TAKE 5 VIEWS

Global Investing

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This year, we've spent a lot of time telling investors to "think outside the box," referring of course to the corner of the investing style-box that measures the return of large-cap growth equities. Measured by the price/earnings ratio, one of the critical metrics money managers use to measure valuation, stocks in big fast-growing companies are at very high levels compared to their historical averages. When that happens, some investors seek to mitigate their stock market risk by investing in parts of the market that may look unreasonably cheap—the beat-up and unloved stocks of the past few years.

One such sector is the non-U.S. stock market, including developed and emerging markets of the world. In the past five years, while large U.S. companies have climbed 23.5% a year, annualized, the rest of the developed world was up 9.4%. Is it time to allocate out of the high-flyers and home and hunt for prospects elsewhere? We asked strategists and portfolio managers from a range of firms to share their thoughts. They begin with a broad survey of the international (non-U.S.) markets, through developed European economies, to the broadly defined emerging markets, and finally with a pair of articles on China, and its prospects for growth—one cautionary, one more rosy.

Enjoy the rest of your summer.

1 A solid first half for international equities Can the pattern hold?

Thomas Banks, CFA, Portfolio Manager, Senior Investment Analyst, Federated Hermes

The tally from the most recent earnings season has been largely positive for international equities—a strikingly different outcome from the year-ago quarter. While we are mindful of the various uncertainties that await in the second half, several positive themes are emerging:

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- **Companies are going from strength to strength.** For the three months ended in June, constituents of the MSCI ACWI ex USA SMID Cap Index, which contains over 5,000 companies in 49 countries, reported consolidated revenue growth of 23.7%, the highest in more than a decade. Of course, that growth rate is flattered by a comparison to 2020's second quarter, which felt the full effect from Covid-19 lock downs. A more realistic comparison to second quarter 2019 sales shows that growth was up 7.5%, still well above the index's flat median quarterly growth rate over the past decade. Encouragingly, many companies are reinvesting their sales windfalls into higher spending on research & development and marketing (as measured as a percentage of their sales), creating what we believe will be a flywheel of sustainable profitable growth over the coming years.
- **Inflation is most likely a manageable headwind.** Pricing power is a critical attribute for commodity-consuming businesses such as Consumer Staples, particularly during periods of rising costs. While most of these companies revised their cost outlooks upward, they reiterated their original profit margin guidance as they are planning price increases and additional cost savings. All signs point to most commodity-exposed companies being able to navigate the current inflationary environment and end up relatively unscathed.
- **Shareholders are being rewarded.** The V-shaped recovery of the past 12 months left many companies with excess capital. We were positively surprised by the large number that have announced a resumption of share buybacks or special dividend payouts. We view these as signs of disciplined management teams when it comes to capital allocation, a key driver of future shareholder returns.
- **Earnings breadth is improving.** A stark contrast from a year ago is the current breadth of earnings strength. Last year's earnings were bifurcated between "stay-at-home winners" and "reopening plays." While many of the reopening plays (i.e., companies typically reliant on travel & leisure) continue to report challenged revenue growth, they have fortified their balance sheets and addressed their cost-bases, leaving them well positioned for an eventual recovery in their markets.

International outlook through year-end

In the third quarter, we expect a continuation of robust growth with the pace of growth gradually normalizing through year-end. Mindful of yet another delayed recovery following Covid-19 variant outbreaks, we believe some of the beaten-down yet larger, well-capitalized travel & leisure companies are ripe for a significant rebound.

Meanwhile, there's no shortage of concerns, whether it's peak growth, transitory or non-transitory inflation, Covid-19 variants or monetary and fiscal policy shifts. Given these uncertainties, we believe investors will be best served by constructing portfolios across a broader array of sectors and around companies with strong long-term fundamentals. Promising industries with long-term secular growth prospects include renewable energy and digital advertising.

As we have observed in the past, uncertainties often breed opportunities. With a large investment universe at our disposal, we continue to canvas our markets for new opportunities as we head into the second half of the year.

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2 European equity outlook

Lazard Asset Management

LAZARD ASSET MANAGEMENT

A Complicated and Mixed Outlook

As Europe emerges from the worst of the pandemic, the outlook is becoming more challenging to decipher. We are currently annualizing the worst of the Covid-19 impacts and this makes the corporate and economic recovery appear very strong against a low base. A variety of metrics are showing significant rebounds, including oil usage, cars on the road, corporate earnings numbers, and the inflation data sets. Because 2020 numbers

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were so low, we are seeing significant increases on these metrics year on year. At the moment, the market feels comfortable that we are in a full state of recovery, and the only debate is about the pace of recovery.

