevailing interest rates; when these rise rapidly, the possibility of financial and economic stress rises, too.

2023 Growth Depends on Inflation

Asynchronous reopening is set to bedevil the global economy for at least another year. We believe economic growth in the United States and Europe will depend largely on how quickly inflation abates. This, in turn, depends on when and how China reopens its economy. A full or significant reopening in China is likely to impact tourism flows in Asia and further afield, especially in Europe and North America. This should buoy local domestic demand and may fuel services-related inflation in the affected jurisdictions. It should also support current accounts and local currencies from Thailand and Japan all the way to Europe.

China's reopening is likely to make inflation readings in the United States and Europe more volatile and thereby complicate the Fed's job of cooling domestic demand. In the absence of Chinese consumers, there are mounting reasons to believe that annual inflation of 3% toward the end of next year is attainable. Since the second half of 2022, housing and rental prices, continued improvement in supply chains, and domestic wage gains all point to accelerating moderation in annual inflation.

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> **Olga Bitel, Partner**

Let's start with housing. The price of shelter accounts for nearly 40% of the Consumer Price Index (CPI); it is thus the single biggest—and stickiest—component of the U.S. basket of prices used to calculate national inflation. As 30-year fixed-rate mortgage rates passed 5% and then 6%, housing activity decelerated precipitously: sales of new builds are at the 2017-2019 average, while sales of existing homes are at decade lows and still falling. Where transactions lead, prices follow: annual housing price inflation peaked in May 2022 and has been falling consistently since then. Private-sector measures of rentals point to outright price declines in the monthly data. Shelter inflation is notoriously difficult to convert into monthly CPI estimates, and we believe it will remain a drag on overall inflation for months to come, but broad housing market activity during much of 2022 suggests that we will see well-behaved shelter prices before the end of 2023.

Goods prices reversed two decades of outright declines and grew strongly in the pandemic years. Supply-chain disruption proved difficult to remedy quickly, but as we enter 2023, spot price of a typical 40-foot shipping container is down some 80% from peak, purchasing manager surveys point to input price normalization, and suppliers' delivery times are within reach of 2018-2019 averages. Annual goods price inflation peaked last February and has been declining steadily ever since.

Lower-value-add, high-touch services do not see much in the way of productivity gains. It is difficult—and maybe even undesirable—to increase the speed of a haircut or improve the efficiency of waitstaff beyond a certain point. For this reason, the Fed worries about wage inflation in services feeding directly into consumer price inflation. Yet, in the second half of 2022, services wage gains have decelerated from four-decade highs.

So, if the Fed reaches its neutral monetary policy stance and the ECB is not far behind; if fossil fuel supply away from Russia is secured, even at higher (but stable) prices; if consumer price inflation is moderating fast and the Fed does not overtighten into a major credit event somewhere; and crucially, if geopolitical pressures do not escalate meaningfully from their current uncomfortably high levels—then the world's biggest demand centers may be able to pivot toward modest growth. If so, risk assets may not be a bad place to be in 2023.

EM Equity | Positioned for a Rebound?

Todd McClone, CFA, Partner
PORTFOLIO MANAGER, EM EQUITIES

In a bleak year for equity investors globally, several EMs have been among the best performers on a relative basis. Although the economic and monetary pictures vary dramatically among EMs, developing economies broadly are further ahead than developed markets in their monetary tightening and equity derating cycles. This cyclical positioning and the resilient macroeconomic fundamentals of EMs lead us to believe that EMs are better positioned for equity gains in 2023 than developed economies.

We examine key economic and investment themes facing EM investors and highlight several important regions. We also look at the long-term trends we believe are creating an increasingly attractive EM investment opportunity set for equity investors.

Five Themes Shaping the EM Equity Landscape

Many of the core issues confronting developed markets—inflation, monetary tightening, equity-market derating, and downward earnings adjustments—are playing out differently in EMs. In many cases, EMs are further along in working through these issues, creating optimism for investors.

Inflation

EM economies, in general, have less of an inflation problem than developed economies. This gives EM central banks more policy options, including restimulating into a global downturn.

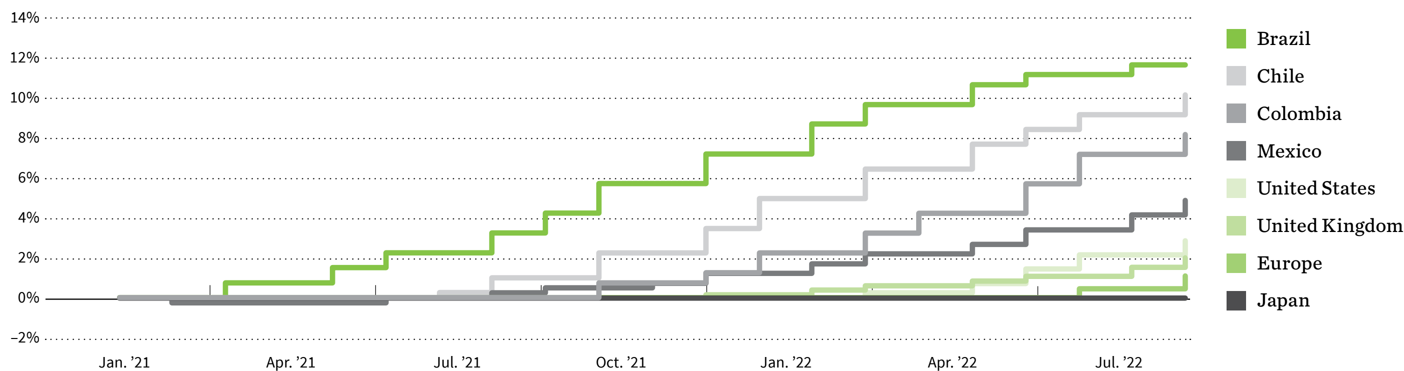
Brazil, Mexico, and other Latin American countries began raising interest rates well before the United States and Europe. Brazil moved furthest; its policy rate was 13.75% as of October 2022, which explains why the Brazilian real has been the top-performing currency against the U.S. dollar in 2022, up 7.3% through November 2022. Inflation rates in these countries remain moderate to high but have started to trend down. All of these countries exhibit positive real interest rates, unlike the United States and Europe.

Inflation in Asia is relatively modest. China, in particular, is experiencing inflation well below the EM average, giving Chinese policymakers room to become even more stimulatory in 2023.

EXHIBIT 2

EM Countries Are Far Ahead of the United States in Raising Interest Rates

By starting their rate-hiking cycles well ahead of developed markets, several EMs appear better positioned to manage inflation and provide leadership in equity markets in 2023.



Source: Bloomberg and William Blair, as of September 30, 2022.

Valuations and Earnings Estimates

Equities have already derated in many EMs, suggesting that these countries are now in the late stages of a bear market. They seem now better positioned for a rebound, especially given that we expect interest-rates cuts and other stimulative measures to come in 2023.

Many metrics suggest that the EM bear market is getting long in the tooth. Historically, the average EM bear market has lasted 263 days and produced a 38.2% drawdown, according to Morgan Stanley. The current EM bear market, which began in February 2021 when China tech stocks peaked, is nearly 600 days old, and the MSCI EM Index was down 40% heading into October 2022. EM valuations have derated 39% versus an average of 34% for EM bear markets, and EM earnings estimates have been downgraded sharply in 2022, in contrast to the United States and Europe, where the negative earnings revision process has barely begun.

Given the combination of price declines, the derating of valuation multiples, and earnings estimate cuts, we believe that EM equity markets have already readjusted and are better positioned for recovery than developed markets. Some select EM equity markets have already been among the top performers globally in 2022 through November, among them Brazil (+17.64%), Mexico (+5.12%), and India (–2.62%), according to Bloomberg.

