EM EQUITIES - 2022 OUTLOOK

HEADWINDS WILL LIKELY PERSIST IN 2022

Author

JULIEN HOLTZ
jholtz@pictet.com

SUMMARY

- Given the global backdrop, emerging market (EM) equities should have performed better than they did in 2021. Yet, China managed to single-handedly drag down the MSCI EM index through its regulatory drive and a significant property slowdown.
- Next year's climate is shaping up to be very different. EM equity investors should expect to be challenged by tightening US monetary policy, China's tricky transition to a slower growth regime and less favourable base effects in commodity prices.
- Taking stock of fully recovered earnings (in aggregate) and a potential decline in margins, we lack notable catalysts for earnings growth at this stage and hence forecast flat 12-month forward earnings for the MSCI EM on a year-over-year basis.
- Current valuations look fair, although we believe the equity risk premium has room to compress further. We see the 12-month forward price/earnings ratio for the MSCI EM index potentially inching towards 13.5x by year-end
- Our 2022 year-end target for the MSCI EM is USD 1'350, 4% higher than our end-2021 forecast (equivalent to a ~6% total return). Finding yield in what is shaping up to be a year for the brave may require delving into riskier parts of the EM universe.
- We are keeping our general preference for Asia (ASEAN notably) and Russia and remain structurally unexcited by Latin America despite cheap valuations.

EM equities did not live up to expectations in 2021

EM equities should have performed much better than they did this year. With a global economy roaring back from year-long lockdowns, spearheaded by China's swift recovery, the macroeconomic backdrop was expected to be very supportive of developed and emerging equities alike.

And yet, China's wide-ranging regulatory drive followed by Evergrande's collapse, managed to drag down the annual performance of EM equity indices at large. At time of writing (7 December 2021), the MSCI EM had returned -2.2% year to date (in USD terms), underperforming developed markets by a staggering 22.6 percentage points.

This is despite a stellar performance from Taiwanese stocks, which benefited from massive global demand for semiconductors, while the Indian economy's swift rebound greatly helped boost local stocks. ASEAN countries generally suffered, especially those whose economies are strongly biased towards tourism (e.g. Thailand, Philippines).

Equity indexes in oil-producing countries were among the biggest beneficiaries of a sharp rebound in energy prices, driven by tight supply and inventories as demand recovered. Logically enough, the Saudi Arabian and Russian stock markets produced some of the best EM performances, rivalling those of the US.

Latin America, on the other hand, failed to deliver attractive returns to investors. Many countries (Colombia, Chile, Peru, Brazil) struggled with political instability throughout the year, and China's slowdown in the second half of 2021 added to the negative sentiment surrounding some commodity prices (iron ore, notably).

EM EQUITIES - 2022 OUTLOOK

HEADWINDS WILL LIKELY PERSIST IN 2022

A more challenging backdrop in 2022

While we expected 2021 to be good for equities, next year's environment could be trickier in general, particularly in emerging countries.

Make no mistake, our central scenario is for the global economy to grow by 4.4% in 2002, a robust rate by historical standards. But the deceleration from global growth of the order of 5.8% this year could prove a hurdle for markets.

Our main macroeconomic indicators point to a difficult environment for emerging markets in particular. We expect the US dollar to remain strong, especially in the first part of the year, as markets look forward to Fed policy normalisation—first through tapering and then via rate hikes (our US economist expects three 25bp rate hikes in the course of 2022). Asian currencies and the Russian ruble could prove more resilient than other EM currencies in this context.

