



## Fundamental Equities Outlook Q3 2022

# Anyone for hiking this summer? Let's get it over with!

- Clarity needed as we enter a period of summer rate hikes
- Emerging Markets and Asia less troubled by inflation
- Value and pricing power important to outperform

### A bad time for a walk...

We've done a lot of hiking in Hong Kong lately. With overseas trips still off limits, we look for little chances to escape the city in our own territory. Fortunately, the hills in Hong Kong offer plenty of such opportunities. Now that the summer is here, though, the weather has become very wet and muggy, so hiking is something you do in winter, not summer.

### ...but a good time for raising rates

But this is not the case for the Federal Reserve, which sees this summer as the right season to hike. With a newfound realization that it is behind the curve, the Fed has implemented some rather aggressive rate hikes. What used to be the Fed put – whereby the Fed stepped in to support the financial markets whenever they were in trouble – clearly is no longer. And rightly so, because inflation seems to be reaching runaway levels and needs to be curtailed. This of course has big implications for people's lives: those on low wages are being hit hard by soaring prices and need protection much more than those who are active in the stock market. As equity investors, we become collateral damage.

**Fundamental Equities Outlook Q3 2022**  
For professional investors  
June 2022

Robeco Fundamental Equity Team

The ECB is set to follow suit by hiking short rates this summer. For those in the pension fund industry, though, rate hikes can be helpful as the increased discount rates they result in mean coverage ratios go up.

### A slowing economy isn't necessarily bad for equities, but we need certainty about rates

The end of zero rates will be deflationary for asset prices. It will also expose those who have been swimming naked in investment terms. Since 2008, we have become accustomed to large-scale money printing, which has obscured a lot of excessive debts and other underlying economic weaknesses. Also, many companies that have been innovative but that have adopted questionable business models have seen their inflated valuations come down dramatically. Most other companies are fighting to protect their margins in a world in which raw materials and labor have become both harder to come by and more expensive.

Equity markets want the hikes to be executed as quickly as possible so they can price in the new reality. That certainty may come in the second half of 2022, if long rates find a new level. Slower growth is a given, but even if a recession were to materialize, that doesn't necessarily mean equities will fall further.

Overall, equity market sentiment has quickly become deeply depressed. But this is exactly why there could be upside in the third quarter. We are not afraid of the slowdown and can find plenty of appealing stocks for those with a longer-term horizon. The collapse in profitless tech has attracted too many negative headlines and has resulted in a widespread sell-off that has hit companies with solid earnings. But we want to know where rates are going to stabilize so we can refresh our discounted cash flow models with a new, higher discount rate. As soon as uncertainty about rates is out of the way, we are confident that our revised models will show our holdings have attractive upside.

### Asia insulated from inflation

As rates rise and economies slow down, we will see the demand destruction that is needed to solve supply-chain problems and tame inflation. Interestingly, Asia has so far had much less of an issue with inflation than other regions. Yes, there has been cost-push inflation because many Asian economies are commodity importers, but there hasn't been so much demand-pull inflation as in Europe and the US as Asian central banks have not printed so much money to prop up their economies – not just during the pandemic, but also in the years before. This means that Asian economies have been operating well below potential for several years. So while Asian markets have historically suffered when US interest rates have been rising, I can't see too much damage being done this time, especially since Asia and emerging markets in general have been out of favor among global investors for some years.

### A grim picture in Europe

In Europe, however, the environment looks grim for consumers: prices are up in broad terms and energy is close to unaffordable (if you can even get it!). At the same time, governments are tightening their belts. The war in Ukraine looks like it's going to be a drawn-out affair, with both parties digging their heels in, which means there's little hope of any relief for energy and food prices. We expect social tensions to rise in the region as wage increases do not prove enough to keep up with the escalation in the cost of living. And yet we will see the end of negative rates during the summer as the ECB has an even clearer mandate to fight inflation than the Fed. In Europe too, all we need is certainty about the path of hikes and the level they will reach for markets to be able to move on.

### Look for value and pricing power

In these conditions, it's vital for equity investors to look for companies with value and pricing power. The good news is that the broad-based market falls have resulted in many high-quality companies returning to attractive levels. What's more, corporate profitability remains healthy and sectors with pricing power like commodities and tech, but also financials and many industrials, have posted solid results, so the price declines have just caused a derating of stock multiples.

### Slowdown could be helpful for the clean energy transition

Many companies have been investing to make their processes cleaner and greener. In general, it's the listed large-cap companies that have been making the changes we need to see for the world to achieve a low-carbon future. It has to be said that an economic slowdown will make it easier for the supply of clean energy to catch up with demand.

## China and Japan could perform well

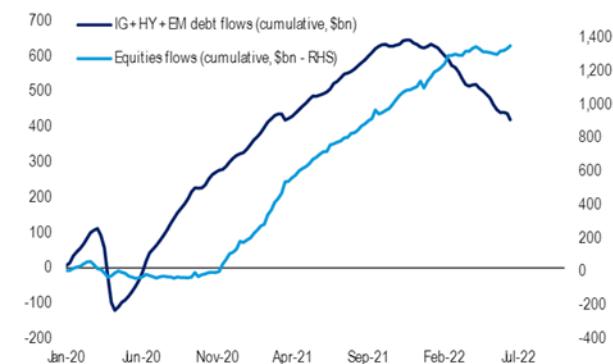
China is slowly giving up on the self-inflicted damage caused by the strict zero-Covid-policies it has implemented, and its reopening may well boost the global economy. Its stock market is showing clear signs of bottoming and liquidity will not be tightened in this country.