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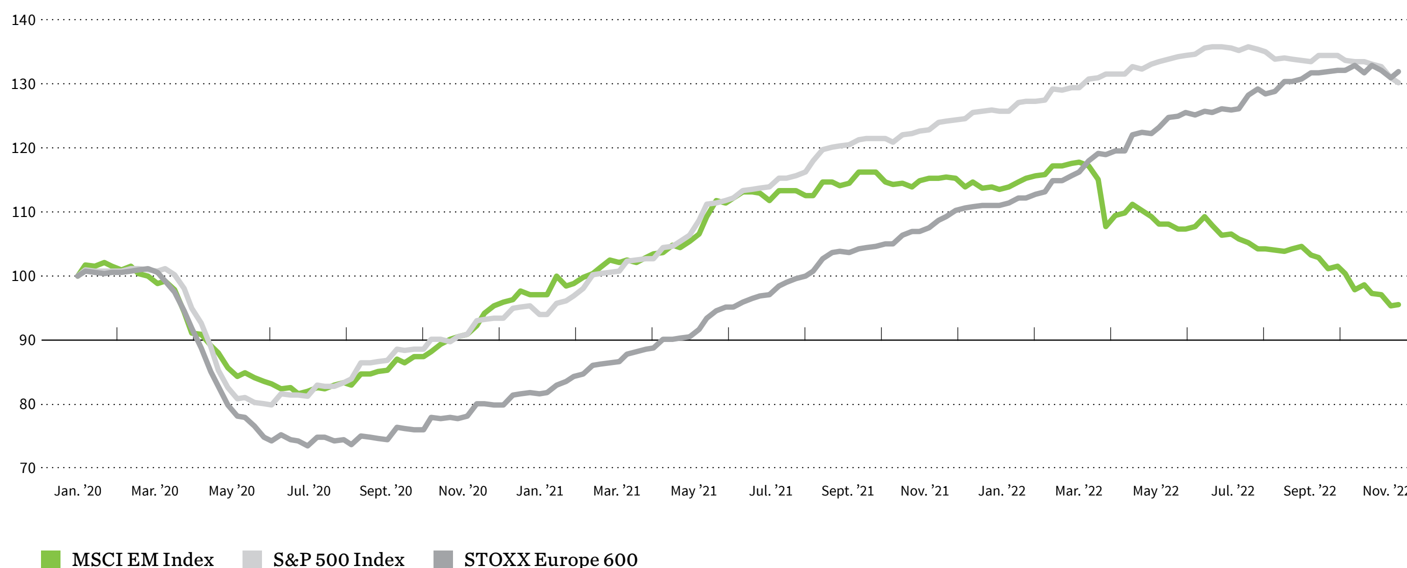
Todd McClone, CFA, Partner

EXHIBIT 3

EM Earnings Estimates Are Ahead in Their Readjustment Phase

Analysts began downgrading earnings estimates for EM companies in mid-2021, and this process is still in its early phases in the United States and Europe.



Sources: MSCI, IBES, and Morgan Stanley Research, as of November 2022. 12-month forward earnings per share (EPS) is rebased to 100 in January 2020. Indices are unmanaged and do not incur fees or expenses. A direct investment in an unmanaged index is not possible.

Currency Exchange Rates

EM equities typically underperform when the U.S. dollar is strong. We believe that the U.S. dollar is likely close to peaking, which could be a bullish signal for EM equities.

As an asset class, the relative performance of EMs tends to be negatively correlated with a strong U.S. dollar. As the dollar rises, EM equities tend to underperform because their currencies come under pressure, and these countries must raise interest rates to protect the exchange rate. Once the dollar peaks, that pressure abates—monetary policy can loosen, and equity markets typically rerate higher.

We expect the U.S. dollar to peak, which would likely turn a headwind into a tailwind for EM equities in 2023.

Style Rotation

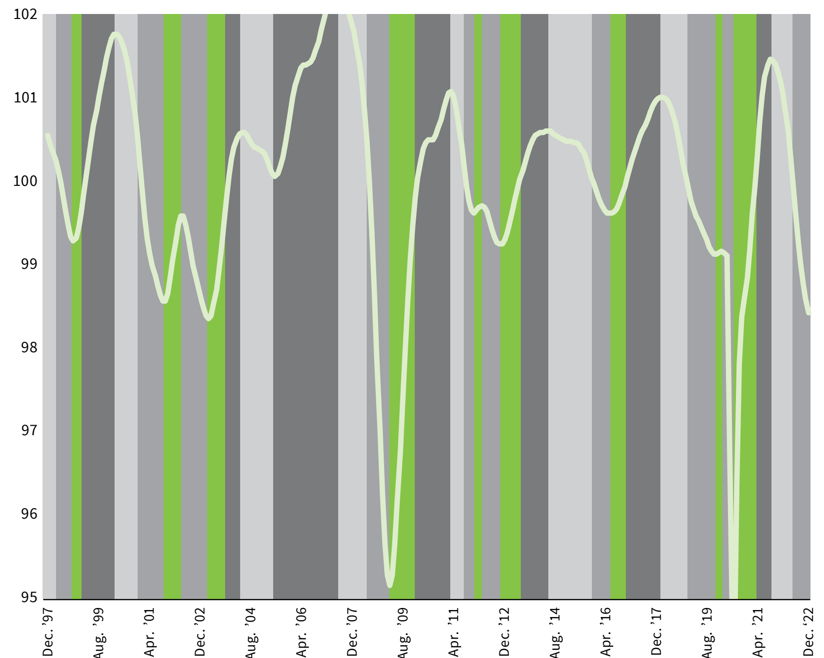
There has been a recent shift in leadership among EM style factors, with the outperformance of value-oriented equities starting to abate somewhat.

EM value stocks outperformed in the first half of 2022, as is typical when interest rates rise. Since then, the global economic regime has switched from “slowdown” to “downturn,” as defined by the Organisation for Economic Co-operation and Development (OECD) composite leading

EXHIBIT 4

Style Leadership Shifted in Mid-2022

While value-oriented EM equities outperformed for most of 2022, value’s leadership started to weaken later in the year, as is often seen in periods of slowing or low economic growth.



Recovery | Slowdown | Downturn | Expansion | OECD CLI Total

Sources: MSCI and William Blair, as of October 2022. **Past performance is not indicative of future returns.** Fundamental model performance is provided for illustrative purposes only. Information is based on William Blair’s proprietary quantitative models and does not in any way relate to actual results of any account or strategy. Coefficient represents the Spearman ranked correlation between factor score and future performance. A positive IC suggests that a given factor has exhibited predictive power of future performance during the backtest period.

indicator, and other equity factors have taken leadership—namely quality, earnings trend, and momentum.

In an economic downturn, higher-growth EM stocks that have derated and have strong and stable earnings could outperform, in our opinion. Strong earnings are usually rewarded in a downturn because most companies' earnings growth tends to weaken and/or decline as the economic downturn progresses. Higher-quality companies generally do better under financial tightening because they have either (a) easier access to credit or (b) stronger balance sheets and are generally self funded. Low-volatility stocks are at a premium because they are more defensive and less exposed to cyclicality.

EMs of Interest

China

The growth outlook remains muted and cloudy while zero-COVID policies persist. But the completion of the recent National Congress could provide clarity and raise the possibility of more stimulative monetary and fiscal policies as well as a roadmap out of zero-COVID policies.

Chinese equities have been among the worst performers in 2022, and valuations are at a 15-year low. The government's zero-COVID policy is much to blame, creating uncertainty and pessimism and causing consumer confidence to collapse. The government has provided some stimulus but not enough to offset the impact of zero-COVID. Other concerns include the government's targeting of technology companies and its reticence to address the property market issues, coupled with uncertainty as to the economic impact of the country's Common Prosperity doctrine, which is intended to promote equality.

Now that the 20th National Congress of the Chinese Communist Party wrapped up in late October 2022, party leadership may have a freer hand to focus on economic growth, setting the stage for China to relax zero-COVID policies and increase economic stimulus. As this occurs, we believe the Chinese equity market could be set to outperform.

As a result, we raised our weighting in China in late 2022. We are still underweight China but less so than we were previously. Valuations appear attractive, and we are cautiously positive on possible policy changes ahead and early signs of a roadmap out of zero-COVID, more definitive support for the property market, and the economy in general.

> "Despite its valuation premium versus other EMs, we are overweight India."
>
> **Todd McClone, CFA, Partner**

India

The country enjoys very favorable fundamentals, including strong economic growth, a pro-business government, and a large and growing middle class of more than 300 million people. But we recognize that some of these are factored into the Indian equity market's valuation premium.

Despite its valuation premium versus other EMs, we are overweight India. In our view, its positives include favorable demographics, a well-educated population, strong economic growth, a pro-business government, and an English legal system and a relatively high degree of visibility into how monetary and fiscal policies are executed.

We believe rising per-capita income and a growing middle class are persistent structural tailwinds for Indian equity markets. When per-capita income crosses the $2,000 mark, developing countries typically see an explosion of demand for consumer goods and services, from household appliances to mortgage loans. India is at that inflection point—over 40% of the population is already there, and this is expected to rise to 60% by 2025, according to Spark Capital.