However, over the rest of 2021 the picture will become dramatically more mixed and nuanced for a whole set of companies as new numbers come out. Both bulls and bears will find data to support their views on the markets as macro lead indicators, corporate results, and sector data sets change at difference paces. Thus, we can expect sentiment to rise and fall as we move through the year.

Inflation Debate at the Fore

Inflation remains the greatest debate. The battle between the market's expectations for inflation and employment data, combined with the U.S. Federal Reserve's market intervention and forward guidance has the market in a quandary. With inflation higher than expected and the rates curve flattening, it's hard to know how the market will respond to the next set of price data. In the near term there is likely to be more inflationary pressure than the market expects. Prices for the vast majority of the inputs that will ultimately feed into the cost of production are rising. These inputs range from raw materials all the way through to electricity, oil, and the cost of services such as transportation. For example, the cost of shipping containers from China remains significantly higher than a year ago (Exhibit 1).

Exhibit 1: Containerized Shipping Costs Spiking

Source: Bloomberg, As of June 17, 2021

The question now is how well companies can pass on input costs to their customers and how inflation impacts others in the supply chain. Recently, some of the pressure has been taken off the stock market as there have been some signs that commodity prices in China are getting close to a near-term peak. It is too early to tell if this turn will broaden, and even if it does, it would have to be a significant shift in trend to relieve the bulk of the inflationary pressure.

A key factor in this debate is the global central banks' response to the inflation numbers. For now they seem keen to maintain a stimulative monetary environment, while continuing to monitor data carefully. A consistent view across different central bankers is that they should not allow the bond market to significantly tighten the monetary environment ahead of their own policy. A highly liquid monetary environment clearly supports recovering equity markets, and we believe that support will continue until central banks start to worry more about inflation. That, in turn, will likely happen if inflation numbers don't begin to stabilize toward the end of the year.

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Supportive Company Management Sentiment

We have maintained a high level of contact with company management teams, and the majority are very happy with the recovery they have seen so far. Low borrowing costs and the strong economic recovery driving revenue growth have made most teams confident about the road ahead, with bullish company statements in most sectors. The more cyclical sectors are outpacing the rest, but even defensive sectors are seeing some demand pick-up.

At the same time, corporates are considering how to deal with an increasingly inflationary environment. Executives across a wide variety of sectors believe they have power to pass on price increases, so outside of Covid-19, they are flagging very few considerable risks. However, it seems relatively unlikely that all companies will enjoy pricing power, particularly as supply bottlenecks are resolved, and this will be worth watching as the year progresses.

Many companies are highlighting that the pandemic has given them new insights into their businesses and illustrated changes they could make for the better, such as opportunities to streamline operations or automate processes, thereby improving margins beyond what they thought achievable pre-pandemic.

Company sentiment should always be taken with a note of caution, as management teams do not always provide good leading indicators on their own businesses. While we're not negative, we are being quite careful about which companies we take seriously in terms of their own outlooks. They are often a bit backward looking and might be getting caught up in the broader euphoria of large positive percentage changes.

Political Breezes of Change

Political change is always a factor, but with Brexit and the Trump presidency behind us, political factors in the short term have settled into more of a breeze than a storm. Germany stages elections in September, but polls currently suggest no significant policy shifts post election. Initially, it appeared that the Green Party was making headway in the polls, but a more stable environment is now emerging. Germany's political environment is quite consensus-based, and none of the political election platforms suggest any significant shifts or market-unfriendly developments.

In the United States, the Biden administration has a relatively limited amount of time before the 2022 midterm elections. Most significantly for markets, President Biden has put forward a broad set of policy proposals on infrastructure and global taxation, and the administration is pushing hard to get global traction for the latter proposal. Should a global single corporation minimum tax rate be agreed and implemented, it could affect company earnings and valuations, particularly in the tech sector. In reality, getting countries to align behind a global tax is a big ask. Nevertheless, the progress of this proposal requires careful monitoring.