CHART 1: MAIN MACRO DRIVERS FOR EM EQUITIES – 2022 ASSESSMENT

Driver	Assessment	Key elements from macro scenario
1 US Dollar	~	• **Dollar to remain strong in H1** (DXY +2.5% over 6m, a bit less for broad +1.6%), but to recede afterwards (DXY -0.8% over 12m, and broad -0.5%) • **EM FX mostly lower**, except for cyclical currencies (TWD, KRW, RUB). Asian currencies more resilient
2 EM-DM growth differential	✘	• **Growth differential to provide limited support:** US still growing at acceptable rate (3.4%), while Europe remains above potential (4.5%) and China slows down materially (4.5%)
3 China	✘~	• **China growth to decelerate sharply (4.5%)**, despite a sequential improvement throughout the year • Property and constrained consumption (zero-covid) key drags
4 Commodity prices	~	• **Global growth still supportive for commodity price levels, yet less so from a change standpoint** as bottlenecks are progressively resolved and oil supply switches into oversupply. • **Supply-driven shocks not as conducive** of EM performance as demand shocks.
5 Global trade	~	• **Sustained growth should continue to support global trade growth (+3.6%)**
6 EM policy stance	~	• **Monetary policy tilted toward tightening** due to rising inflation, Fed policy and local fiscal issues • **Fiscal space also somewhat constrained** to scale back covid support programmes (where possible) as debt sustainability comes back into focus

Source: PWM - AA&MR, 7 December 2021

The growth differential between emerging and developed economies should also provide limited support next year, both due to a sharp slowdown in China and above-potential growth in the US and Europe (helped by fiscal stimulus in both places). We see GDP growth in the euro area next year matching growth in China (4.5%)—something almost unheard of.

Commodity prices are typically a good indicator of EM equities' fortunes as they tend to correlate (negatively) with the US dollar and indicate the strength of the economic cycle, particularly on the demand side. Yet, after a dramatic rebound in 2021 (metals prices are back to historical highs), this tailwind could fade next year. Oil may be an exception. After a lull in the first half of the year due to a slight oversupply, we expect demand for oil to move back up to pre-pandemic levels, which could put further pressure on prices as energy transition-related measures gather pace.

EM EQUITIES - 2022 OUTLOOK

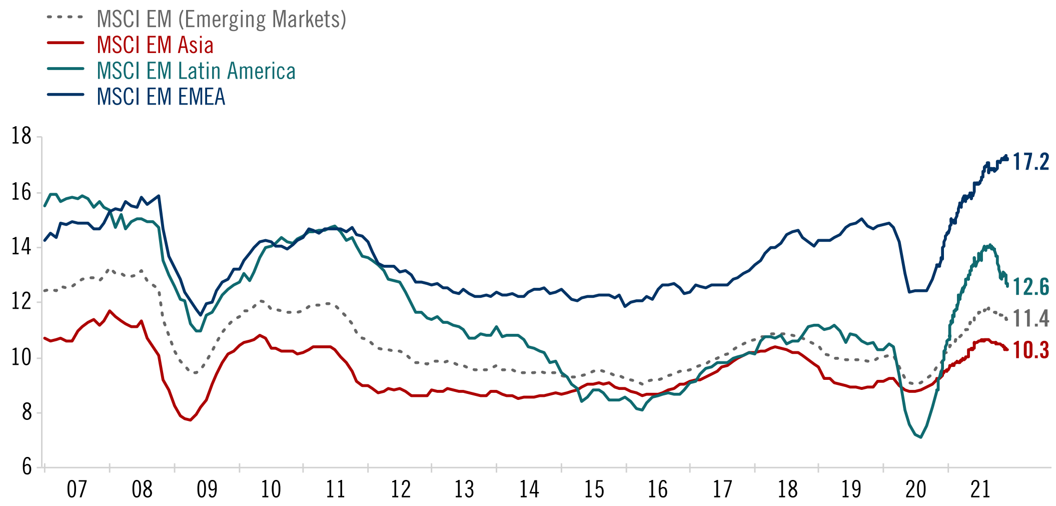
HEADWINDS WILL LIKELY PERSIST IN 2022

EM countries' room for manoeuvre in terms of monetary and fiscal policy is likely to be constrained next year. The scars left by the pandemic continue to weigh on governments' finances, while rising inflation and higher US rates will constrain monetary policies.