The Japanese economy could also perform better than expected now that the Bank of Japan is the only central bank to be providing free money. Its yield curve control policy seems increasingly unsustainable, but the bank just doesn't believe that the deflationary mindset has been completely stamped out from its citizens despite ten years of considerable effort to push inflation up to 2%. So the tail risk is that Japan could possibly move from inflation to runaway inflation very quickly.

## Attractive opportunities for long-term investors

Fund flows into equities have been surprisingly resilient over the past 18 months (see chart below). Bond yields don't yet seem to be appealing enough to bring about a major rotation into fixed income, and wider credit spreads actually seem to be scaring investors away from corporate bonds. With bond rates likely to remain too low to offer positive real yields, equities will continue to be the best choice. Some investors with weak hands may lose their grip of equities over the summer, but such a shake-out will create opportunities for long-term investors. Our portfolio managers and analysts will look beyond the upcoming hikes and seek to identify those companies that can thrive in a slowing economy.

### Credit vs Equity cumulative flows



Source: BofA Global Investment Strategy, EPFR

Please take in the views of our fundamental equity teams over the next few pages, with a brief summary below, and enjoy your summer. Take heart that by the end of the third quarter, the veil of uncertainty about rates will have lifted and could set the stage for a rally as we approach the end of the year.

## Key takeaways for developed and emerging markets

For Global Markets sentiment has deteriorated from neutral to negative given the rate hike environment. Consumer confidence has fallen which will likely squeeze margins but it is important to note that household and corporate balance sheets are in good health particularly compared to pre-recessionary periods. To best navigate the current environment we continue to look for high quality companies with pricing power. One sector of particular interest is healthcare and with its recurring revenues it is widely considered to be more recession-proof than other sectors. We also continue to find high-quality companies in two favoured sectors, technology and financials, where we have high exposure.

We are more optimistic about emerging equities' prospects over the coming quarter than we were at the beginning of Q2. Some emerging countries have room to loosen monetary and fiscal policies or are near the end of their monetary tightening cycle. In fact, emerging markets overall are at a different stage of the cycle to most developed countries. We would still advocate caution towards the asset class based on our five factor scores, but investors might consider increasing their allocation if they have a big underweight in emerging markets relative to developed equities. We advocate a neutral position in a global equity portfolio for now.

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June 2022

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## Developed Market Equities | Reduce portfolio risk during the Summer of Hikes

- Sentiment has deteriorated from neutral to negative as we enter what looks set to be a summer of rate hikes.
- We expect worsening consumer confidence to drag on earnings forecasts, although some sectors, like energy and financials, should prove relatively resilient.
- We have downgraded our earnings and technicals scores but upgraded valuation, which is more favorable than at any time in the past 10 years.
- Overall, we have a neutral outlook for developed equities and recommend minimizing portfolio risk until the volume and magnitude of rate hikes reduce by continuing to invest in high-quality companies with pricing power.

### Five-factor summary

Factors	Score	Changes since last quarter
Macro	=	No change
Earnings	-	↓
Valuation	+	↑
Technical	=	↓
Sentiment	=	No change
Overall	=	No change

Source: Robeco Global Equities team

### Sentiment

Fifty-five years ago, we had the Summer of Love... now we have the Summer of Hikes.

The summer of love was about yearning for peace and calmness. The summer of hikes is about yearning for lower inflation and lower prices. So far, we are seeing uncertainty rather than calmness. For example, the VIX Index – which is often referred to as the fear index and is a measure of the expected volatility of the S&P 500 – was in a “normal” range around 15 during the two years prior to the pandemic, which included the US-China trade war. It rose during the pandemic to an average of about 25. We noted in our previous Quarterly Outlook that the VIX peaked at around 40 in early March after Russia’s invasion of Ukraine. But this did not lead to a “wishes” buy signal – instead, the VIX averaged about 28 during the second quarter rather than reverting to its pre-pandemic range.

The VIX is currently over 30 suggesting investors are still worried. We expect the bulk of the Fed’s rate hikes to take place during its late July and early September policy

meetings, so we recommend that investors stay patient for now. We expect opportunities to arise, but perhaps not until rate hikes slow down or become smaller in magnitude.

Despite the VIX’s high range recently, our sentiment indicators are currently mixed. The result is that the sentiment factor remains neutral in our scorecard. We do not see a market capitulation signal yet, and neither are our sentiment indicators flashing “buy”. Our research shows that market rallies of 10% are common even during bear markets, so we believe it is more important than ever to focus your portfolio on high-quality, defensive value stocks as these tend to outperform during economic slowdowns. We provide more details on our positioning later.