Consumption Binge Is Generating Opportunities

Because the environment is nuanced and quirky, we are finding value and stock ideas across an unusually wide range of sectors. Extremely robust household balance sheets bode well for consumption. This theme is strongest in the United States, but resonates across Europe and Asia as well. We believe investors can find exposure to this theme through a broad set of stocks in the consumer discretionary sector, including luxury and other consumer goods, retail, and even travel-related stocks.

ESG: Environmental Legislation in German Property

From an environmental, social, and governance (ESG) perspective, corporate activity in German property highlights an interesting example of how environmental legislation is changing market returns. We believe the market is overly focused on the politics around rent rises and ownership of rental properties in Germany, while the real opportunity is in investing in property portfolios to make them more energy efficient. This offers the potential to have both a positive environmental impact and attractive investment returns, which is something we think the market is underestimating.

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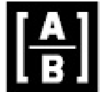
Overall, the complex and nuanced environment, at both a macro and company level, is a positive one for stock selection, with a wide dispersion of returns across sectors and companies likely. A focus on fundamentals and active management will be critical for identifying potential winners as the recovery strengthens. Meanwhile, investing with an ESG lens continues to unearth opportunities.

3 Looking back and ahead: eventful decades for emerging markets



Morgan C. Harting, CFA, FRM, CAIA, Portfolio Manager—Multi-Asset Solutions, AllianceBernstein

In 2010, 68% of the companies in Fortune Magazine's Global 500 were domiciled in Group of Seven (G7) countries, compared with 17% in the E20* emerging-market (EM) countries. When 2020 ended, the percentage of E20 companies had nearly doubled to 34%. And 124 China-domiciled firms resided in the Global 500, pushing the U.S. into second place.

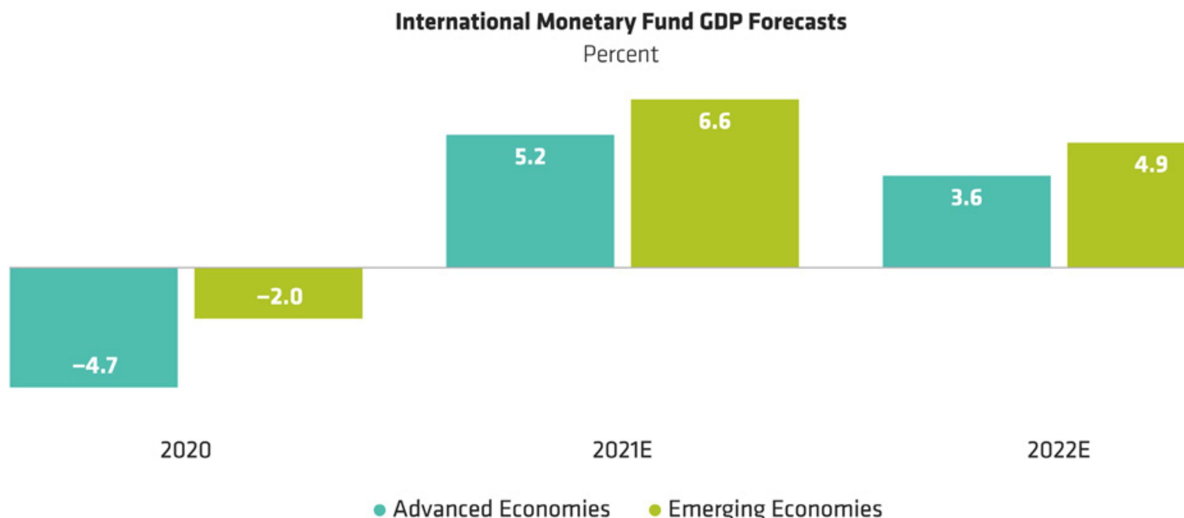
That's quite a decade for EM corporations, and an eventful one for emerging markets more broadly. In a period roughly bookended by the recovery from the global financial crisis and the Covid-19 pandemic, there were good years and bad years that required multi-asset investors to manage volatility while tapping into opportunity.

We've seen many attention-grabbing headlines in the past decade, but slower-moving trends may have been even more impactful. We'll focus on two: the relationship between economic growth and valuations and a transformation from commodity-driven to technology-driven. We'll also highlight two key trends we expect to see in the decade ahead—and a story that we believe remains timeless.

