Emerging Markets: China, India, and Thematic Opportunities

As we look toward 2022, we see a range of investment opportunities within the diverse EM universe.

As we approach 2022, evolving political environments and diverging COVID-19 recovery paths are among the drivers of dispersion between and within emerging markets (EM). Meanwhile, technology adoption, infrastructure development, and urbanization are a few of the trends fueling growth across many of these markets. In this outlook, we explore how these factors impact opportunities and risks in Chinese equities, the potential for a bright future in India, and several enduring themes across EMs.

China

Chinese equities were often in the headlines in 2021 driven by geopolitical tensions, substantial regulatory shifts, and high-profile debt concerns.

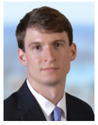
"We expect volatility may remain elevated in 2022, driven by the Chinese political cycle and continued international tensions, potentially yielding significant longer-term opportunities." – Bo Meunier, CFA, Equity Portfolio Manager

More broadly, some of the tailwinds that have supported Chinese growth over the past decade are fading. Demographics, for example, could soon begin to dampen growth potential. The government is working to lower healthcare costs and make education more affordable in an effort to mitigate the social impact of slowing growth.

Importantly, however, lower aggregate economic growth doesn't directly translate to lower equity returns. Within China's now vast public equity markets, we see attractive and enduring investable themes with the ability to drive China's upside potential in the years ahead—including consolidation, localization, and a growing focus on margins.

- **Consolidation** – Many sectors remain fragmented with thousands of players with weak bargaining power. But pricing power, excess capital, and consumer taste are becoming more differentiated. We believe these large markets are facing consolidation pressures and market share winners stand to benefit.
- **Localization** – Supply-chain disruptions have driven business to local players—particularly in technology, industrials, and healthcare. These companies are investing more into research and development and, thus, are closing the gap on leading multinationals. So, even if the pie isn't growing as much, local leaders can meaningfully grow the topline by taking share from international peers. Local players are supported by an ability to offer better customization and customer service and may also benefit from favorable policies as governments continue to regionalize global supply chains.
- **Margin improvement in operations** – Chinese companies were historically focused on topline growth but are increasingly shifting governance and corporate cultures to drive margin improvement.

Insight from sub-adviser Wellington Management



Graham Proud
Investment Director

Graham shares insights from four emerging markets portfolio managers: Bo Meunier, Murali Srikantaiah, Niraj Bhagwat, and Dáire Dunne. These include perspectives on China, India, and thematic opportunities.

Key Points

- Within China's now vast public equity markets, we see attractive and enduring investable themes with the ability to drive China's upside potential in the years ahead.
- India is poised to continue benefiting from its stable democratic institutions, significant long-term structural tailwinds, and economic reforms.
- Broad areas of interest for EM investors in 2022 include the deepening of financial markets, digital connectivity, and environmental consciousness.

For many investors, the question is whether China can generate excess returns vs. the rest of world going forward. We believe Chinese equity returns may be driven by the quality of the underlying companies and the price paid for ownership stakes. Critically, we think current Chinese valuations reflect the underlying political and regulatory risks, which contrasts with many developed markets and the US in particular, where valuations have become increasingly extended.

We expect continued volatility next year as President Xi Jinping positions himself to be appointed to an unprecedented third term and other senior party leaders vie for key positions coming into the 2022 National People's Congress. Notably, some of the politicking that typically occurs on the election year has shifted earlier compared to previous cycles. We believe this headline volatility could offer significant opportunities for investors to build exposure in China's compelling underlying structural tailwinds.

"India may be the world's single greatest COVID beneficiary over the long term." – Murali Srikantaiah, Equity Portfolio Manager

India

Looking to 2022, India continues to offer investors a large and diverse economy and equity market supported by stable democratic institutions.

India is the world's leading vaccine manufacturer and will produce many of the low-cost (non-mRNA) vaccines needed for the developing world. Moreover, as digitization rapidly increases both domestically and internationally in 2022 and beyond, India's deep technology talent market may be a major beneficiary.

Furthermore, India is poised to benefit from other significant long-term structural tailwinds such as demographics, labor shifting away from agriculture into higher productivity sectors, urbanization, an aspirational and entrepreneurial population, and low household debt. Finally, significant reforms such as the Goods and Services Tax and the new bankruptcy code—alongside an unprecedented focus on economic reform and privatization initiated in the Modi government's 2021 National Budget—have begun to bolster its economy.