### Technical indicators take a back seat to risk

Technical factors are supportive of US dollar investments as there are no real signs that the euro-US dollar or Japanese yen-US dollar rates are bottoming. Risk remains high and sentiment is dominating market returns. In these kinds of conditions, we watch CDS indices and credit spreads closely – both continue to widen. Fixed income spreads are flattening, while 10-year bond yields are heading higher.

We must consider the possibility that some major institutions, banking systems or even countries are under tremendous stress. It is possible that something will blow up – for example, an overleveraged hedge fund or over indebted country or other surprise). This should signal that a bottom for equities and a broad reversal of trends are near. Meanwhile, we are searching our technical signals for signs of significant changes in trends during the Summer of Hikes, but do not see any. As such, we are downgrading our technical factor from positive to neutral.

### Macro: a mixed picture

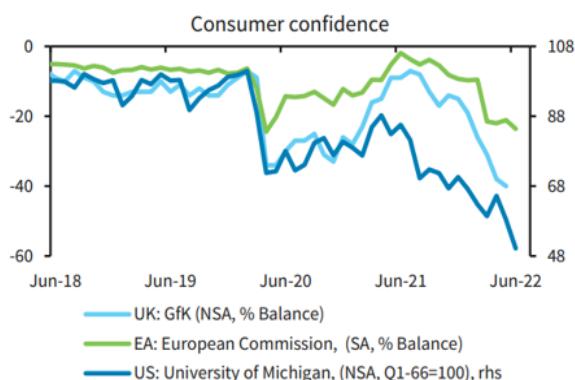
We maintain a positive long-term outlook for developed market equities – especially those from the US – although we have made some adjustments to our positioning based on the changing backdrop. In the final quarter of 2021, we correctly lowered our macro score from positive to neutral as we anticipated tighter monetary policy in late 2021 and the first half of this year. But other than a worsening macroeconomic backdrop, the first half of the year has not panned out as we expected. High inflation, war and lockdowns in China have derailed the global recovery. Global growth forecasts for 2022 and 2023 have come down in H1, while inflation risks and policy-rate projections have risen.

We also began the year watching for signs of a potential monetary policy mistake, and this risk remains. However, the more urgent threats now are persistent high global inflation and the potential for stagflation in Europe. We’re also concerned that soaring prices will lead to a slowdown in consumption. Inflation levels in Europe are very concerning, especially gas prices. Our research indicates

that a 1% rise in inflation (which is mainly determined by energy prices) reduces Eurozone GDP by 50 basis points.

Should we lower our macro score again? We assign a 30% chance of recession in the US, but not before late 2022. We expect a slowdown in growth in H2, but we don't expect economic contraction in the coming quarter. We spoke to the CEO of a leading US retailer who told us he expects stable consumption supported by relatively solid consumer health along with low unemployment, a stockpile of savings and continued sales momentum driven by store traffic growth and bigger buying baskets. While there are economic risks due to inflation, especially for the low-end consumer, we believe those risks will not materialize until after the back-to-school season. One reason is that personal consumption, which accounts for over 70% of US GDP, is just coming out of the Covid hibernation period. Overall, we believe these trends justify a neutral score for our macro factor, both for the US and global economies.

**Figure 1 | Weaker consumer confidence**



Source: University of Michigan, GfK, European Commission, Barclays Research.

We acknowledge that there are challenges, especially the poor sentiment reflected in weaker consumer confidence in the UK, Eurozone and US (Figure 1). But we also see many signs that the economy is in much better shape than in previous pre-recessionary periods. For example, corporate inventories are relatively modest, household and business balance sheets are in fairly good shape, supply constraints have inhibited excessive hiring, and the banking system is strong and well capitalized. The economy is resilient especially because households have accumulated an estimated USD 2.5 trillion more in savings than they would have if there had been no pandemic. Businesses have also accrued sizeable savings.

A recession is not guaranteed. It may be averted if the Fed is lucky and inflation falls, restoring real purchasing power, and if bottlenecks in global supply chains ease, providing a boost to global production and distribution and reducing production costs. However, even if a recession is averted, the Fed-induced slowdown in demand will squeeze margins, resulting in lower profits and rising unemployment. By exactly how much unemployment rises depends critically on

companies' responses to the slowdown in demand for their products.

It will be vital to monitor whether central banks' tightening measures are able to help bring down inflation without derailing growth, especially after the Federal Reserve hiked rates by 75bp to a range of 1.50–1.75% at its June meeting. This was a record rate hike in the US that the markets had not seen since 1974. Central banks in Australia, Canada, New Zealand, Switzerland, and Norway have all recently announced 50bp hikes but, as in the US, their real policy rates remain well below zero after adjusting for inflation. As we noted earlier this year, interest rates and the pace of growth are vital factors in deciphering the future direction of the markets.

Once again we point out that in past economic cycles, rate hikes have not necessarily resulted in the end of bull markets. In the US, for example, there have been four major policy tightening cycles over the past 30 years, and all but one of them saw equities continue to rally over the medium term. It is recessions, not rate hikes, that typically end bull markets.

We do not expect imminent recession in Europe in Q3, but we do believe there is a growing risk – more so than in the US – of a recession in Q4 or early 2023. The EU's energy situation is precarious, and we expect four hikes in 2022, with the likelihood of a first hike of 50bp on 21 July rising. This means a Summer of Hikes will hit Europe notwithstanding the return of tourism across the continent. A high level of tourism also risks increasing inflation further. Supply bottlenecks, energy prices and food prices create an environment in which Europe could enter stagflation against a backdrop of persistently high inflation and declining GDP.