Disconnect Between Economic Growth and Equity Valuations

The years 2011 through 2020 saw a healthy expansion in emerging economies, with real gross domestic product (GDP) growth averaging 4.1% annually, handily outpacing developed markets' 1.5%, a trend we expect to continue (display below). China led the cohort of larger countries, but many smaller countries—including Vietnam, Turkey, Ivory Coast and the Dominican Republic—posted above-average growth, too.

Above-Trend Growth Expected for Emerging Markets



Source: International Monetary Fund and AllianceBernstein (AB), As of March 31, 2021
Past performance and current forecasts do not guarantee future results.

*The E20 is a group of top 20 emerging markets selected by Fortune based on their economic and demographic weights. In 2020, the E20 included Argentina, Bangladesh, Brazil, China, Colombia, Egypt, India, Indonesia, Iran, Malaysia, Mexico, Nigeria, Philippines, South Korea, Saudi Arabia, South Africa, Thailand, Turkey, Poland and the Russian Federation.

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Surging economies bolstered government revenues, fundamentals and creditworthiness. All of this was reflected in strong credit returns—given superior growth and declining interest rates globally, that's not surprising. Many countries with the fastest growth, and therefore greatest credit improvement, such as Ivory Coast and Dominican Republic, could only be accessed by debt investors.

What may be surprising is that overall equity returns weren't stronger. Historically, equity returns generally outpace debt returns, especially when growth is good. So, how do we square the difference? We think it comes down to earnings growth and valuations. Some firms certainly shone, notably innovative global tech leaders: over the past decade, Tencent's earnings per share (EPS) vaulted from 1.05 to 14.82 and Samsung Electronics' from 1,660 to 5,778.

But EM equity indices also include a raft of less competitive companies, many heavily influenced by state owners or regulators. These constituents dragged down overall EPS growth to 5% (total, not annualized) versus 104% for the S&P 500. As a result, investors haven't bid up overall EM valuations as much (10.2x in 2011 to 14.2x today) as they have in the U.S., where S&P 500 EPS has risen from 13.5x to 22.6x.

So, growth matters, but in different ways for emerging equity and debt. Equity investors need to find companies that will deliver the strongest earnings growth; sovereign debt investors focus on countries undergoing credit-strengthening reforms that support higher and sustainable economic growth. For multi-asset investors, both trajectories matter to capitalizing on opportunities.

The Great Commodity-to-Technology Transition

A decade ago, emerging equity indices reflected industries typically associated with less developed economies—heavily reliant on natural resources. Index heavyweights were often natural resources issuers needing capital to grow, including energy and mining firms. Banks and telecoms were heavily represented, too.

Fast forward a decade, and technology and innovation dominate emerging equity indices, including many global market leaders (display below). Technology stocks, just 10% of the MSCI EM Index 10 years ago, have doubled their share to 20%. The real proportion is arguably higher, too, because companies such as Tencent and Alibaba aren't officially classified as technology.

The natural resources to technology evolution has been a sea change for emerging equity indices, and creates an exciting opportunity set that's very different from the days of dominance by the likes of Gazprom and Petrobras.

The Changing Face of Emerging Markets

Top Five EM Stocks: 2011	Top Five EM Stocks: 2021
1. ● **Samsung Electronics** (South Korea)	● **Taiwan Semiconductor**
2. ● **Gazprom** (Russia–energy)	● **Tencent** (China–e-commerce, entertainment)
3. ● **Petrobas** (Brazil–energy)	● **Alibaba** (China–e-commerce, retail)
4. ● **Taiwan Semiconductor**	● **Samsung Electronics**
5. ● **Vale** (Brazil–mining)	● **Meituan** (China–e-commerce, food)

● Natural Resources ● Technology and Tech-Driven

Source: MSCI and AllianceBernstein (AB) As of March 31, 2021

Past performance and current analysis do not guarantee future results.

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Recovery and Emergence From Covid-19

Just as the past 10 years have seen transformation in emerging markets, so will the decade ahead. One notable short-term dynamic will be the road back from the pandemic—a path that will differ for every nation. China, hit first by the pandemic, was also the first to emerge on the other side, leading many Western countries. Taiwan was barely affected, while India and Brazil have been among the hardest hit. As the paths vary, so will the risks and opportunities.