"Momentous changes have taken place in India over the past 12 months that I believe have helped to fast-track the country's nascent growth story. It's now clear that Indian Prime Minister Narendra Modi is going all out to spur an economic renaissance." – Niraj Bhagwat, Equity Portfolio Manager

India's private markets may also signal its promising future. Estimates range from 40 to 100+ unicorns (private companies with >US $1 billion valuations) that are beginning to IPO.[1] As this listing trend continues, US $250 billion or more of new market cap may be created.[1] These companies may further diversify the public markets and offer attractive opportunities to public-market investors.

Thematic Opportunities

Across the diverse range of countries within EMs, many of our investors are finding attractive opportunities for the year ahead within a common set of thematic areas.

"For instance, the impacts of smart data and the growing access to quality healthcare are among the long-term opportunities we find attractive in EMs in 2022." – Dáire Dunne, CFA, Portfolio Manager

Smart Data: As EMs continue their transition away from manufacturing economies to service/digital economies, they increasingly look to unlock productivity gains from enterprise intelligence. This trend has seen software spending steadily increase, following a similar path to developed markets

(DM), but from a much lower base. In China, for example, public-cloud spending was only 11% of the US equivalent in 2020.[2] Notably, the growth of cloud computing is driving greater affordability and availability of software solutions and, when combined with rising labor costs and more data to process, is accelerating this structural shift. In our view, software spending across the stack—in things such as Enterprise Resource Planning and cybersecurity—has a long runway for growth across EMs in 2022 and beyond.

Healthcare Inclusion: The vast majority of the world's population lives in developing economies and most still have inadequate access to healthcare. Healthcare spending across low- and middle-income countries was only US $264 per capita in 2018, compared with US $5,665 in high-income countries—a difference of more than 20 times. However, between 2000 and 2018, spending grew almost twice as fast in low- and middle-income countries relative to high-income countries.[3] This was driven in part by an increasing government policy focus on supporting investment in public health. In addition, medical-research spending is rapidly accelerating, particularly in China. We believe these factors make healthcare inclusion a significant long-term thematic opportunity.

Other broad areas of interest for EM investors in 2022 include the deepening of financial markets (driving inclusion and supporting development), digital connectivity (e.g., the growth of e-commerce and online leisure), and environmental consciousness (a rising focus in a world of climate change).

Bottom Line

Looking to 2022, in our view, EM offers equity investors high growth potential and significantly lower valuations than DM. For long-term investors that are willing to use volatility as an opportunity, we see a range of investment opportunities within the diverse EM universe.

ESG Considerations in Emerging Markets

Supply-chain risks related to modern slavery—a term encompassing forced labor, child labor, debt bondage, and human trafficking—are a growing priority for many of our clients globally, particularly in the current COVID-heightened environment. Though these unfortunate and illegal practices take place across the globe, they are often most prevalent within developing countries and commodity industries.

In 2021, our Sustainability Team initiated a new survey-based initiative to better understand the management of human rights and modern slavery risk within public companies globally. We aim to collect and maintain survey data from 2,000+ public companies globally. This will help us improve our EM investors' ability to productively engage with company boards and management teams as we seek to combat modern slavery by improving companies' risk-management policies in 2022 and beyond.

In the coming year, we will begin to harness our unique insights into labor market policies to understand and promote best practices. Beyond our work on this important social factor, our teams will continue their research and engagement on other environmental, social, and governance factors, including leveraging our growing climate change forecasting ability to identify opportunities and risks across emerging markets.

Talk to your financial professional to learn more about EM opportunities.

[1] Sources: Bloomberg, Credit Suisse, March 2021. PitchBook, September 2021. Wellington Management, November 2021.

[2] Source: International Data Corporation, 2020.

[3] Source: World Bank, 2021. Data as of 2018 (latest data available).

Important Risks: Investing involves risk, including the possible loss of principal. • Foreign investments may be more volatile and less liquid than US investments and are subject to the risk of currency fluctuations and adverse political, economic, and regulatory developments. • These risks may be greater, and include additional risks, for investments in emerging markets or if a fund focuses in a particular geographic region or country. • Fixed income security risks include credit, liquidity, call, duration, and interest-rate risk.

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