Inflows from domestic retail investors also act to underpin Indian equity markets. Systematic investment plans (SIPs) that automatically invest in mutual funds have become wildly popular. The share of equities in household savings is at an all-time high of around 5%, having been as low as 2.5% only a few years ago—but it still has a long way to grow before approaching the levels of more developed countries.

In India, we are constructive on financials and housing-related stocks. In the financial sector, penetration levels of financial products are extremely low and set to rise along with the emerging middle class. In addition, high-quality private-sector banks in which we invest have the potential to take a huge amount of market share from public-sector banks that still control nearly 70% of the Indian financial sector. In housing, affordability is at a 10-year high, and the market is booming, which we believe are positive tailwinds for our Indian financial and property-development companies.

Other EMs to Watch

Brazil

Brazil raised interest rates sharply in 2021 to counter high inflation. These moves drastically hurt equity markets in 2021 but put Brazil much further ahead in the monetary cycle than most countries. Brazil has been a top-performing equity market this year (as of November 2022). We expect Brazil to be one of the first countries globally to begin a rate-cutting cycle, perhaps early in 2023. Once this happens, we expect investors to take a positive view of forward growth, corporate fundamentals to improve, and valuations to rise.

Indonesia

Indonesia has an attractive combination of strong GDP growth, moderate inflation, and gently rising interest rates combined with a strong demographic profile and an emerging middle class. We believe this provides a long runway for secular growth. Indonesia is also a beneficiary of commodity-price increases and a reform-minded government. In our view, corporate fundamentals are predominantly good and valuations appear reasonable, and the economy is still on a strong growth trajectory. We are overweight Indonesia, particularly financials.

> "We expect Brazil to be one of the first countries globally to begin a rate-cutting cycle, perhaps early in 2023."

Todd McClone, CFA, Partner

Saudi Arabia

Saudi Arabia now represents more than 4% of the MSCI EM Index. It has in some ways filled the gap that Russia left when it was removed from the index after invading Ukraine. Saudi Arabia's market is active with numerous initial public offerings (IPOs) and a plethora of companies benefiting from strong oil prices and the transformation of the country's economy. The economy is evolving rapidly; women are increasingly in the workforce, more social events are allowed, and tourism is encouraged.

Rich and Growing Opportunity Set for Quality Growth Investors

EM companies punch well above their weight globally with regard to sustainable value creation, as measured by return on capital employed. As of December 2021, EMs represented slightly more than 10% of the MSCI ACWI IMI by market cap but accounted for about 40% of the global top quintile of quality growth companies as defined by sustainable value creation, up from about 15% in 2002. By contrast, the United States represented about 60% of the index but less than roughly 30% of the top value quintile.

Many of these quality growth companies are in China and India, which have rising per-capita income, a fundamental driver of sustainable value creation. Opportunities to find quality in these countries are abundant. For example, about 40% of China A-share companies—more than 1,200 companies in total—exhibit higher quality, based on return on equity (ROE), than the average of the broader EM universe. In India, 20% of companies have higher ROE than the EM average, which represents around 400 companies.

Sectors to Watch

We identify two specific sector opportunities going into 2023 and beyond:

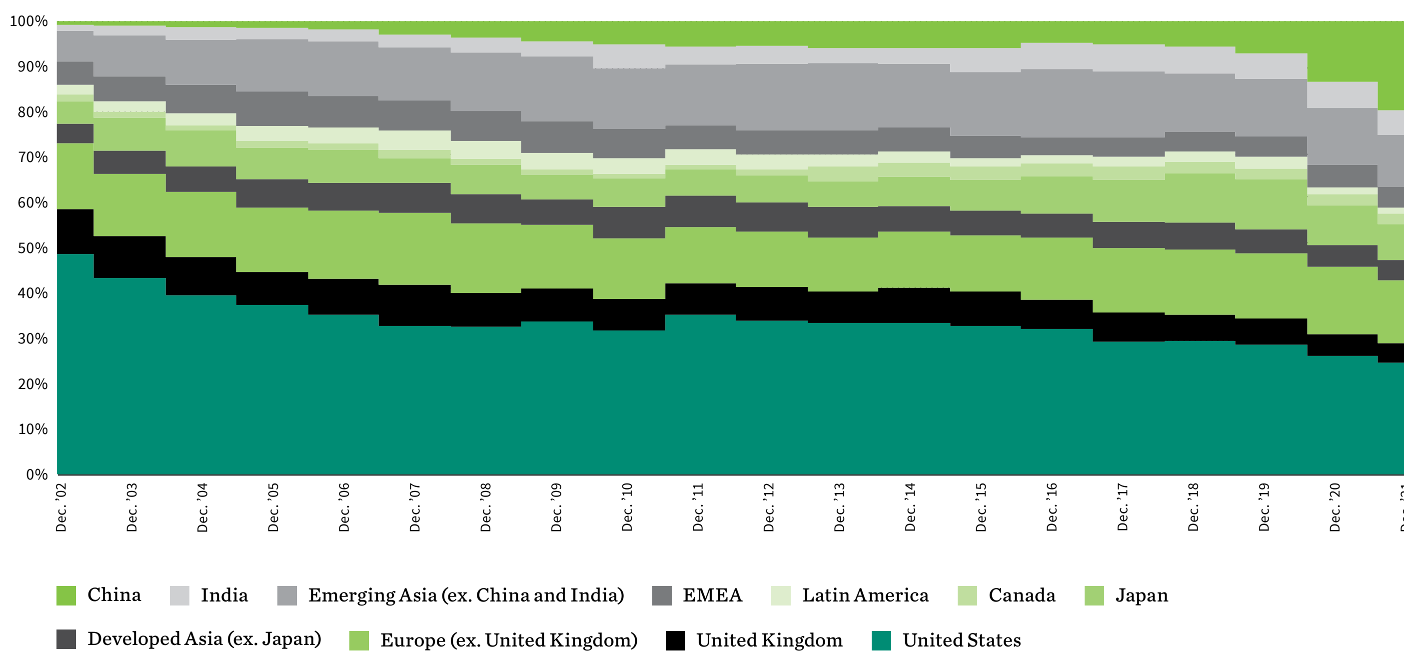
Technology

We believe the semiconductor industry is in the midst of a cyclical slowdown, but the long-term, secular growth story remains very attractive. While we have tactically reduced our technology hardware exposure, we will look to increase positions as opportunities arise in 2023.

EXHIBIT 5

EM Continues Growing Its Share of Sustainable Value Creation

For investors focused on finding companies that generate strong returns on capital and exhibit other quality characteristics, EMs continue to represent a growing share of the top companies in terms of sustainable value creation.



Sources: MSCI and William Blair, as of December 2021. Countries are those in the MSCI EM IMI. Sustainable value creation is an aggregate measure of corporate returns on capital. Several quantitative financial statement factors are used to measure total corporate profit/cash flow relative to total invested capital, corporate equity profit/cash flow relative to invested equity capital, as well as operating efficiency.

Healthcare

Healthcare expenditure in developing countries ties into the growth dynamic of an emerging middle class. Healthcare spending in EM countries is well below developed country averages, both per capita and as a percentage of GDP. We believe this is another secular growth path that will track income growth, and we are positioning ourselves accordingly.

Green Economy

We believe the world's transition to a low-carbon economy offers strong growth opportunities for years to come. Decreasing cost curves, increasing innovation, and policy/societal support are some of the factors boosting adoption and growth. Many EM companies are well positioned for this transition; some are even global leaders in the space, especially in solar and electric vehicle (EV) batteries. We believe growth momentum and investments could accelerate in the coming years as the world seeks to reach net-zero targets. We have increased exposure to renewable energy and energy storage and their supply chains across our portfolios.

EM Debt | Clearer Skies Ahead?

Marcelo Assalin, CFA, Partner
HEAD OF EM DEBT

While we believe high inflation and monetary policy tightening have the potential to cloud the beginning of 2023, we expect market conditions to improve as we move through the year and inflationary pressures dissipate, particularly in the United States.

There, we believe a combination of declining food and energy prices, improving global supply-chain dynamics, a still strong U.S. dollar, and softening economic conditions should drive inflation lower. Declining inflation, in turn, should allow for a less aggressive rate-hiking cycle, leading to lower U.S. Treasury yields and reduced risk of a sharp economic contraction.