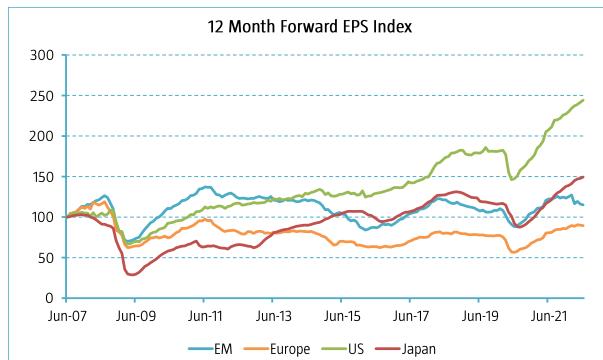
And even though it is not hitting the headlines as much as earlier this year, we mustn't forget coronavirus, which is still contributing to supply chain issues in some regions. However, as a result of improvements here we expect some of the pressure on global supply chains that is contributing to inflation to ease. The relaxation of pandemic-related restrictions and a revival in service sectors (including travel and tourism, recreation and arts) represents a key supportive factor for growth. However, the fallout from tightening financial conditions is likely to lead to a downward revision for the global growth outlook in the next series of quarterly forecast. The soft landing we anticipate for Q2s likely to give way to a bumpier ride.

**Despite the risks, we maintain our score for the macro factor at neutral** as consensus 2022 GDP forecasts for the world (3.2%) and its developed regions (US 2.6%, Eurozone 2.8% and Japan 1.8%) remain resilient, which is indicative of a neutral outlook for the economy.

## Moderating global earnings

Tightening monetary policy often triggers reductions in earnings forecasts. However, as Figure 2 shows, as of June earnings expectations remained resilient, with the 12-month forward EPS Index continuing to climb, especially in the US. The sectors leading the positive earnings revisions are energy, financials, utilities, and industrials, which continue to see more upgrades than downgrades this earnings cycle. The downgrades are most pronounced in the consumer staples sector, which is being squeezed by inflationary pressures including higher commodity prices, supply chain issues and logistics obstacles.

**Figure 2 |** Global earnings growth expectations remain resilient and above pre-pandemic levels, especially in the US



Source: IBES, MSCI, Robeco, June 2022.

Earlier in the year we shared our concerns that earnings may have peaked in 2021 after a very strong post-pandemic recovery. However, all the signs continue to suggest that earnings still have momentum, even though they are not going to continue to increase at their record-setting pace of over 45% in the US and nearly 60% in Europe in 2021. We expect continued earnings strength in 2022, even relative to the difficult comparative base of record-high earnings last year. Consensus EPS estimates continue to be revised upwards for most regions of the world, albeit more slowly than last year.

## Declining consumer confidence will drag on earnings

As of mid-June, 56.9% of the S&P 500 companies have Buy ratings by Wall Street analysts. According to FactSet, the 5-year average of percentage Buy rating is 53.3%. This indication of price and current earnings optimism suggests a rosy outlook. However, given the declining consumer confidence and deteriorating sentiment, it appears the number of negative surprises is just beginning and will increase in the future. More S&P 500 companies have issued negative EPS guidance during Q2 2022 compared to recent quarters, but guidance so far has not had a meaningful impact on June 2023 EPS forecasts, except for emerging markets, where they have fallen (Figure 2). Two sectors have been especially resilient, with no negative guidance reports so far this quarter: energy and financials.

Year-to-date, consumer discretionary has seen a sharp decline in full-year 2022 earnings growth expectations from 17.2% to 2.4%, while other sectors, including energy, industrials and materials, have seen improvements in their outlook over the quarter. These sectors make up a bigger proportion of the European market than the US, supporting Europe's recent earnings resiliency (Figure 3).

**Figure 3 |** Europe earnings resiliency likely to be dented

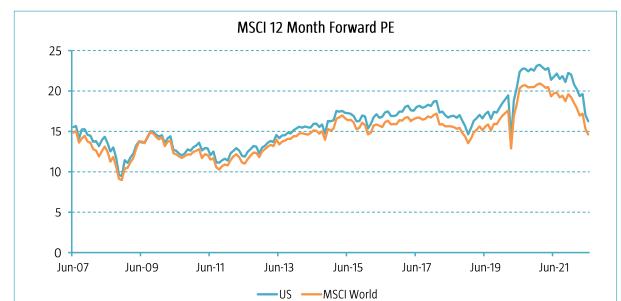


Source: IBES, MSCI, Robeco, June 2022.

Consensus expectations are for S&P 500 constituents to report earnings growth of about 10% in 2022, while expectations for European companies have risen to 13–14%. And despite five rate hikes by the Bank of England since December – a record since the current Monetary Policy Committee of nine members was formed – UK company earnings are forecast to grow in the mid-double-digits. Japan is lagging other developed markets, with expected earnings growth of just 5–6%. Despite the consensus forecasts of resilient growth, we believe the current environment of high inflation, war in Ukraine and continued supply-chain, distribution and logistics issues will dent the rosy earnings forecasts in H2. As such, we are downgrading our earnings outlook from neutral to negative.