Flat forward earnings, or how to fly on a single engine

If history is any guide (2011 and 2018, for instance), earnings per share (EPS) in emerging markets tend to grow only mildly (mid-single digits) after a rebound of this year's magnitude. Part of the explanation lies in the rapid exhaustion of operating leverage after initially sharp recoveries. Expectations for operating and net margins have indeed already started to roll over in EM Asia and Latin America, while EMEA has held up better thanks to energy prices. From an absolute standpoint, net margins (12-month forward) are already 10-20% higher than their pre-pandemic levels and close to their 10-year highs.

CHART 2: NET MARGIN BY EM REGION (CONSENSUS, 12-MONTH FORWARD)



Source: PWM - AA&MR, Factset (December 2021)

In addition, the year-on-year growth in Chinese imports – our preferred proxy for EM earnings growth – appears likely to drop rapidly after reaching extremely high levels in 2021. At face value, and based on our macro scenario hypotheses, this indicator implies that the change in EM equities' 12-month EPS growth could be flat to negative by year-end 2022.

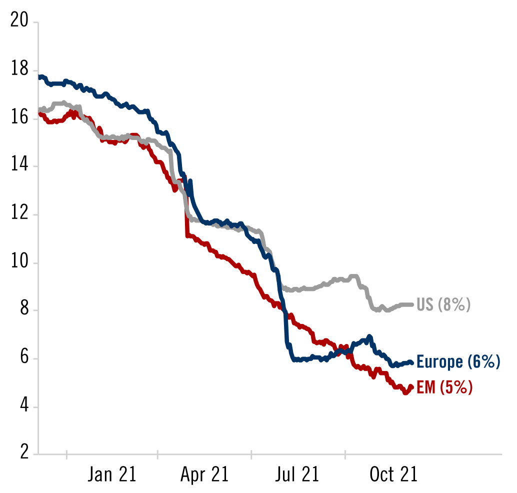
Of itself, this would not be a bad performance given that EPS for the MSCI EM are already back to the pre-pandemic (2018) highs of ~USD 100. We simply fail to see new material earnings drivers kicking in at this stage and hence forecast 2022 to be a year of consolidation at the aggregate level, with a potential rotation towards consumer and financial sectors. We also note that earnings revisions have been exhibiting a downward trajectory in the past months.

Absent a notable increase in earnings, the return potential offered by EM equities' returns therefore lies in valuations and shareholder returns.

EM EQUITIES - 2022 OUTLOOK

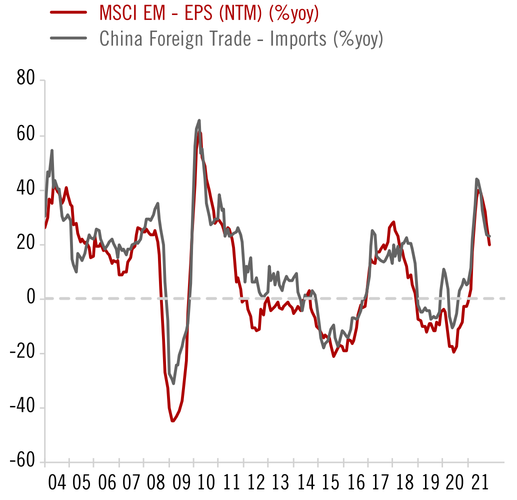
HEADWINDS WILL LIKELY PERSIST IN 2022

CHART 3: 2022 EPS GROWTH EXPECTATIONS (CONSENSUS)



Source: PWM - AA&MR, Factset (December 2021)

CHART 4: PROJECTED GROWTH OF CHINESE IMPORTS

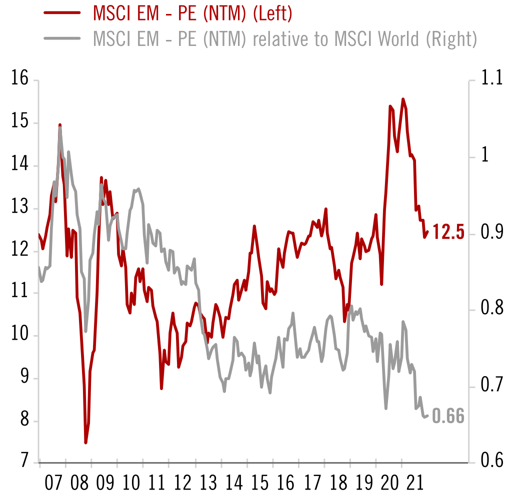


Source: PWM - AA&MR, Factset (December 2021)