Despite a better market environment in 2023, we believe global growth is likely to be lackluster. While there is the risk of a recession in the United States, the Fed should be able to engineer a soft landing. Economic conditions could be more challenging in Europe, however, as the continent faces an unprecedented energy crisis. In China, we believe economic conditions should improve after a very weak 2022, but COVID-related measures and uncertainty in the property sector could limit the potential for a stronger economic recovery in the near term.

While we anticipate softer economic conditions in EMs more broadly, we believe economic growth in these countries could come in around 3.6% in 2023 (approximately 2.5 percentage points higher than the International Monetary Fund's [IMF's] projected growth for advanced economies) thanks to improved economic conditions in China and still-supportive commodity prices.

Against this backdrop, let's examine some of the factors that are shaping the opportunity set and risks in EM debt as we head into 2023.

Chinese Growth Set to Improve

Economic growth was lackluster in China in 2022 due to strict zero-COVID policies and prolonged stress in the real-estate sector, but Chinese policymakers have started to address these challenges by easing macroeconomic policies.

For example, in 2022 China lowered medium-term lending facility and prime loan rates; relaxed the floor on mortgage rates for first-time homebuyers; and encouraged state-owned banks to increase financing to property developers. It also introduced tax cuts and rebates to encourage higher consumption.

We therefore see potential for improving economic activity in 2023. However, we do not believe growth will rebound to pre-pandemic levels, because China is likely to lift its zero-COVID policy very gradually given low vaccination rates among the elderly and the potential for new strains of the virus to emerge. Challenges are also likely to remain in the Chinese property sector, given subdued housing demand and private developer debt restructuring.

Supply and Demand Dynamics Support Oil Prices

As we write this outlook, West Texas Intermediate (WTI) crude futures are trading around $75 per barrel as investors weigh the impact of tight supply against an uninspiring outlook for demand. In our view, however, the balance of demand and supply factors should support oil prices in 2023.

On the demand side, oil prices reached multiyear highs in the first half of 2022, thanks in part to the war in Ukraine, but fell in the second half of the year due to lockdowns in China and global growth concerns. While there is certainly reason to be concerned about demand growth in 2023, particularly in developed markets, we believe demand from EMs, particularly China, could rebound, supporting prices.

On the supply side, several factors are likely at play. In the United States, oil-supply growth has stagnated recently, but we believe it will likely continue its general upward momentum, thanks in part to the likelihood of more releases from the strategic petroleum reserve.

Outside the United States, we do not believe we will see significant supply growth. While Russian oil seems to have found buyers, albeit at heavy discounts, the effect of sanctions on supply will be more visible in 2023. At the same time, the Organization of the Petroleum Exporting Countries Plus (OPEC+) has decided to curtail supply at higher prices and lower inventory levels than past interventions. This suggests we will see a higher floor for prices going forward.

Structural and Cyclical Forces Underpin Metal Prices

Metal prices were weaker in 2022 as the complex faced looming recession risks, sluggish demand, and U.S. dollar strength.

In most of the world, demand was subdued by macroeconomic uncertainty. In China, however, the property-market downturn and zero-COVID policies weakened demand—although some metals (such as copper) managed to offset the demand loss with demand stemming from green energy and exports.

In 2023, we expect structural and cyclical forces to underpin prices. On the structural side, continued investment in the energy transition should support demand for a number of metals, including copper, aluminum, and nickel. On the cyclical side, improved economic conditions in China and elevated market tightness should help metal prices show signs of recovery. Inventories are at multiyear lows and we believe cost pressures will remain, affecting some metals (such as aluminum and zinc) more than others.

Resilient Economic Activity Supports Fiscal and Debt Dynamics

Resilient economic activity could continue to support fiscal dynamics across EMs. We believe the overall fiscal deficit in 2023 will be approximately −5.8% of EM GDP, marginally lower than last year's number. Basic balances (current account balances plus net foreign direct investments) should remain healthy at 1.3% of EM GDP, partly reflecting recent terms-of-trade gains enabled by higher commodity prices. Stable fiscal accounts should support debt dynamics in the next year, leading us to anticipate an overall total debt of 57% of GDP in 2023, marginally higher than in 2022. Exhibit 6 illustrates.

Effective Central Bank Action Eases Inflation Concerns

The outlook for inflation varies widely across EMs. Central banks have reacted quickly to peaking inflation across Emerging Africa, Eastern Europe, and Latin America, leading to peak policy rates. Asia has been a bit further behind the curve in both inflation and central-bank policy, owing mainly to food subsidies and higher base prices from the prior year. But broadly speaking, with central banks in many EMs preemptively hiking interest rates, real interest rates in EMs are now significantly higher than they are in advanced economies. This has supported local currencies and added to the positive fundamental landscape. We expect global inflation to moderate significantly in coming months as the global economy slows, commodity prices moderate, and tighter monetary policy curbs demand.

Corporate Credit Fundamentals Continue Weakening

Fundamental dispersion and varying business cycles are a feature of this diverse asset class, but as we mentioned in last year's outlook, credit quality does not improve in perpetuity—and in 2023, we believe EM corporate credit fundamentals should see a continuation of the weakening trend that emerged in the second half of 2022.

As central banks around the world raise rates to combat inflation, top lines (revenues) for nonfinancial corporates are feeling the pinch. We also expect loan growth to decelerate in most countries, with the likely exception of China.

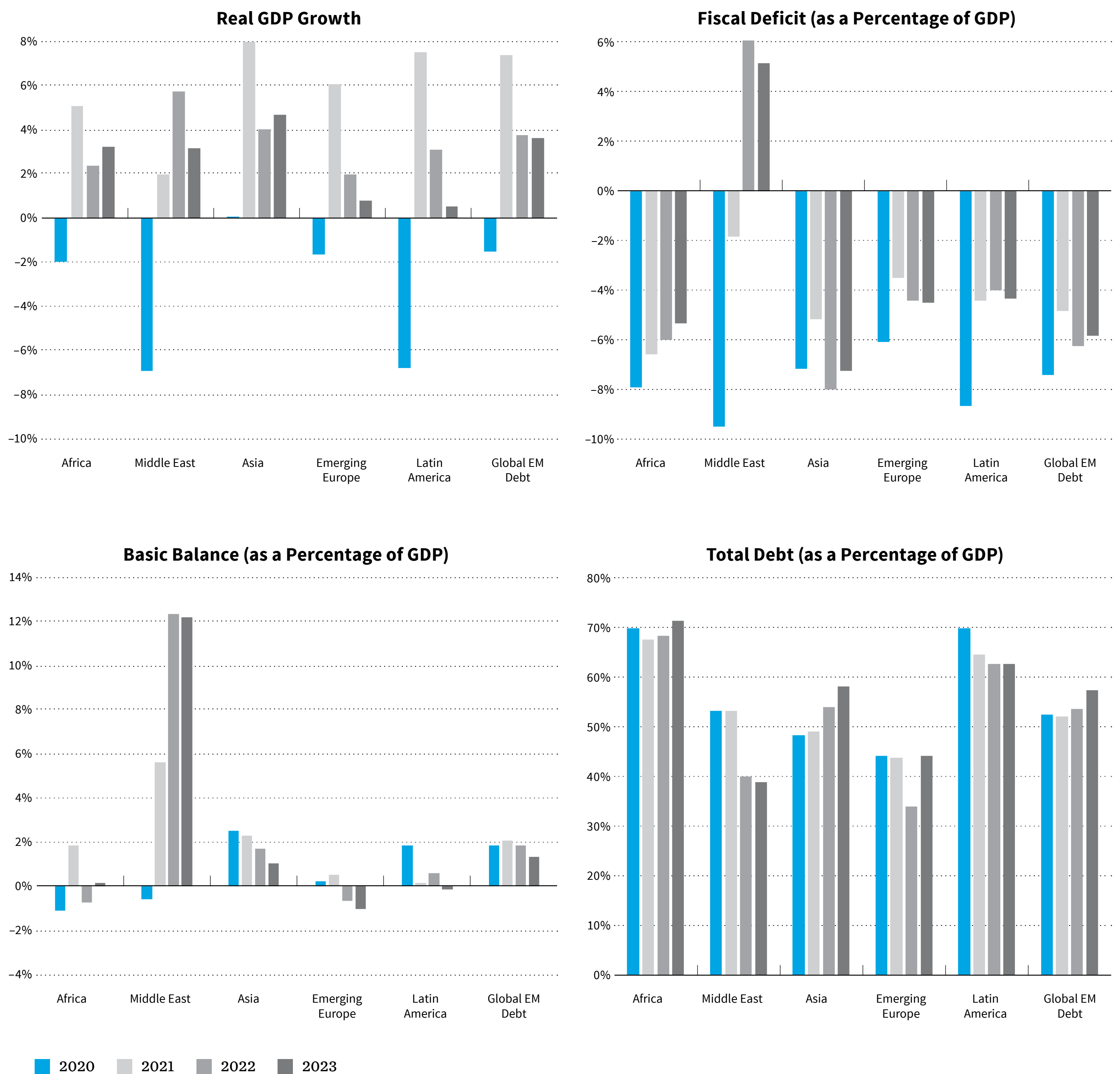
For nonfinancial corporates, the inability to fully pass through rising costs in a weaker macroeconomic environment has led to lower earnings before interest, taxes, depreciation, and amortization (EBITDA) margins, and therefore lower cash flows.