**Valuation:** the 2022 bear market means equities are more attractively valued today than over the past 10 years

**Figure 4 |** Valuations in the US and developed markets are healthier since the sell-off



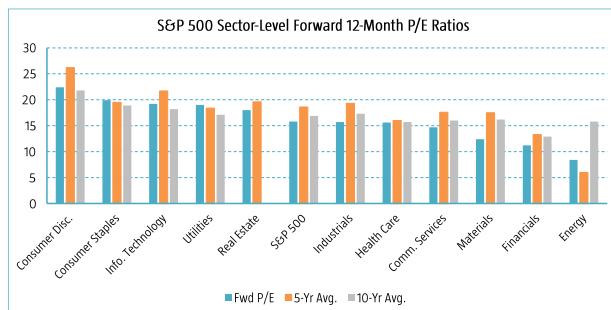
Source: IBES, MSCI, Robeco, June 2022.

Since the start of the year, the MSCI World (EUR) has fallen by 12.5% on the back of multiples collapsing from 19.2x to

14.6x (Figure 4). Stock market valuations have fallen below their five- and 10-year averages due to price declines. The result is that 2022 valuations on a P/E basis alone look more attractive than during the past decade.

For example, the S&P 500's forward P/E is 16.3x, below its five-year average of 18.6x and 10-year average of 16.9x. However, it is marginally above its 50-year average. At the start of the year, the 100 most expensive stocks in the index were trading at a premium of 25.8x multiple points to the rest of the market. Following the correction, they are trading at a 15.1x premium, in line with long-term averages. Some sectors appear cheap relative to history. Banks, for example appear the most inexpensive relative to history for more than 20 years, while cyclical sectors such as energy and materials are trading at their largest discounts relative history.

**Figure 5 |** S&P 500 and sector-level valuations are contracting as is expected during Fed tightening cycles



Source: Factset

As we have pointed out in previous outlooks, high P/Es generally contract as yields rise. Over the past 40 years the P/Es of only a handful of sectors, including financials, energy and industrials, have tended to rise as yields move upwards. But during the current bear market the reverse has been true for those sectors. In fact, most sectors, including health care, industrials, communication services, materials, financials and energy, are more attractively valued than they have been over the past 5- and 10-year periods.

**As a result, we are upgrading our valuation factor score from neutral to positive as valuations are significantly more attractive today than they were at the start of the year.** The MSCI World Index is trading at close to 14.6x 12-month forward earnings, down from 19.2x at the end of 2021. The US market, which has greater exposure to technology and services stocks, is trading at higher forward earnings multiple – 16.3x – than Europe's 11.6x and Japan's 12.4x. Discounted developed markets are starting to attract value-oriented investors as a result.

The decline in forward P/E ratios receives some additional support from momentum of record-breaking corporate buybacks and dividend expenditures in Q1 (and expected in Q2) despite the backdrop of falling stock prices and higher market volatility and uncertainty. According to S&P, the

record expenditures led to 17.6% of S&P 500 companies increasing their EPS by at least 4% (by reducing their share count) in Q1, up from 5.8% in Q1 2021. In Q2, we observe companies are maintaining their buyback activities which reduces share counts adding to their EPS further reducing P/Es. Buybacks amongst the S&P 500 hit nearly USD 1 trillion in Q1, with technology, financials, and healthcare companies the most active in this respect.

## Implications for portfolio positioning

We have more closely aligned our portfolio's regional allocation with that of its benchmark to reduce risk, although we remain underweight in the Asia-Pacific region and Japan. Our portfolios are focused on what we view as high-quality sectors and stocks that we believe can perform well in a period of higher-than-average inflation, and we are positioning our portfolios to reflect that high inflation could last for some time.

### Emphasis on high quality companies selling at discounted valuations

Having upgraded our valuation score but downgraded our growth expectations, we continue to position ourselves in highly profitable companies with pricing power and strong cashflows to face the "Summer of Hikes" accompanied by inflationary headwinds.

We continue to focus on quality companies with strong operational track records and high free cash flow generation. We especially prefer companies with pricing power in the US and Europe, where inflation is having a bigger impact than in Japan. We believe companies offering premium products in their segments will outperform across all sectors.

During H1 we focused on finding those leading companies that will outperform as the consumer environment deteriorates – especially for discretionary purchases. As a defensive move we increased our exposure to consumer staples and consumer healthcare companies that have a strong track record and are able to raise prices without losing market share. High-quality brands matter in an inflationary environment.

**High-quality stocks and defensive sectors** have provided protection during previous bear markets, and we would expect more of the same if earnings growth takes the hit we anticipate. While the valuations of these groups are roughly in line with long-term averages, we would expect them to achieve clear premiums, as they have in previous periods of slowing earnings.

Within manufacturing, we are reducing our exposure to consumer discretionary firms whose production and distribution could be impacted by supply-chain issues. We are selectively adding to companies that are able to pass through higher materials and commodities costs to their clients. We believe cost pressures and supply-chain issues

will remain above pre-pandemic levels and higher than their long-term averages.