Valuations look fair, but China is a wild card

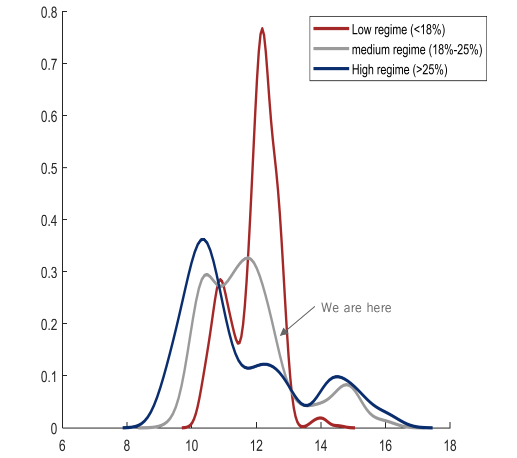
We argued last year that valuations were stretched and would contract by 10% as earnings recovered. That has indeed been the case (with valuations dipping even more than we anticipated), creating a more neutral starting base than last year. The MSCI EM 12-month forward price-to-earnings ratio (P/E) stood at 12.5x in early December, in-line with pre-pandemic levels.

CHART 5: P/E RATIO (12M FORWARD) FOR THE MSCI EM



Source: PWM - AA&MR (December 2021)

CHART 6: P/E DISTRIBUTION VS IMPLIED VOLATILITY (EM)



Source: PWM - AA&MR, Factset (December 2021)

EM EQUITIES - 2022 OUTLOOK

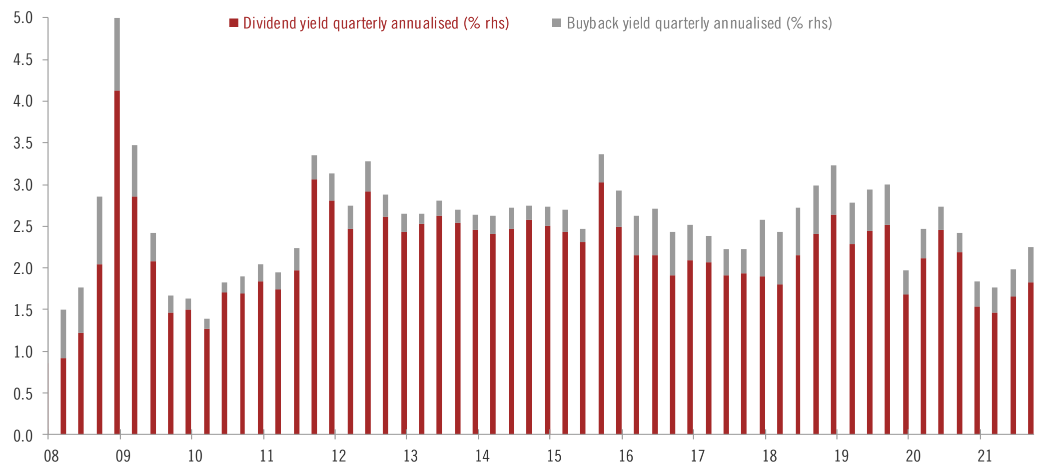
HEADWINDS WILL LIKELY PERSIST IN 2022

As EM equities' valuations are essentially back to their pre-pandemic level, they now appear historically cheap relative to developed markets, displaying a P/E discount of close to 35%. This gives credence to the argument that **EM equities could perform relatively better than DM equities in the case of a general market correction.**

We note that current valuations are also consistent with several other variables such as volatility and yields on local-currency EM government bonds. The equity risk premium (ERP, defined as the difference between equities' earnings yield and sovereign yields) currently stands at ~2% and has room to compress further provided the global economic cycle holds and geopolitical tensions are contained. Should our 2022 core macro and fixed-income scenarios materialise, we believe the ERP could reach 1.5% by year-end, pointing to slightly higher valuations (i.e. a P/E ratio of ~13-14x for the MSCI EM index).