With the world continuing to reopen, we expect business demand for capital and government demand for liquidity to push capital flows beyond the U.S. and early reopeners into other regions, including emerging markets. Strong central bank policy stimulus will likely continue, tempering economic risks. And, as vaccine progress releases pent-up activity, many EM firms will benefit from surging demand in both their domestic and international marketplaces.

A Quest for Supply-Chain Diversification

Another trend that we expect to play out, over the next five years, is accelerating supply-chain diversification, driven in part by concern over geopolitical risk. Today, most products are built with components produced and sourced across the globe, whether it's a car, computer, coffeemaker or shampoo. Firms will seek to insulate those all-important supply chains from flare-ups and conflicts.

The Suez Canal blockage by a wayward ship highlighted that non-geopolitical risks can crimp stretched supply chains and thin inventories, too. We think companies should—and will—reevaluate existing operations, and emphasize building in greater resilience for the future. In practice, this push will likely translate into building more production facilities and rebuilding inventory in more locations.

Growing scrutiny of environmental, social and governance (ESG) behaviors will also alter supply-chain sourcing. Human rights abuses and climate change, for example, are pressing issues, and the world is increasingly using ESG considerations to steer capital. That will push firms to address ESG concerns in their supply chains, which will require new capital enticed from investors by higher potential returns.

Diversification and Flexibility Still Required

One story that we don't expect to change over the next decade is the need for investors to integrate exposures thoughtfully when tapping equity, debt and currency opportunities. Getting the formula right can bolster potential returns and diversification, potentially reducing the impact of losses in one company, industry or asset class.

Flexibility will be needed, too, because the full range of emerging opportunities reaches well beyond broad indices. One widely used emerging equity index, for instance, includes issuers domiciled in 26 countries; from our perspective, the emerging universe spans more than 60 countries. A "go anywhere" approach may give investors access to a wider array of opportunities.

4 Outlook for China

Carl Ang, Research Analyst, MFS

Carl Ang recently answered questions about what lies ahead.

Could you provide a perspective on China as a regional economic driver for Asia in the current post-Covid-19 environment?

From a business cycle perspective, a key differentiator during the Covid-19 period has been that the demand impulse has been a little more concentrated in goods compared to services and all that has been tied to advanced-economy demand for consumer goods. Part of this reflects the material government support that's been extended to households in advanced economies. By contrast, that's been largely missing in China, as you can tell from retail sales as a consequence. I think China's recovery has generated fewer positive spillovers to the Asia region compared to earlier cycles. So one way this has played out has also been in the absence of Chinese services consumption, such as tourism, which is a sector that's fairly important to emerging economies like Thailand and to a lesser extent, some of the developed economies in the region like Japan.

I think this situation is at risk of persisting as China's broadly conservative stance on Covid-19 management will likely roll on for several quarters. Chinese border restrictions will likely extend well into 2022. Another aspect to this is also quality over quantity emphasis in China's monetary and fiscal stimulus. So that means that compared to the past, we've seen a little more domestically focused social services spending and a little less support for infrastructure and real estate investment. And the latter tends to be more commodity intensive.

Can you comment on the prospects for some of the Asian economies in terms of growth and inflation?

In Asia, we have some leading economies exhibiting a combination of robust recovery-related internal demand and strong exports. Examples of this would include electronics exports from South Korea or iron ore exports from Australia, with both economies more on the developed end. In contrast, there is a much more subdued outlook for many of the emerging economies, such as Indonesia, which remain weighed down by low vaccination rates. This uncertain environment is helping to keep inflationary pressures for downstream consumer prices in check, both in the region and globally, despite some large increases in upstream producer prices.

We're also starting to see that in terms of the policy divergence in the region as well. China recently embarked on a new monetary policy easing, with a reduction in its reserve requirement ratio, while expectations are for New Zealand's central bank to tighten later this year via policy rate hikes, given concerns over the risk of a wage-price spiral amidst international border restrictions. The stimulus-induced increase in house prices and household leverage is also a complicating factor for the growth and inflation outlook, given the range of possible policy responses. For example, in South Korea, these financial stability risks underpin the monetary policy tightening bias, whilst in New Zealand less traditional responses are underway, such as government regulation and macro-prudential lending restrictions.

How much positive momentum remains in upstream commodity prices?