### Spotlight on favored healthcare sector

Our biggest sector overweight is in healthcare sector (20%) as our research suggests the sector is amongst the top third relative to the 10 other sectors in terms of both high quality and cheap value. The sector has better fundamentals and lower risk than other sectors thought to be more recession-proof such as Utilities (0%). In this economically volatile period, we believe pharmaceuticals, medtech, managed care and consumer healthcare companies are relatively insulated from macroeconomic headwinds. For example, US biopharma companies have pricing power and can protect their operating margins, and they outperformed in the previous three periods of economic contraction. In fact, hospital revenues in the US actually grew during the global financial crisis. As such, we feel the sector is the safest haven at this point in the economic cycle.

Two other sectors with large portfolio weights are technology (24%) and financials (14%). We continue to find high-quality, profitable companies in both cyclical sectors. Within technology, we are reviewing companies that have fallen sharply but have strong or improving sustainability profiles, impressive long-term track records of return on invested capital and attractive valuations as measured by high free cash flow. Within financials, we favor the insurance sector as property & casualty rates are rising faster than inflation.

## Emerging Market Equities | Overall, emerging markets are less troubled by inflation and some have even room for fiscal and monetary stimulus

- Although some markets in our view look very appealing, we remain cautious against a backdrop of geopolitical uncertainty.
- Key topics over the remainder of 2022 include:
  - the humanitarian disaster and geopolitical challenges in Ukraine
  - the Chinese economy being at a different stage of the cycle given its low inflation and ample room for stimulus, whereas inflation is still an issue in many other parts of the world
  - economic resilience combined with tight monetary policy could still be a catalyst for “value” asset classes such as emerging equities.

### Five-factor summary

Factors	Score	Changes since last quarter
Macro	=	No change
Earnings	=	No change
Valuation	+	No change
Technical	-	No change
Sentiment	=	No change
<b>Total</b>	<b>=</b>	<b>No change</b>

Source: Robeco Emerging Markets Team

As the first half of 2022 comes to an end, I really would like to be more bullish about emerging equities over the remainder of the year. Central bankers in the developed world have become more hawkish, whereas there is scope for looser fiscal and monetary policies in pockets of the emerging world. As a result of the tightening bias among developed market central banks, the MSCI Emerging Markets has outperformed the MSCI World by around 3 percentage points year-to-date. Unfortunately, in contrast to my gut feeling to turn bullish, the scores for the five factors in the table above suggest conditions are not yet supportive enough of a convincing overweight in emerging markets relative to developed equities.

Over the past couple of months, the Federal Reserve has tightened monetary policy more than expected and adopted a more hawkish tone in an attempt to get what is stubbornly high inflation under control. Rate hikes have not ended yet and significantly higher rates are likely not just in the US, but also in the Eurozone and UK.

By contrast, some large emerging countries either have room to cut interest rates – the most prominent example being China – or are almost at the end of their monetary tightening cycle, such as Brazil.

In fact, Brazil started hiking rates very early in the cycle, beginning over a year ago. Since March 2021 the Selic rate in Brazil has steadily increased from 2.00% to its current level of 13.25% after the latest hike on 15 June.

After the severe Covid-induced economic disruptions in China, its government is actively, and more convincingly than in the recent past, stimulating the economy with more and larger investment programs to support its real economy. Inflation in China is currently running at a relatively low level – just 2.1% in June. The largest and most important emerging nation has a relatively benign macroeconomic backdrop, and it also has abundant foreign exchange reserves and is running a large current account surplus every month.

Some other countries, however, are still struggling to get inflation under control and have only just started to hike interest rates. For instance, the Indian and South African economies could slow down more substantially in the coming quarters. Meanwhile, emerging countries in central Europe are currently dealing with the twin issues of high inflation and the macro- and micro-economic disruptions resulting from Russia’s invasion of Ukraine.

All in all, we believe it is wise to remain prudent, so maintain our overall neutral stance on emerging equities. The macroeconomic backdrop is mixed, as is the earnings picture. Earnings revisions have weakened recently, with earnings revision ratios for both developed and emerging markets falling below 1.0. We still have a neutral view on emerging markets’ earnings growth prospects relative to developed markets.

As the table above shows, our valuation factor is still positive, and it became even more compelling in Q2. Emerging equities’ derating has led to the price/earnings (P/E) ratio of the MSCI EM Index falling to close to 10x 2022 expected EPS. By contrast, the MSCI World’s P/E ratio is over 14.6x.

Meanwhile, the technical picture for emerging markets is less appealing than for developed markets, although it has improved over the past six months relative to developed markets.

Our sentiment factor remains neutral as there have been unprecedented inflows into emerging equities of around USD 200 billion since October 2020. Sentiment is likely to persist as investors are increasingly looking for “value” opportunities. So, we expect continued inflows, but at a slower pace than in recent quarters.

In conclusion, high inflation, accelerated global monetary tightening and weakening G7 growth are likely to weigh on

emerging market ex-China assets. But structurally strong commodity demand will also create winners, while depressed valuations will give rise to value opportunities over the longer term. But for the coming quarter, we maintain our five factor scores as they are and our neutral stance in emerging markets relative to developed markets.

