BARINGS

EM Equities: Is the Bear Market Closer to the End Than the Beginning?

INSIGHTS

A number of the headwinds facing EMs are already reflected in company valuations—and some are even beginning to fade, suggesting that EM equities may be close to a turning point.

Michael Levy
Co-Head
Emerging Equities

William Palmer
Co-Head
Emerging Equities

Following the COVID-19 liquidity-fueled rebound of 2020, emerging markets (EM) equities peaked in February 2021 before entering what has now become the longest-running bear market in the index's post-1995 history. This short paper aims to explain the factors that have worked against EM equities and highlight a number of signals that we as investors are looking for to confirm a sustainable turning point for the asset class.

Figure 1: EM Equities Remain in a Bear Market

Source: Barings; MSCI; Factset. As of September 30, 2022.

Challenges Facing EM Equities

The peak in the MSCI EM Index in February 2021 coincided with the beginning of a withdrawal of some of the stimulus injected into EM economies during 2020. Chinese policymakers, encouraged by the swift recovery in the economy and mindful of the potential inflationary threat, moved quickly to remove excess liquidity from the local money market and pulled back on fiscal spending. Other EM countries, such as Brazil, followed shortly thereafter. Investors soon began to interpret this policy pivot as a headwind for economic activity and corporate earnings progression across EM, which has indeed proved to be correct.

Another factor that impacted investor sentiment in EMs was a deterioration in the outlook for the largest EM market: Chinese equities. This began with increased regulatory intervention on some of the well-owned secular growth sectors such as internet platforms, private education and, to a lesser extent, health care. Additional China-specific challenges, which have appeared over the past two years, include trade tensions with the U.S., de-listing risks for Chinese ADR stocks, a residential property market downturn due to policy over-tightening and, more recently, a reluctance to abandon the zero tolerance COVID-19 policy.

The war in Ukraine has also weighed heavily on EMs, both directly on Russian equities and indirectly in the form of growing inflationary pressures, accelerating developed market monetary tightening, and weakening global economic activity. This in turn has had a negative impact on EM equity valuations, as well as on revenue and profit margins for EM companies.

Finally, the U.S. dollar has continued to appreciate following the ending of quantitative easing by the U.S. Federal Reserve. Historically, EM equities have struggled during a strong U.S. dollar environment **(Figure 2)**—and this occasion has proven no different.

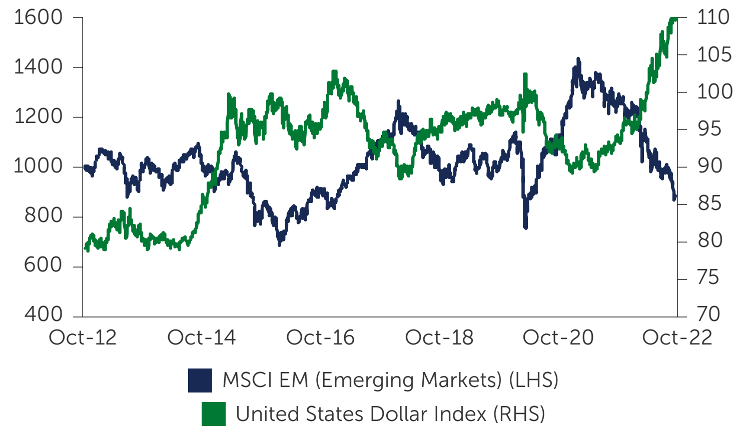
Many Headwinds Are Reflected in Valuations

Given the challenges outlined above, it is easy to understand why EM equities remain out of favor. However, as long-term investors, it is also important to recognize that these headwinds are now well-known and already reflected in earnings expectations and valuations of EM equities. For instance, earnings expectations for 2022 and 2023 have declined by approximately 20% over the past two years **(Figure 3)**, while valuations as measured by the price-to-book ratio are near previous crisis lows **(Figure 4)**. This resetting of expectations to a much lower level raises the potential to positively surprise at some point in the near to medium term.

In addition, we note that some of the headwinds facing EMs are beginning to fade. In China, for example, fiscal and monetary policy has already turned modestly expansionary in response to the weak domestic economy, while in Brazil, the central bank has signaled that interest rates may have peaked due to easing inflationary pressures. We expect to see similar dovish developments in other EM countries over the next year.

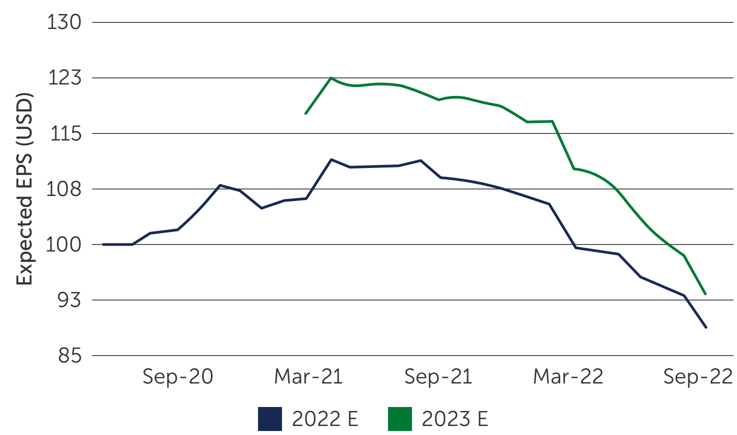
Looking specifically at China, the regulatory review and implementation appears largely complete, while significant progress has been made toward satisfying the SEC's requirements for auditing Chinese companies with ADR listings. The residential property sector, however, remains fragile, but recent policy initiatives should help improve funding for developers while lower mortgage rates may lift transaction volumes. These developments will be monitored closely by investors over the coming months, as will China's zero tolerance COVID policy. Any positive development on either or both is likely to be well-received by investors.

