Global Market Outlook 2023

Fidelity Global Emerging Markets Fund

Amit Goel

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Emerging markets – well positioned for 2023

While the challenges that made markets volatile in 2022 are likely to persist in the new year, emerging markets are well positioned, given their economies' underlying structural growth prospects and the lessons learnt from the past.

Key points

- On a positive note, we could see inflation peaking, allowing global central banks to loosen monetary policy. This will be positive for emerging market equities, trading at an extreme discount to developed market peers.
- In contrast, geopolitics and a sustained slowdown in the global economy could have an adverse impact, particularly for technology hardware exporters and those dependent on commodity exports.
- The emergence of dominant domestic consumption names that can take market share from their global peers and technology firms that are becoming integral in global supply chains have strengthened the makeup of the emerging market index.

Under the backdrop of inflation, geopolitical tensions and slowing growth, what is the investment outlook for Emerging Markets in 2023?

Geopolitical concerns, higher inflation, rising interest rates and slowing economic growth have created significant challenges for equity markets, fuelling much of the volatility in 2022. This is likely to continue in the new year. Although it is hard to predict how markets will behave in a year's time, we continue to believe that emerging markets are better placed than their peers in such an environment due to their economies' underlying structural growth prospects, which will go on underpinning corporate earnings and returns over the medium to long term.

Having learnt their lessons from past crises, developing economies should be able to continue to find a firm footing, given their robust government balance sheets, better current account balances, comfortable foreign exchange reserves and higher import cover. Inflationary pressures have also been receding, and interest rates are near their peaks. In North Asia, including China, we believe that inflation – on aggregate – will be lower than in past cycles. In other parts of emerging markets, aggressive monetary tightening is yielding results, and inflation is retreating. Also, some of these countries are used to coping with high inflation levels, and there are robust mechanisms of inflation transmission built into wages and other contracts, which should prevent a standard-of-living crisis that we see in the West.

We will continue to follow our bottom-up, research-driven process and the investment philosophy of holding high-quality companies with robust sustainability characteristics in sectors where structural growth opportunities exist. Top-down macro views will inform our assumptions as we assess key fundamentals, such as draw-down risk, cost of risk, discount rates and hurdle rates. While we will continue to be aware of what's happening on the macroeconomic and political fronts, we will focus sharply on the specifics of each company that we hold or want to include in our portfolio to drive alpha for our investors.

What do you think could surprise the market in 2023, either positively or negatively?

One area we are watching closely is China. Over the last three to four months, we have been trimming our exposure to China, particularly in the internet space. Our current exposure to mainland China and Hong Kong is through a select group of high-quality businesses with solid long-term growth outlooks. Most of these are domestic leaders within the sectors they operate in and hence, are not affected by geopolitical headwinds while trading at reasonable valuations.

More positively, we could see inflation peaking, allowing global central banks to loosen monetary policy to support growth and avert a cost-of-living crisis in the developed world. This will be positive for emerging market equities currently trading at an extreme discount to developed markets. Also, with a growing focus on sustainability, our holdings in companies with good or improving environmental, social and governance (ESG) credentials should re-rate and help us generate alpha.

What themes, sectors or regions would offer opportunities and potential risks?

We believe geopolitics and a sustained slowdown in the global economy are potential risks that could have an adverse impact on emerging market equities, particularly for exporters of technology hardware in markets such as Korea and Taiwan and for those that are dependent on commodity exports, as in the case of Latin America and EMEA.

Over the mid to long term, however, the emerging markets benchmark is becoming a more competitive index than in the past, which is a better starting point in valuations. In addition, the emergence of dominant domestic companies in areas of consumption that can take market share from their global peers, and those in technology that are becoming more integral in global supply chains, have strengthened the makeup of the emerging markets index. In comparison, this improved index is now trading at a substantial discount of some 40 to 50 per cent to the developed market benchmark on a historical basis. In addition, the index is behind the curve on sustainability factors. This confers on the underlying holdings a substantial re-rating potential as companies in this asset class catch up to their developed market peers.

Within your portfolio, what has worked well in 2022, and what will you do differently in 2023?

Our focus on high-quality, sustainable businesses with strong corporate governance practices worked well for us in 2022. Notably, holdings that have proved particularly rewarding include several high-quality private sector lenders in India and Indonesia and domestic-focused consumer names, such as a premium motorcycle maker in India and a Brazilian car rental company.

We will stick to our process as we enter 2023. Instead of diversifying our portfolio to counter a tough macro environment and volatile markets, we prefer to deepen our focus and get closer to the businesses we invest in. We will intensify our engagement with the management teams of the companies we hold, as well as with other key stakeholders. The idea is to ensure that we fully understand their sustainability policies, pricing power, and their ability to gain market share to navigate a challenging period of elevated cost pressures amid a slower growth backdrop. This deeper understanding of our investee companies should also help us assess the risks more accurately.

How do you expect sustainability factors to influence returns in 2023, and how is this reflected in your portfolios?

Fundamental and sustainability analyses are the bedrock of our due diligence and investment decisions. Staying with businesses with strong or improving sustainability practices will continue to be key in generating higher returns for our clients and protecting the portfolio from downside risks.

In terms of the portfolio's credit rating, more than 80 per cent is rated BBB and above, while over 90 per cent is rated BB and above. The remainder of the portfolio either has a better rating assigned by our analysts or an improving ESG profile.

Meanwhile, the portfolio maintains a lower carbon footprint than its investment universe. In particular, the carbon emission per million dollars invested is less than 10 per cent of the index.