### **Emerging markets continue to face headwinds, including geopolitical uncertainty**

In our last quarterly outlook, we referred to stubbornly high inflation resulting in monetary tightening in the US as a risk factor for emerging markets. The tragedy in Ukraine added to the problems and we concluded that the war might remain an issue for months. Meanwhile, the situation in China was uncertain due to its zero-Covid policy and selective lockdowns.

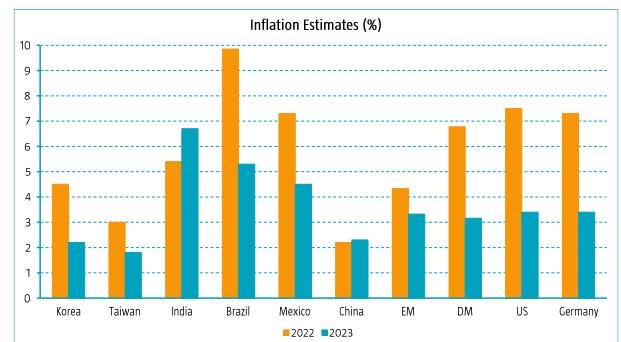
Fast forward a quarter and we are still in an environment of high inflation and increasing interest rates in most parts of the world. Sadly, the war in Ukraine continues and energy prices remain high as one of the economic consequences. The Chinese macroeconomic situation looks a lot better than it did, however, with almost all of the country having reopened and only a small number of areas where the authorities are still mass testing and keeping some restrictions in place. China's reopening and substantial stimulus packages mean the third quarter should be a lot better than the second from a GDP growth perspective, and the second half of the year a lot better than the first half, all else being equal.

Having added to our existing positions in Q2 already, we have become more positive towards Latin American and southeast Asian equities as these markets' commodity exposure means they tend to act as better inflation hedges than large markets such as South Africa and India. Another argument in support of these portfolio moves is that some Latin American and Asian companies are able to maintain operating margins in their respective sectors since they are more vertically integrated than companies elsewhere and thus don't suffer that much from the rise in most commodity prices.

### **Emerging markets have been tackling inflation better than the developed world**

While inflation is a global phenomenon, it is currently a much bigger issue in developed than emerging countries. Turkey is an obvious aberration, of course, and remains uninvestable for the time being. Other than Turkey, only in Brazil is inflation currently slightly higher than in the US. But as we mentioned earlier, Brazil has taken appropriate monetary measures to rein in inflation. In all other emerging countries in the MSCI Emerging Markets, inflation is lower than in the US. Figure 6 makes clear the current discrepancy between inflation in emerging and developed markets.

**Figure 6 | Inflation estimates in EM and DM**



Source: Bloomberg, Robeco.

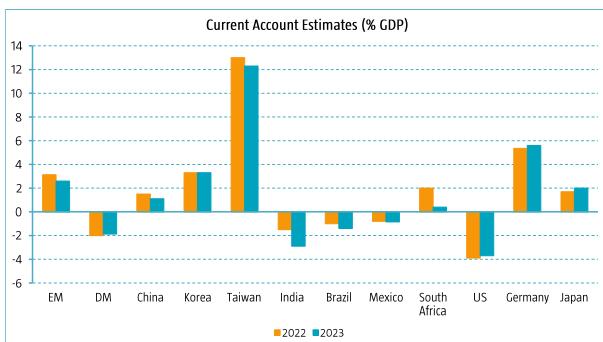
Central banks in almost all emerging countries are still tightening, with Latin America the most aggressive. Interestingly, however, China has been easing monetary policy by cutting rates and reducing the required reserve ratio. It has ample room to engage in further monetary stimulus, and with inflation not currently a problem in the country – the latest reading came in at 2.1% – we expect further easing in the second half of 2022.

### **This is not taper tantrum 2013 revisited**

Back in 2013, when the US last set out on a severe tightening cycle, some emerging countries were labelled as fragile. Most economists agreed that Brazil, South Africa, Turkey, India and Indonesia fell into this category as they had large deficits on both the fiscal balance and the current account. This time around, however, fundamentals have changed for the better in most of these countries. Indonesia, for example, had a current account deficit of close to 5% of GDP in 2013, but now it is running a current account surplus. This provides considerable fundamental support for the rupiah. South Africa has also turned its current account deficit into a surplus over the last decade.

As a group, emerging countries have a substantial current account surplus, whereas developed countries run a combined current account deficit, as Figure 7 shows. This is the main reason why we do not expect severe depreciation of some of the emerging market currencies as the Fed continues to tighten. Some currencies might even appreciate versus the dollar due to their countries' strong trade account and large forex reserves.

**Figure 7 | Current account estimates**



Source: Bloomberg, Robeco.

### Earnings expectations are slowing down in both developed and emerging markets

The one-month earnings revision ratio for emerging markets fell to 0.6 in June, as we can see in Figure 8. It remains below its long-term average, which is a negative sign for emerging market corporate earnings. However, the earnings picture for emerging markets is only slightly worse than for developed markets.