Figure 2: EM Equities Tend to Decline Amid U.S. Dollar Strength



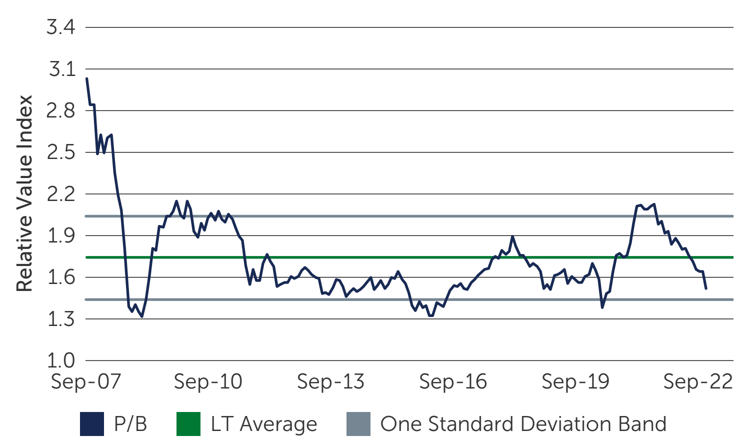
Source: Barings; MSCI; Factset. As of September 30, 2022.

Figure 3: EM Equities Earnings Expectations Decline



Source: Bloomberg Finance L.P.; J.P. Morgan. As of September 30, 2022.

Figure 4: Price-to-Book Ratio Near Previous Crisis Lows



Source: Barings; MSCI; Factset. As of September 30, 2022.

"Following the market decline over the past two years, our process is now identifying many under-valued investment opportunities across the EM equity universe today."

In the near term, global inflationary pressures and monetary tightening concerns are likely to keep volatility elevated across equity markets, until investors have an inflection point in sight, which could potentially coincide with a peak in U.S. dollar strength. As fundamental, bottom-up investors, we will not attempt to forecast when this point could occur—but based on experience, we are confident that it will act as an additional positive driver for EM equities performance.

Our Approach

In the meantime, we will continue to follow our investment process which is underpinned by long-term, forward-looking fundamental company research produced by our large and highly experienced EM equity team. Unsurprisingly, following the market decline over the past two years, our process is now identifying many under-valued investment opportunities across the EM equity universe today. Our long-term approach enables us to avoid the distraction of the near-term unpredictability and volatility of markets, and focus on where the future earnings potential is not fully reflected in company share prices. In our opinion, this is the most effective way to potentially deliver excess returns.

Barings is a $349+ billion global investment manager sourcing differentiated opportunities and building long-term portfolios across public and private fixed income, real estate and specialist equity markets. With investment professionals based in North America, Europe and Asia Pacific, the firm, a subsidiary of MassMutual, aims to serve its clients, communities and employees, and is committed to sustainable practices and responsible investment.*

IMPORTANT INFORMATION

Any forecasts in this document are based upon Barings opinion of the market at the date of preparation and are subject to change without notice, dependent upon many factors. Any prediction, projection or forecast is not necessarily indicative of the future or likely performance. Investment involves risk. The value of any investments and any income generated may go down as well as up and is not guaranteed by Barings or any other person. PAST PERFORMANCE IS NOT NECESSARILY INDICATIVE OF FUTURE RESULTS. Any investment results, portfolio compositions and or examples set forth in this document are provided for illustrative purposes only and are not indicative of any future investment results, future portfolio composition or investments. The composition, size of, and risks associated with an investment may differ substantially from any examples set forth in this document. No representation is made that an investment will be profitable or will not incur losses. Where appropriate, changes in the currency exchange rates may affect the value of investments. Prospective investors should read the offering documents, if applicable, for the details and specific risk factors of any Fund/Strategy discussed in this document.

Barings is the brand name for the worldwide asset management and associated businesses of Barings LLC and its global affiliates. Barings Securities LLC, Barings (U.K.) Limited, Barings Global Advisers Limited, Barings Australia Pty Ltd, Barings Japan Limited, Baring Asset Management Limited, Baring International Investment Limited, Baring Fund Managers Limited, Baring International Fund Managers (Ireland) Limited, Baring Asset Management (Asia) Limited, Baring SICE (Taiwan) Limited, Baring Asset Management Switzerland Sarl, Baring Asset Management Korea Limited, and Barings Singapore Pte. Ltd. each are affiliated financial service companies owned by Barings LLC (each, individually, an "Affiliate"). Some Affiliates may act as an introducer or distributor of the products and services of some others and may be paid a fee for doing so.

NO OFFER: The document is for informational purposes only and is not an offer or solicitation for the purchase or sale of any financial instrument or service in any jurisdiction. The material herein was prepared without any consideration of the investment objectives, financial situation or particular needs of anyone who may receive it. This document is not, and must not be treated as, investment advice, an investment recommendation, investment research, or a recommendation about the suitability or appropriateness of any security, commodity, investment, or particular investment strategy, and must not be construed as a projection or prediction.

Unless otherwise mentioned, the views contained in this document are those of Barings. These views are made in good faith in relation to the facts known at the time of preparation and are subject to change without notice. Individual portfolio management teams may hold different views than the views expressed herein and may make different investment decisions for different clients. Parts of this document may be based on information received from sources we believe to be reliable. Although every effort is taken to ensure that the information contained in this document is accurate, Barings makes no representation or warranty, express or implied, regarding the accuracy, completeness or adequacy of the information.

Any service, security, investment or product outlined in this document may not be suitable for a prospective investor or available in their jurisdiction.

LEARN MORE AT BARINGS.COM

**As of June 30, 2022*

22-2466924