Admittedly, since Chinese stocks account for 35% of the MSCI EM market cap, what happens in China is likely to determine the fate of EM equities in general. We would nonetheless argue that a lot of negative sentiment is already in the price after this year's massive derating of Chinese stocks. We thus see scope for sentiment to turn more positive (for example, if, in the interest of stability ahead of the 20th National Congress of the Communist Party in October, authorities slow the regulatory drive and ramp up stimulus measures), thus helping support a slight re-rating of EM equities by late 2022.

CHART 7: CASH RETURN TO SHAREHOLDERS - MSCI EM INDEX



Source: PWM - AA&MR, Factset (December 2021)

Meanwhile, cash return to shareholders should remain roughly in line with past trends at around 2.5% in aggregate, but with wide discrepancies (e.g. Russian equities offer close to a 9.5% yield on a 12-month forward basis). Dividends should continue to account for a large share of shareholder returns as share buybacks remain uncommon across EM.

Hoping for mildly positive total returns in 2022

All in all, we believe next year's environment could be challenging for EM equities based on our ex-ante macroeconomic and cross-asset scenarios. Rising US (real) bond yields, a strong US dollar, China's reset to a lower growth regime, monetary tightening (both in EM & DM) and an unusually low EM/DM GDP growth gap depict an environment where EM equities are unlikely to shine.

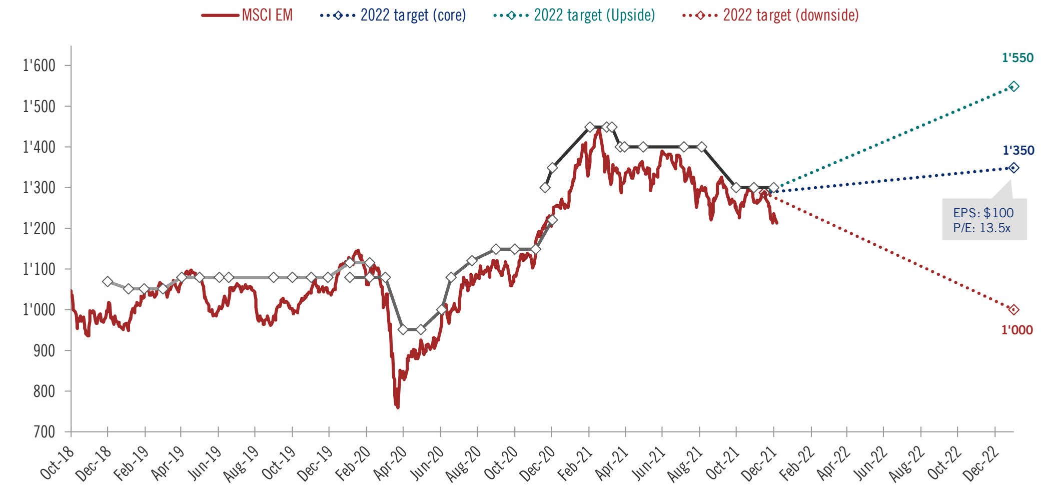
EM EQUITIES - 2022 OUTLOOK

HEADWINDS WILL LIKELY PERSIST IN 2022

Nonetheless, after the impact of this year's regulatory drive and property slowdown in China, we see some potential upside–mainly driven by valuations rather than earnings. China is the main swing factor and could make or break EM equity returns in 2022. The lack of support from earnings growth means we are less confident about the direction (up or down) of EM equities in 2022 than in previous years.

From a sequential standpoint, H2 may prove more supportive than H1 as Fed tapering and rate hikes should have been digested by then, Chinese growth may have stabilised (perhaps thanks to moderate, front-loaded stimulus measures) and political volatility may have lessened.