Offsetting lower near-term cash flows are years of proactive debt-profile management, which has improved interest expenses and kept maturities from becoming a broad problem. This has resulted in low default rates outside idiosyncratic situations such as Chinese real estate and Russia's invasion of Ukraine.

EXHIBIT 6

Improving Growth Stabilizes Credit Metrics

We believe the overall fiscal deficit in 2023 will be approximately –5.8% of EM GDP, marginally lower than last year's number.



Sources: Oxford Economics and William Blair, as of September 30, 2022. Methodology is GDP-weighted (based on the JP Morgan EMBIGD).

For financials, lower growth, high interest rates, and high inflation pose downside risks to asset quality. However, while several large EM banking systems have certain vulnerabilities, few of them have broad challenges that would create near-term solvency and financial-stability concerns. Most EM banking systems look better positioned in terms of capital than they were during the Global Financial Crisis, thanks to the implementation of robust macroprudential regulation in recent years.

Technical Conditions Should Provide Support

Technical conditions should be more supportive in 2023, in our opinion. We saw record outflows from dedicated EM debt portfolios, high market volatility, and low liquidity, which resulted in limited new-debt issuance in 2022. Forced selling by passive funds and exchange-traded funds (ETFs) created significant dislocation in the marketplace, driving prices far below their fundamental values.

While we see market conditions gradually normalizing in 2023, we anticipate another year of limited net debt issuance. Higher funding costs in primary markets should encourage issuers to tap into more affordable multilateral and bilateral financing. We also anticipate flows coming back to dedicated EM debt portfolios, attracted by appealing valuations. Reduced long-investor positioning and high investor cash levels should also add to a more constructive technical landscape.

Valuations Appear Attractive, Particularly Relative to U.S. High Yield

In our opinion, EM debt appears attractively valued on both an absolute and relative basis, with spreads wider than their historical levels. EM sovereign high-yield spreads appear particularly compelling, especially relative to U.S. high-yield levels, as exhibit 7 shows. In the distressed credit space, we believe current prices overestimate the probability of credit events and under-estimate potential restructuring and recovery values.

Similarly, in the local currency universe, currency valuations remain attractive despite the broad outperformance of EM currencies versus those of developed countries in 2022.[1]

1 Measures the performance of the EM currency basket of the J.P. Morgan GBI-EM Global Diversified versus the performance of the U.S. Dollar Index (which measures the performance of a basket of developed-market currencies versus the U.S. dollar).

EXHIBIT 7

Valuations for EM Sovereign High-Yield Debt Appear Compelling

Heading into 2023, valuations for EM sovereign high-yield debt appear attractive compared with U.S. high-yield bonds, as spreads have widened considerably from the long-term average.

Sources: Bloomberg, JP Morgan, and William Blair, as of November 30, 2022. **Past performance is not indicative of future returns.** Index representation is JP Morgan EMBI-GD High Yield minus Bloomberg U.S. Corporate High Yield Index. A direct investment in an unmanaged index is not possible.

The dollar itself has backed off its peak reached in the third quarter of 2022, but still appears stretched on a longer-term trade-weighted basis. While we do not expect a significantly weaker dollar while the Fed is still in tightening mode, we see some scope for modest EM currency appreciation and a reduction in volatility as risk appetite improves.

Coupled with high nominal and real interest rates (and the latter rising further as inflation falls), we expect currencies to remain well supported by a resumption of inflows into the asset class.

On the local rates side, there is considerable variation in attractiveness vis-á-vis our estimates of excess term premium embedded in local curves. Those markets that hiked early and often (mainly in Latin America but also more recently in Eastern Europe) have seen better support from bondholders with some curves already inverting in anticipation of policy loosening in the second half of the year. We expect curves in Asia to face some additional upwards pressure, at least in the very near term.

All things considered, we continue to believe that current valuations overcompensate investors for credit, currency, and local rate risk, as well as volatility—so EM debt may offer attractive value to investors with a medium- to long-term horizon and a willingness to tolerate a period of higher volatility.

Development Partners Help Meet Financing Needs

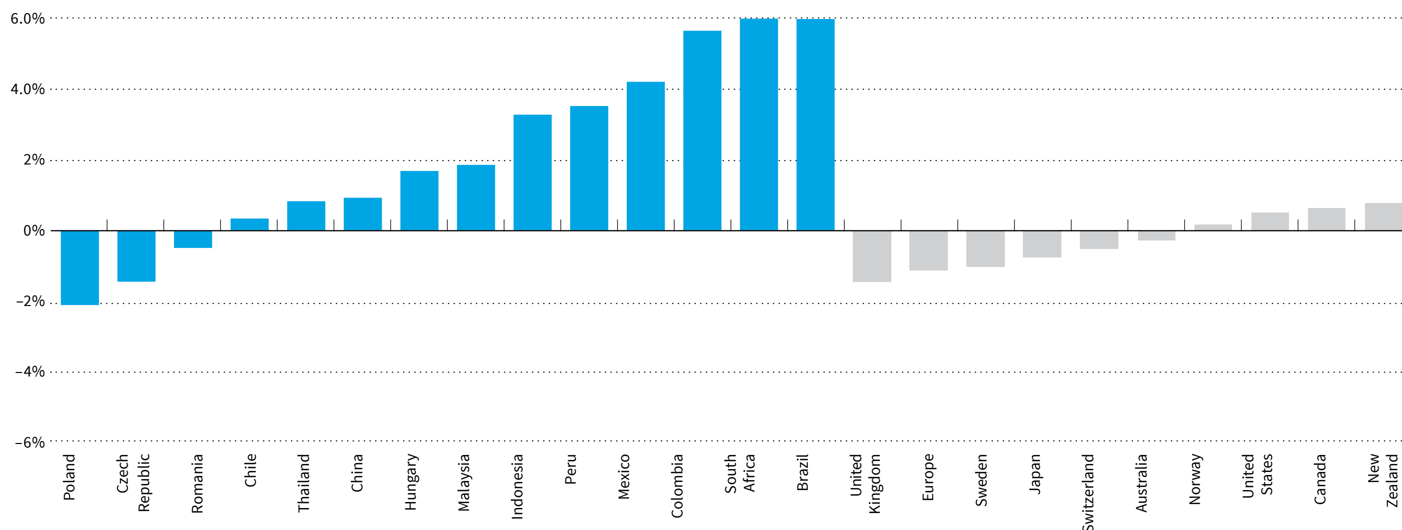
We believe development partners will continue to provide critical support to EMs, helping frontier markets meet their short- to medium-term external financing needs against the backdrop of challenging market conditions.

The IMF and World Bank have shown a strong commitment to meeting the external financing needs of frontier markets through both existing and new tools, such as the Food Shock Window (FSW) and Resilience and Sustainability Trust (RST). And the World Bank is considering the creation of new tools to support countries in reduction of new emissions.

EXHIBIT 8

Local-Currency EM Debt Offers Premium in Real Yields

Compared with other fixed-income assets, yields on local-currency EM debt remain attractive. With few exceptions, inflation-adjusted yields of local-currency EM debt were in positive territory, in stark contrast to the negative real yields for most developed markets.



Source: Bloomberg and William Blair, as of December 5, 2022. Real yield calculated using 12-month consensus forecast Consumer Price Index (CPI).

Lastly, bilateral donors are providing further pivotal financing. Members of the Gulf Cooperation Council (GCC), for instance, have provided more than $12 billion in financing to Egypt with further financing to follow.

Downside Risks Remain

Although we are constructive on the asset class into 2023, we acknowledge that there are several downside risks to our optimistic outlook.

We believe current U.S. interest-rate hikes are necessary to dampen inflation and prevent embedded second-round effects in the labor market. However, as the Fed continues with monetary tightening, there is a risk that overshooting rates results in a policy mistake that could potentially engineer a U.S. recession.