It depends on the commodity in question, but my overall sense is that upward price pressures are not broad-based. I see a risk of a more persistent supply-demand mismatch and higher prices in electric-related base metals like copper, rather than bulk commodities such as coal. Bulk commodities also include iron ore, Australia's major export to China, where prices remain at historically high levels on still strong steel producer demand, mainly from China as well as yet-to-be resolved supply disruptions in Brazil. However, the balance of price risks appear to be to the downside, given supply normalization and eventually lower demand from Chinese efforts to reduce steel output and curb pollution in the economy. The sustainability of further iron ore price rises is challenged by the softness in related commodity currencies like the Australian dollar.

5 A closer look at the Chinese tech sell-off

Kristina Hooper, Chief Global Market Strategist,
Invesco Distributors, Inc.

Key takeaways

- **New regulations surprised investors.** Chinese regulators surprised markets by publishing regulations requiring tutoring service providers to be run as not-for-profit entities.
- **Chinese stocks dropped.** This triggered a substantial sell-off: Chinese tech stocks and Chinese equities in general sold off indiscriminately.
- **A buying opportunity in tech?** I believe this is an opportunity for investors to look for buying opportunities in Chinese tech stocks, albeit through a discerning lens.

Recently, it seems almost all the questions we are getting from clients are about China – what is going on with Chinese stocks and whether investors should abandon them. The catalyst for these recent jitters: Last week, Chinese regulators surprised markets by publishing regulations requiring tutoring service providers to be run as not-for-profit entities. This triggered a substantial sell-off across Chinese equities.

What prompted these regulations?

First of all, I think it's important to understand the rationale for China's decision on for-profit educational businesses. Currently, it is very expensive for Chinese families to utilize tutors to help their children perform well during their compulsory years of education, but many families view it as a necessity to help their children succeed academically and be accepted at a highly regarded university. The Chinese government recognizes that this places a significant and unfair burden on families – and may be a hindrance to China's goal of encouraging couples to have larger families. China recognizes that it is in the best interest of the country that all its children have equal access to educational opportunities. It's clear that the Chinese government is willing to tolerate short-term volatility in order to achieve longer-term goals.

It's understandable that this regulation of the for-profit education industry, which includes the banning of foreign investors, would exert downward pressure on stocks in that industry. However, the reaction was far more broad-based: Chinese tech stocks and Chinese equities, in general, sold off indiscriminately. I suspect it's because this decision follows on the heels of a series of other regulatory decisions in recent months that impacted other industries. The objective of these regulatory actions is not to drive foreign investors from China – or for China to undermine its market economy. Rather, authorities seem to be doing what other countries have only talked about doing in terms of addressing issues that have arisen in recent years:

- **Financial stability:** China wants to ensure adequate risk controls for financial services companies, including sufficient capitalization.
- **Data protection:** Data security is an important issue for all companies and consumers, but countries have done little to protect data. Chinese policymakers believe data security is a national security issue, and as such, do not want foreign entities to have access to Chinese companies' data.
- **Break-up of tech monopolies:** Authorities are concerned that some companies may gain an unfair ability to set higher prices because they control an industry. They also want to ensure that smaller businesses are not at a disadvantage when competing.
- **Better conditions for workers:** China wants to ensure "gig workers" receive adequate treatment from employers, including earning a living wage and receiving health benefits.
- **Combating climate change:** The government wants to support a "greening" of the economy.

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China seeks to calm investor fears

The Chinese government showed that investors matter by quickly pulling together a meeting last week between Chinese regulators and brokerage firms to help explain its most recent decision and to assuage fears. China Securities Regulatory Commission Vice Chairman Fang Xinghai reassured participants that Chinese companies will still be allowed to go public in the United States as long as they meet criteria set out by the Chinese government for listing. That doesn't mean we won't see more regulation going forward, as authorities think strategically about the longer term, but I would expect it to be targeted and based on China's focus on achieving higher-level goals.

My takeaway from this situation is that many Chinese equities, especially Chinese tech companies, have been unfairly punished by investors as a result of recent regulatory actions. However, that has created more attractive valuations. As of July 30, the trailing price-to-earnings (P/E) ratio on the MSCI China Index is 18.86, which compares favorably to that of the MSCI World Index at 26.07[1]. Rather than abandoning Chinese tech companies, I believe this is an opportunity for investors to look for buying opportunities, albeit through a discerning lens.

1 Source: Bloomberg L.P as of July 30, 2021

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