CHART 8: MSCI EM 2022 TARGET (CORE & ALTERNATIVE SCENARIOS)



Source: PWM - AA&MR, Factset (7 December 2021)

As for individual EM markets, we believe **Chinese equities** could benefit from a re-rating provided: (i) the real estate sector stabilises; (ii) the authorities provide a credible economic backstop; and (iii) US/China tensions do not worsen. **South Korea and Taiwan**, which are typical early-cycle plays, may eventually suffer should there be a pause in the pandemic-induced surge in demand for semiconductors. While the signs are good, we worry over the lack of marginal buyers for **Indian equities** at current valuations, especially if the Reserve Bank of India starts tightening monetary conditions. Earnings in **ASEAN** countries have not fully recovered from the pandemic and could outperform if economic growth picks up, as we expect, and covid-19 concerns lessen significantly.

We see **Latin American equities** as generally unattractive despite historically discounted valuations, owing to low economic growth rates (partly due to the rapid tightening of monetary policy), high inflation and persistent political noise throughout the region.

Outside Latin America and Asia, we continue to like **Russia**, which provides pure exposure to energy prices. The associated geopolitical risk must nonetheless be monitored carefully and could be diversified away via exposure to other oil exporters, such as Saudi Arabia.

All in all, 2022 is shaping up to be a year for the bravehearted, when finding yield may require delving into some of the riskiest parts of the EM universe. *Buyers beware!*

DISCLAIMERS

Distributors: Banque Pictet & Cie SA, Route des Acacias 60, 1211 Geneva 73, Switzerland and Pictet & Cie (Europe) SA, 15A, avenue J. F. Kennedy, L-1855 Luxembourg/B.P. 687 L-2016 Luxembourg.

Banque Pictet & Cie SA is established in Switzerland, exclusively licensed under Swiss Law and therefore subject to the supervision of the Swiss Financial Market Supervisory Authority (FINMA).

Pictet & Cie (Europe) SA is established in Luxembourg, authorized and regulated by the Luxembourg Financial Authority, Commission de Surveillance du Secteur Financier.

This marketing communication is not intended for persons who are citizens of, domiciled or resident in, or entities registered in a country or a jurisdiction in which its distribution, publication, provision or use would violate current laws and regulations.

The information, data and analysis furnished in this document are disclosed for information purposes only. They do not amount to any type of recommendation, either general or tailored to the personal circumstances of any person. Unless specifically stated otherwise, all price information is indicative only. No entity of the Pictet Group may be held liable for them, nor do they constitute an offer or an invitation to buy, sell or subscribe to securities or other financial instruments. The information contained herein is the result neither of financial analysis within the meaning of the Swiss Bankers Association's Directives on the Independence of Financial Research, nor of investment research for the purposes of the relevant EU MiFID provisions. All information and opinions expressed in this document were obtained from sources believed to be reliable and in good faith, but no representation or warranty, express or implied, is made as to its accuracy or completeness.

Except for any obligations that any entity of the Pictet Group might have towards the addressee, the addressee should consider the suitability of the transaction to individual objectives and independently assess, with a professional advisor, the specific financial risks as well as legal, regulatory, credit, tax and accounting consequences.

Furthermore, the information, opinions and estimates in this document reflect an evaluation as of the date of initial publication and may be changed without notice. The Pictet Group is not under any obligation to update or keep current the information contained herein. In case this document refers to the value and income of one or more securities or financial instruments, it is based on rates from the customary sources of financial information that may fluctuate. The market value of financial instruments may vary on the basis of economic, financial or political changes, currency fluctuations, the remaining term, market conditions, the volatility and solvency of the issuer or the benchmark issuer. Some investments may not be readily realizable since the market in the securities can be illiquid. Moreover, exchange rates may have a positive or negative effect on the value, the price or the income of the securities or the related investments mentioned in this document. When investing in emerging countries, please note that the political and economic situation in those countries is significantly less stable than in industrialized countries. They are much more exposed to the risks of rapid political change and economic setbacks.

Past performance must not be considered an indicator or guarantee of future performance, and the addressees of this document are fully responsible for any investments they make. No express or implied warranty is given as to future performance. Moreover, forecasts are not a reliable indicator of future performance. The content of this document can only be read and/or used by its addressee. The Pictet Group is not liable for the use, transmission or exploitation of the content of this document. Therefore, any form of reproduction, copying, disclosure, modification and/or publication of the content is under the sole liability of the addressee of this document, and no liability whatsoever will be incurred by the Pictet Group. The addressee of this document agrees to comply with the applicable laws and regulations in the jurisdictions where they use the information reproduced in this document.