Geopolitical tensions are also likely to continue to weigh on investor sentiment. The conflict in Ukraine remains unresolved, with significant risks of escalation. The outlook for Chinese growth appears challenging (as long as China continues to pursue its zero-COVID policy). And tensions between China and Taiwan pose an ongoing headwind to sentiment in Asia.

While it seems easy to point to incidents that could further disrupt market sentiment, it is important to remember that there are always potential disruptors,

Innovative Strategies Help Overcome ESG Hurdles

Events of 2022—including Russia's invasion of Ukraine and the associated energy crisis in Europe; extreme weather conditions globally; and the political polarization of environmental, social, and governance (ESG) factors in advanced economies, most notably the United States—could have a lasting effect on EM debt investing. But at the same time, innovative strategies are facilitating the flow of funds toward climate change adaptation and mitigation efforts in EMs.

Loss and Damage Finance Facility On the Table

EMs were not spared extreme weather conditions in 2022, with catastrophic flooding in Pakistan and Nigeria and the Horn of Africa facing its fifth consecutive year of extremely dry conditions. To ensure a comprehensive approach to climate impacts, developing countries called for the establishment of a loss and damage finance facility at the UN Climate Change Conference in Glasgow (COP26) last year. Some progress was made in getting this topic on the agenda, with at least signs that financial support to climate-vulnerable countries may be coming.

Adaptation Bonds Bridge the Finance Gap

In EMs, the adaptation finance gap—the gap between actual and required adaptation financing—is widening, with adaptation cost estimates increasing continually. This might encourage innovation in climate finance. One example is adaptation bonds—bonds that will fund climate resilience—in EMs. We also see other examples of innovative efforts in EMs to raise financing for transition and mitigation efforts.

Carbon Credits Incentivize Green Practices

Gabon, a net absorber of carbon emissions, has moved to sell carbon credits, allowing it to at least partly monetize the value of its forest conservation efforts. Although carbon credits are not consistent with the UN's path to net zero, they can incentivize forest protection and rehabilitation.

Partnership Drives Clean Energy Investments

Another innovative strategy for assisting the energy transition in developing economies is the Just Energy Transition Partnership (JETP) between South Africa and Indonesia. By encouraging the flow of investments in clean energy while addressing accompanying societal issues, such as job relocation, the project seeks to hasten the phaseout of coal-fired power generation.

GSS Bond Market Expands

Bond markets—the largest and most liquid sources of capital for EMs—should continue to play an important role in channeling funds toward endeavors such as those mentioned above. And the market for green, social, and sustainability (GSS) bonds is expanding quickly. While issuance is highly concentrated by country (Korea, India, China, Brazil) and sector (financials and utilities), we expect it to grow and diversify.

and the risks are already well known and perhaps even fully priced in by the markets.

Opportunities in Hard- and Local-Currency Debt

We believe EM hard-currency debt could perform well in 2023. We favor high-yield issuers over high-grade issuers, and remain strategically overweight in higher-yielding frontier markets, where we believe investors are overcompensated for credit risk and volatility.

We continue to see scope for fundamental differentiation among countries. We prefer commodity-exporting countries, especially in the energy space, but remain cautious about countries with strong trade and financial links to Russia. We also remain cautious about countries that depend on food and energy imports and countries with negative political dynamics that create institutional risks. We also prefer countries with easier access to financing, especially those that have strong relationships with multilateral and bilateral lenders.

We continue to see opportunities in select distressed debt positions, where we believe bond prices do not reflect realistic assumptions for default risk and recovery values.

We also see selective opportunities in EM corporate credit, where we believe a combination of differentiated fundamental drivers, favorable supply technical conditions, and attractive absolute valuations could continue to provide ample investment opportunities.

Given near-term growth concerns and intermittent primary markets, we are focusing on issuers with low refinancing needs and robust balance sheets. In Latin America, our positions are diversified across oil and gas; technology, media, and telecommunications (TMT); utilities; and financials. In Central and Eastern Europe, the Middle East, and Africa (EMEA), our positions are diversified across financials; oil and gas; metals and mining; and real estate. In Asia, our positions are diversified across oil and gas; financials; industrials; metals and mining; utilities; and real estate.

In local-currency debt, we have gradually added both rates and FX exposure after being underweight risk for much of 2022. We believe the higher-yielding benchmark countries and countries where central banks have been most active could outperform from a combination of high carry levels and flattening yield curves. We also see more attractive opportunities in frontier markets, where prices have adjusted significantly and expanded multilateral support could bolster credit profiles and improve policymaking.

In Sum: An Optimistic Outlook

Despite softer economic conditions globally, overall EM credit fundamentals remain supportive—and while we see some pockets of weakness, especially among energy- and food-importing countries, overall we believe EM debt is well positioned to withstand a period of weaker global growth.

Russia: When a Country Becomes "Uninvestable"

In a rare event since the emergence of EMs as an asset class (which most would argue was in 1994), a meaningful market was severed from global financial markets through the sanctioning of sovereign debt. Russia joined the ranks of just a few other countries—Iran, Syria, North Korea, Venezuela, Myanmar, and Cuba—and is now the most sanctioned country in the world. At the same time, Russian authorities imposed restrictive measures, such as capital controls, on investors. The combination of sanctions and restrictive measures led to the exclusion of Russia from conventional fixed-income and equity indices. These events demonstrate the extent to which geopolitical tensions and the adherence to international law and terrestrial agreements remain central considerations in investment decisions. Along those lines, we, along with the markets, will continue to closely watch relations between China and Taiwan in 2023.

China | Zero-COVID Remains Key Growth Variable

Vivian Lin Thurston, CFA, Partner
PORTFOLIO MANAGER,
EM AND CHINESE EQUITIES

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

After a year of anemic growth—by China's standards—projections for a recovery in Chinese economic activity hinge largely on whether and when the country's leadership begins to relax its zero-COVID policy. The potential for zero-COVID easing combined with a benign inflationary environment that gives China's policymakers room to increase stimulus is a reason for optimism in 2023, but major policy questions and geopolitical risks cloud the outlook.

How has the Chinese economy performed in 2022?

Vivian: Consensus estimates for GDP growth in 2022 are about 3%, which would be China's lowest in several decades, except for 2020, the first full year of the COVID outbreak. While 3% growth compares well with the developed economies, it is equivalent to a recession in China.

Exports were quite strong in the first half of 2022, driven by both the global economic recovery and the Russia-Ukraine war, which exacerbated supply shortages and led to additional demands for Chinese exports. But domestic consumption has been very weak in 2022. This is primarily due to lockdowns under zero-COVID, which are creating physical constraints on consumer activity while also severely damaging consumer and business confidence.

At the start of 2022, there were hopes that more fiscal stimulus or infrastructure spending would materialize, but it did not. Given the lockdowns, and with local governments diverting resources to manage COVID, the government likely assumed that more aggressive spending would be ineffective.

Clifford: Coming into 2022, investors did not expect the government to be so passive in dealing with falling property prices and so rigid in addressing COVID. The property market cannot make a comeback when public mobility is far below normal due to lockdowns. This has wider repercussions because property is entwined with so many other economic sectors.

A third surprise in 2022 was the deterioration in U.S.-China relations, in particular the sanctions on China's access to high-end chip technologies. This will be a setback as China tries to advance its high-tech industries.

What is the latest on the zero-COVID policy? How does it relate to China's Common Prosperity goals, if at all?

Vivian: Zero-COVID and Common Prosperity are linked, but they also conflict in some ways. The government's strict COVID policy acknowledges the public's desire for health and security. But there is a divergence of attitudes within China's vast population. The elderly and less urbanized populations, in general, are much more fearful of COVID and more suspicious of vaccines than younger and more urbanized groups.

This puts the Chinese government in a difficult position. It may have vast authority and power, but it also has unlimited liability for protecting the public's health. Meanwhile, zero-COVID has hurt growth, and the unemployment rate among younger people is more than 20%. The government cannot tolerate this either because it will lead to social unrest. So it has to solve the dilemma.

Several newly released policies designed to materially ease COVID restrictions and support reopening largely reflect the government's tilt back toward growth. We

> "Protecting life is more important than growth and prosperity; you cannot have growth and prosperity if people are not alive and healthy."
>
> Clifford Chi-wai Lau, CFA

believe a likely playbook is that the government pushes for greater vaccination, especially among the elderly, and increases educational efforts to shift thinking about COVID while gradually reducing lockdowns.