Distributors: Bank Pictet & Cie (Asia) Ltd ("BPCAL") in Singapore and/or Banque Pictet & Cie SA, Hong Kong Branch ("Pictet HK Branch") in Hong Kong.

The information, tools and material presented in this document are provided for information purposes only and are not to be used or considered as an offer, an invitation to offer or solicitation to buy, sell or subscribe for any securities, commodities, derivatives, (in respect of Singapore only) futures, or other financial instruments (collectively referred to as "Investments") or to enter into any legal relations, nor as advice or recommendation with respect to any Investments. This document does not have regard to the specific investment objectives, financial situation and/or the particular needs of any recipient of this document. Investors should seek independent financial advice regarding the appropriateness of investing in any Investments or adopting any strategies discussed in this document, taking into account the specific investment objectives, financial situation or particular needs of the investor, before making a commitment to invest.

BPCAL/Pictet HK Branch has not taken any steps to ensure that the Investments referred to in this document are suitable for any particular investor and accepts no fiduciary duties to any investor in this regard, except as required by applicable laws and regulations. Furthermore, BPCAL/Pictet HK Branch makes no representations and gives no advice concerning the appropriate accounting treatment or possible tax consequences of any Investment. Any investor interested in buying or making any Investment should conduct its own investigation and analysis of the Investment and consult with its own professional adviser(s) as to any Investment including the risks involved.

This document is not to be relied upon in substitution for the exercise of independent judgment. The value and income of any Investment mentioned in this document may fall as well rise. The market value may be affected by, amongst other things, changes in economic, financial, political factors, time to maturity, market conditions and volatility, and the credit quality of any issuer or reference issuer. Furthermore, foreign currency rates of exchange may have a positive or adverse effect on the value, price or income of any Investment mentioned in this document. Accordingly, investors must be willing and able to assume all risks and may receive back less than originally invested.

Past performance should not be taken as an indication or guarantee of future performance and no representation or warranty, expressed or implied, is made by BPCAL/Pictet HK Branch regarding future performance.

This document does not constitute the investment policy of BPCAL/Pictet HK Branch, or an investment recommendation, and merely contains the different assumptions, views and analytical methods of the analysts who prepared them. Furthermore, the information, opinions and estimates expressed herein reflect a judgment at its original date of publication and are subject to change without notice and without any obligation on BPCAL/Pictet HK Branch to update any of them. BPCAL/Pictet HK Branch may have issued or distributed other reports or documents that are inconsistent with, and reach different conclusions from, the information presented in this document.

While the information and opinions presented herein are from sources believed to be reliable, BPCAL/Pictet HK Branch is not able to, and do not make any representation or warranty as to its accuracy or completeness. Accordingly, BPCAL/Pictet HK Branch accepts no liability for loss arising from the use of or reliance on this document presented for information purposes only. BPCAL/Pictet HK Branch reserves the right to act upon or use any of the information in this document at any time, including before its publication herein.

BPCAL/Pictet HK Branch and its affiliates (or employees thereof) may or may not have long or short positions in, and buy or sell, or otherwise have interest in, any of the Investments mentioned herein, and may or may not have relationships with the issuers of or entities connected with Investments mentioned in this document. BPCAL/Pictet HK Branch and their affiliates (or employees thereof) may act inconsistently with the information and/or opinions presented in this document.

The information used to prepare this document and/or any part of such information, may have been provided or circulated to employees and/or one or more clients of BPCAL/Pictet HK Branch before this document was received by you and such information may have been acted upon by such recipients or by BPCAL/Pictet HK Branch.

This document is provided solely for the information of the intended recipient only and should not be reproduced, published, circulated, or disclosed in whole or in part to any other person without the prior written consent of BPCAL/Pictet HK Branch.

Singapore

This document is not directed to, or intended for distribution, publication to or use by, persons who are not accredited investors, expert investors or institutional investors as defined in section 4A of the Securities and Futures Act (Cap. 289 of Singapore) ("SFA") or any person or entity who is a citizen or resident of or located in any locality, state, country or other jurisdiction where such distribution, publication, availability or use would be contrary to law or regulation or would subject BPCAL and any of its affiliates or related corporations to any prospectus or registration requirements.

BPCAL is a wholesale bank regulated by the Monetary Authority of Singapore ("MAS") under the Banking Act Cap. 50 of Singapore, an exempt financial adviser under the Financial Advisers Act Cap. 110 of Singapore ("FAA") and an exempt capital markets licence holder under the SFA. Please contact BPCAL in Singapore in respect of any matters arising from, or in connection with this document.

Hong Kong

This document is not directed to, or intended for distribution, publication to or use by, persons who are not "professional investors" within the meaning of the Securities and Futures Ordinance (Chapter 571 of the Laws of Hong Kong) and any rules made thereunder (the "SFO") or any person or entity who is a citizen or resident of or located in any locality, state, country or other jurisdiction where such distribution, publication, availability or use would be contrary to law or regulation or would subject Pictet HK Branch and any of its affiliates or related corporations to any prospectus or registration requirements. If you do not want Pictet HK Branch to use your personal information for marketing purposes, you can request Pictet HK Branch to stop doing so without incurring any charge to you.

In distributing investment products as agents for third party service providers, Pictet HK Branch is an agent of the third-party service provider, and the product is a product of the third-party service provider but not Pictet HK Branch. In respect of an eligible dispute (as defined in the Terms of Reference for the Financial Dispute Resolution Centre in relation to the Financial Dispute Resolution Scheme) arising between Pictet HK Branch and you out of the selling process or processing of the related transaction, Pictet HK Branch is required to enter into a Financial Dispute Resolution Scheme process with you; however any dispute over the contractual terms of the product should be resolved between directly the third party service provider and you.

Banque Pictet & Cie SA is a limited liability company incorporated Switzerland. It is an authorized institution within the meaning of the Banking Ordinance and a registered institution (CE No.: BMG891) under the SFO carrying on Type 1 (dealing in securities), Type 4 (advising on securities) and Type 9 (asset management) regulated activities. The registered address of Pictet HK Branch is 9/F., Chater House, 8 Connaught Road Central, Hong Kong.

Warning: The contents of this document have not been reviewed by any regulatory authority in Hong Kong. You are advised to exercise caution in relation to the offer. If you are in any doubt about any of the contents of this document, you should obtain independent professional advice. Please contact Pictet HK Branch in Hong Kong in respect of any matters arising from, or in connection with this document.

Distributor: Pictet Bank & Trust Limited, where registered office is located at Building 1, Bayside Executive Park, West Bay Street & Blake Road, Nassau, New Providence, The Bahamas.

The document is not directed to, or intended for distribution or publication to or use by persons who are not Accredited Investors (as defined in the Securities Industry Regulations, 2012) and subject to the conditions set forth in the Securities Industry Regulations, 2012 or to any person or entity who is a citizen or resident of or located in any locality, state, country or other jurisdiction where such distribution, publication, availability or use would be contrary to law or regulation or would subject Pictet Bank & Trust Limited to any prospectus or registration requirements. Pictet Bank & Trust Limited is incorporated in The Bahamas with limited liability. It is a bank and trust company that is licensed in accordance with the Banks and Trust Companies' Regulation Act and is regulated by the Central Bank of The Bahamas. Additionally, Pictet Bank & Trust Limited is registered with the Securities Commission of The Bahamas as a Broker Dealer II and is approved to (i) Deal in Securities 1.(a) & (c); (ii) Arrange Deals in securities; (iii) Manage Securities ; (iv) Advise on Securities.

Warning: The content of this document has not been reviewed by any regulatory authority in The Bahamas. You are, therefore, advised to exercise caution when processing the information contained herein. If you are in any doubt about any of the content of this document, you should obtain independent professional advice.