Clifford: China does not have a vaccine with high-level efficacy, so the government views zero-COVID as the best way to limit the disease's impact. Protecting life is more important than growth and prosperity; you cannot have growth and prosperity if people are not alive and healthy.

The other factor behind the strict enforcement of zero-COVID in 2022 was the 20th National Congress of the Chinese Communist Party in October. Going into a big political event like that, the government wanted to keep COVID numbers low. Now that the congress is over, I believe that the government is thinking hard about how to transition the policy. There were already some big steps announced to loosen restrictions in the fourth quarter of 2022, confirming earlier rumors that the policy focus is shifting to managing risk while reviving the economy.

What indications of future economic policy came out of the 20th National Congress?

Vivian: One new theme was national security—not only regarding U.S.-China tensions and geopolitical risk but also embracing food safety, energy safety, supply chain safety, cybersecurity, and even ideological security.

Other than that, the key messages were similar to what the government under President Xi Jinping has promoted in the past. One exception is that policymakers seem to be putting more emphasis on high-quality growth—focusing on the quality and sustainability of growth versus the magnitude of growth.

We will know more about the direction of economic policy following two key sets of meetings—the Central Economic Work Conference (CEWC) in December 2022 and state council reports to the National People's Congress and the Chinese People's Political Consultative Conference in March 2023.

The Western media portrayed the new party leadership alignment as Xi surrounding himself with loyalists, but that is too simplistic. Several people added to the standing committee of the Chinese Communist Party Politburo, the seven-person inner circle that leads policymaking, are all from China's southern provinces, which are the wealthiest and most pro-growth parts of China. These new members have solid track records of successfully leading economic growth in various towns, cities, and provinces in these areas, including Zhejiang, Fujian, Guangdong, and Shanghai. Therefore, it's important to wait and see the new leadership's economic policies and subsequent execution of the policies before drawing conclusions on their stance related to the market economy and growth.

Clifford: It is likely a good thing from an economic perspective that the congress is over. These events are preceded by months of lobbying and political wrangling, which means the political agenda was prioritized in 2022 at the expense of economic policy.

It is premature to make firm judgements about the direction of economic policy under the new government. But I do not foresee major changes in monetary policy, which has been moderately accommodative for the past two years. China does not face high inflation like Europe and the United States, so China can keep interest rates low and stimulate growth, which gives it a competitive edge relative to the rest of the world.

What is your projection for China's GDP growth in 2023?

Vivian: The consensus GDP growth forecast for 2023 is 4.5% to 5.0%, which factors in a degree of relaxation of China's zero-COVID policy. There could be upside to the forecast if the government relaxes the zero-COVID policy further and faster combined with more effective monetary and fiscal stimulus.

Exports drove growth in 2022, especially in the first half, when both demand and commodity prices were strong. We are unlikely to see accelerated export growth in 2023 amid a global economic slowdown and coming off a tough comparison year, so the Chinese economy will have to rely more on domestic consumption. Again, this hinges on

zero-COVID. The collapse in consumption in 2022 was due to both an inability to consume (because of lockdowns and closures) and unwillingness to consume because of a collapse of confidence. Essentially, people were hoarding money. China's household savings rate jumped to 40% in 2022, well above its historical level of 25% to 30%. The high savings rate means pent-up demand could be strong once the government loosens COVID restrictions.

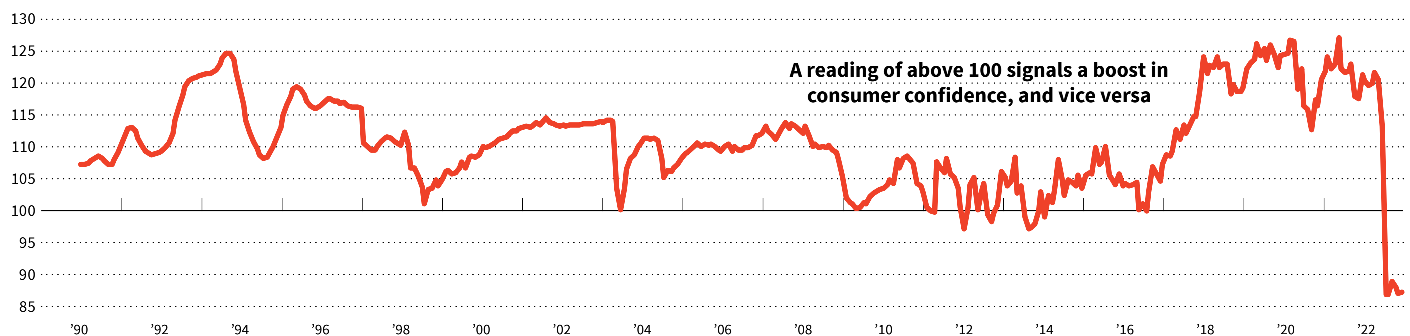
> "I do not foresee major changes in monetary policy, which has been moderately accommodative for the past two years."
>
> **Clifford Chi-wai Lau, CFA**

EXHIBIT 9

Lockdowns Destroy Chinese Consumer Confidence—But Record Savings Set the Stage for a Strong Recovery

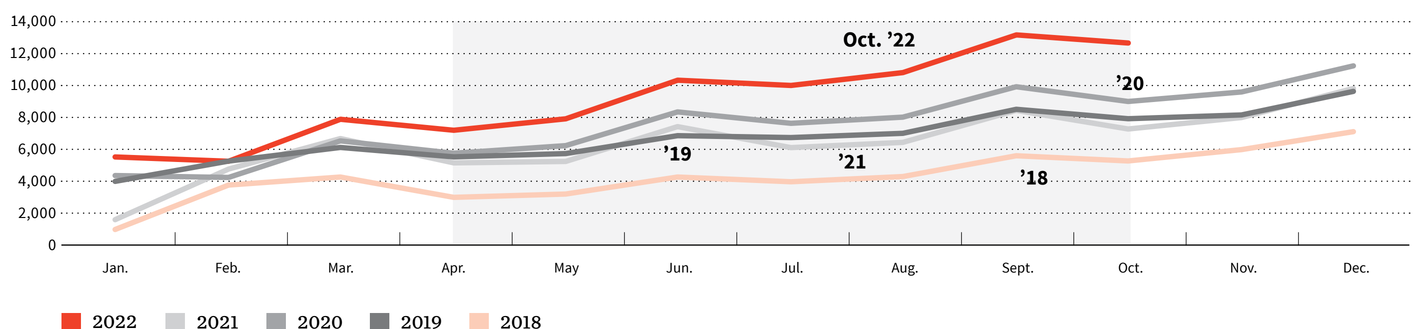
China's zero-COVID policies have caused consumer confidence to plummet and led to a drastic increase in personal savings. If China continues relaxing its COVID policies in 2023, it could unleash massive amounts of pent-up demand.

China's Consumer Confidence Index (Monthly)



Sources: Autonomous Research and William Blair, as of January 9, 2022.

Net Change in Chinese Household Deposits (in Billion Yuan)



Sources: Evercore ISI and William Blair, as of October 2022.

Clifford: The government needs to gain the people's confidence to transition the economy away from strict lockdowns and toward some sort of reopening, perhaps even accepting the idea of living with COVID. China recently approved the use of an inhaled COVID-19 vaccine, which could be more palatable for the elderly than needles. This might improve immunization rates, which is key to building confidence for a full reopening. The major reset of the central government's attitude toward its national COVID policy, and the recalibration of expectations regarding local governments meeting COVID targets, could mean our 4.5% to 5% GDP growth expectations could have some upside potential. If these measures prove successful, it will brighten the prospects for domestic consumption in 2023. While human mobility still hasn't completely normalized, the updates made recently are nevertheless an unexpected big leap forward.

How did China's debt markets perform in 2022, and what are your expectations for 2023?

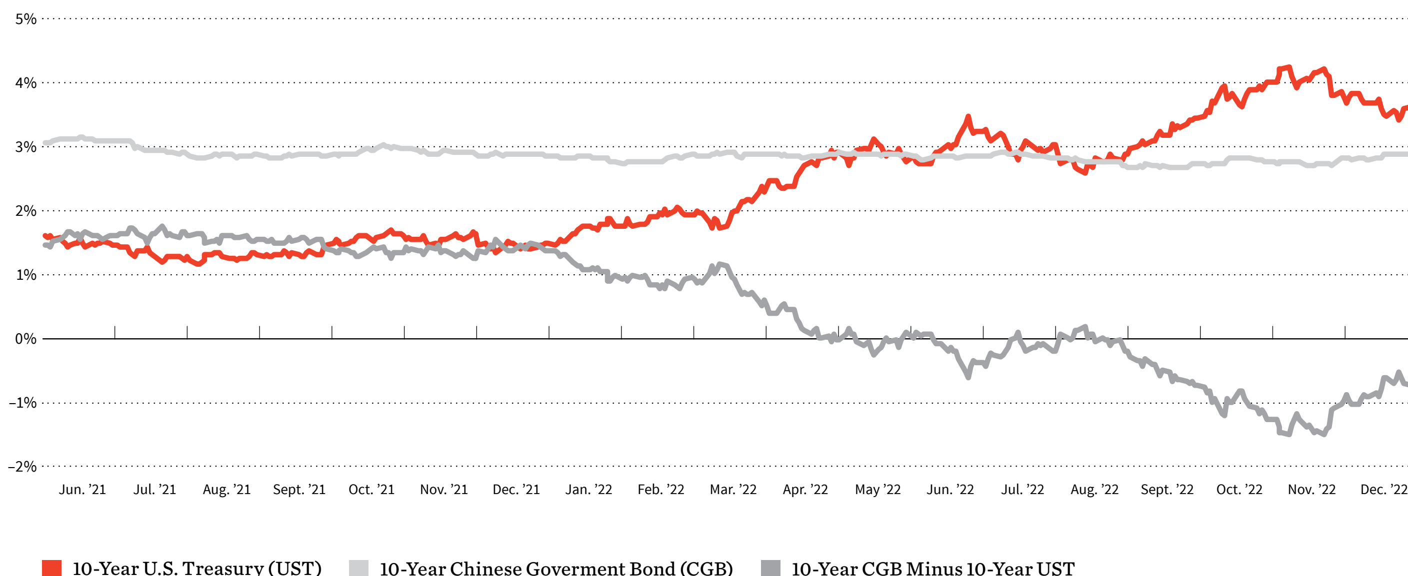
Clifford: On an unhedged basis, Chinese government bonds, based on the J.P. Morgan Government Bond Index—Emerging Markets (GBI-EM) Global Diversified, have returned –6.36% in 2022 year-to-date through December 13, 2022. While negative, this is significantly better than the broader J.P. Morgan GBI-EM, which is down 13.21% year-to-date.

The offshore renminbi has fallen 8.92% against the U.S. dollar in 2022, so on a hedged basis, stripping out currency effects, year-to-date performance in Chinese government bonds has been positive. The benign inflation environment and easier monetary policy helped push yields lower and enhance returns. China was definitely an outlier among government bond markets in 2022.

EXHIBIT 10

Chinese Bonds Lose Their Competitive Edge

Inflation has remained subdued in China, allowing China's central bankers to gradually reduce interest rates to spur growth while the United States and Europe have drastically raised rates. This divergence has made the Chinese bond market one of the most expensive in the world.



Source: Bloomberg, as of December 13, 2022.

Looking forward, interest rates in China are moving opposite to global interest rates, which makes the Chinese government bond market currently one of the most expensive. Two years ago, the Chinese 10-year bond offered 175 basis points of pickup over 10-year U.S. Treasurys, but now that relationship has inverted—so the Chinese bond market has lost its competitive edge as global interest rates jumped.

I do not expect Chinese interest rates to rise much in 2023; until consumer spending comes back strong after a successful reopening makes inflation a threat, I do not envision interest rates will increase significantly. We see value in having some exposure to the Chinese government bond market because of the resilience of the underlying economy, but we do not believe it warrants an overweight position. I believe the technicals of investing in China's lower-return fixed-income market, such as Chinese government bonds or onshore credits, are likely to weaken as the broader reopening of China could inspire reallocation from fixed income to stocks. I believe other markets are more likely to deliver better returns, especially if central banks around the world start pivoting away from rate hiking.

How did Chinese equity markets fare in 2022? What opportunities do you see for quality growth investors in 2023?

Vivian: Even though Chinese interest rates declined in 2022, China's equity market returns resembled what you would expect to see in a rising-rate environment. Higher-valuation, growth-oriented sectors dramatically underperformed lower-valuation, lower-quality stocks. In addition, valuations for Chinese quality growth companies contracted dramatically in 2022, and consumption and economic activity overall were hurt by ongoing COVID lockdowns and property issues. This made for a very challenging environment for investors focused on quality growth.

Looking ahead to 2023, we are focusing on a gradual easing of zero-COVID as a key theme. Beneficiaries could be consumer, internet, and digital economy companies. We have exposure to quality growth companies in the consumer space—the leading liquor company, the leading duty-free company, the leading ingredients company, the leading cosmetics company, and so on. We believe they have the potential to benefit strongly as zero-COVID continues to ease. We also have substantial exposure to internet companies. These are out of favor among global investors, but we take a long-term view. Valuations now appear attractive, in our view, and regulatory measures affecting these companies have been stabilizing.

"We are focusing on a gradual easing of zero-COVID as a key theme. Beneficiaries could be consumer, internet, and digital economy companies ."

Vivian Lin Thurston, CFA, Partner

Another longer-term structural story we like is energy transition, including electric vehicle batteries, solar panels, and companies related to these industries. These higher-valuation segments underperformed traditional energy companies in 2022, but we remain bullish on the long-term opportunities related to the transition to a lower-carbon economy.

We pay close attention to fundamental corporate earnings, which are already in recovery after earnings expectations came down dramatically year-to-date. If you combine earnings recovery with attractive valuations and a stabilizing regulatory environment, plus reopening and policy support, we believe 2023 may be a good year for quality growth investors.

How does the geopolitical environment affect China's investment landscape?

Vivian: Clamping down on China has become a bipartisan effort in the United States. This creates a risk factor for investors that has little to do with fundamentals. If you look at restrictions on semiconductor sales to China, for example, China could deal with the problem

technically and practically over time, but it raises bigger concerns about the investability of Chinese equities. A U.S.-based investor must ask whether the U.S. government may eventually put China-based tech companies on the restricted entity list.

Clifford: In the bond market, we are dealing with the same investability issue. Several Chinese companies deemed to have close connections to the military have suddenly been put on the restricted list. You cannot research this kind of risk, because you do not know the rationale behind it and it is hard to anticipate. It also raises the question of whether these restrictions will extend to the sovereign side. If we talk about tail risks in Chinese investment, this is a big one.

"Clamping down on China has become a bipartisan effort in the United States. This creates a risk factor for investors that has little to do with fundamentals."

Vivian Lin Thurston, CFA, Partner

Final Takes

Olga Bitel, Partner

GLOBAL STRATEGIST

If the Fed reaches its neutral monetary policy stance and the ECB is not far behind; if fossil fuel supply away from Russia is secured, even at higher (but stable) prices; if consumer price inflation is moderating fast and the Fed does not overtighten into a major credit event somewhere; and crucially, if geopolitical pressures do not escalate meaningfully from their current uncomfortably high levels—then the world's biggest demand centers may be able to pivot toward modest growth. If so, risk assets may not be a bad place to be in 2023.

Todd McClone, CFA, Partner

PORTFOLIO MANAGER, EM EQUITIES

The EM bear market is long in the tooth in terms of time, price, and multiples. Earnings expectations have already been cut, and many EMs are well ahead of developed markets in monetary tightening. EMs could be a bright spot in a cloudy picture for equities globally in 2023.

Marcelo Assalin, CFA, Partner

HEAD OF EM DEBT

Despite softer economic conditions globally, overall EM credit fundamentals remain supportive—and while we see some pockets of weakness, especially among energy- and food-importing countries, overall we believe EM debt is well positioned to withstand a period of weaker global growth.

Vivian Lin Thurston, CFA, Partner

PORTFOLIO MANAGER, EM AND CHINESE EQUITIES

Growth-oriented, higher-valuation companies underperformed in 2022 despite China's accommodative monetary environment. If you combine earnings recovery with attractive valuations and a stabilizing regulatory environment, plus gradual reopening and continued policy support, we believe 2023 may be a good year for quality growth investors.

Clifford Chi-wai Lau, CFA

PORTFOLIO MANAGER, EM DEBT

When it comes to projecting China's economic growth for 2023, everything hinges on the government updating its zero-COVID policy. If it does, the economy could surprise to the upside, especially given the benign inflationary environment, which allows for further stimulus if needed.

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