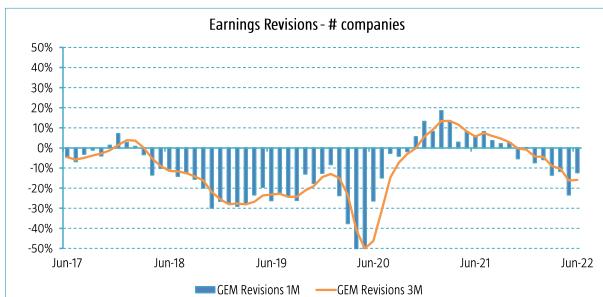
**Figure 8 | Emerging market earnings revisions ratio**



Source: Bank of America, June 2022

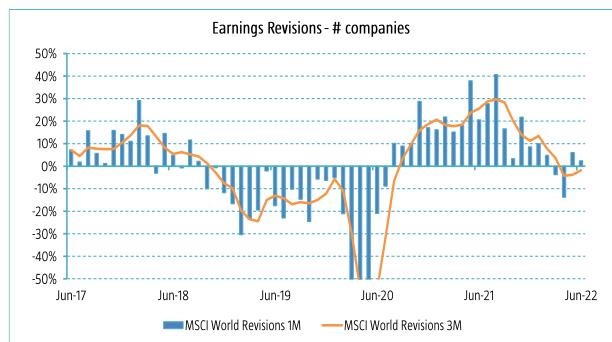
After earnings in emerging markets rose by around 40% in 2021, expected earnings growth is likely to fall to around 10% this year. Overall, we view earnings as neutral for emerging equities.

**Figure 9 | Emerging market earnings revisions**



Source: IBES, Robeco, June 2022

**Figure 10 | MSCI World earnings revisions**



Source: IBES, Robeco, June 2022.

### Valuations positive for emerging equities

Valuations remain positive for emerging equities, in our view. After their 12-month forward P/E ratio approached a ten-year low of 10x in early 2020 it rebounded sharply but has since fallen back again, as Figure 11 shows.

**Figure 11 | Emerging equity valuations look attractive**



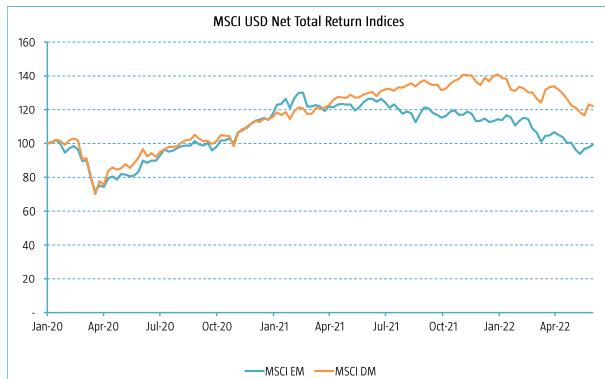
Source: MSCI, Robeco, June 2022.

Currently the P/E ratio of emerging equities is close to 11x – well below the 14.6x of the MSCI World. This is equivalent to a 30% valuation discount – significantly lower than its historical average discount of closer to 20%. Emerging equities are also trading at a 30% discount to developed markets from a price-to-book perspective.

### Technical picture still negative

Over the past 12 months, emerging equities have underperformed developed equities by 12 percentage points. As a result, our assessment of the technical picture for emerging markets is still negative.

**Figure 12 |** Relative performance of MSCI EM and MSCI DM

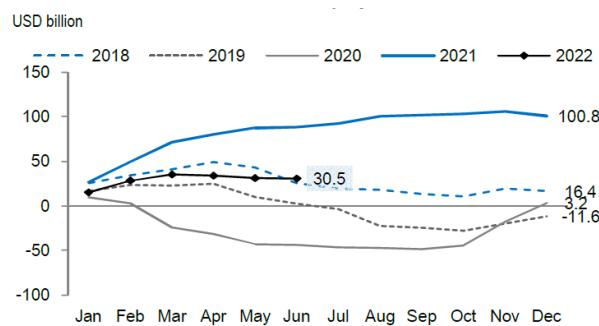


Source: MSCI, Robeco, June 2022.

### Sentiment still neutral

Our assessment of sentiment towards emerging equities is still neutral. There have been USD 200 billion of inflows into emerging equity funds since October 2020, and we expect inflows to continue as investors look for attractively valued asset classes providing high yields. However, inflows have slowed down somewhat – so far in 2022 there have been USD 30.5 billion of inflows into emerging equity funds after more than USD 100 billion of inflows in 2021, as Figure 13 shows. We expect the current slower pace of inflows to persist over the remainder of 2022 due to the tightening in the developed world.

**Figure 13 |** Cumulative flows into emerging equities by year



Source: EPFR Global, June 2022.

### Implications for portfolio positioning

As we mentioned earlier, we have increased our overweights in commodity-rich nations such as Brazil and Indonesia. We have also become more optimistic about China's prospects as we expect its economy to rebound. We remain positive on stocks from north Asia based on the region's relatively strong macroeconomic fundamentals. In the current era of tapering, investors' focus is likely to shift towards potential macroeconomic vulnerabilities, such as current account deficits. The largest current account surpluses are to be found in the north Asian countries of China, Taiwan and South Korea, so these countries' currencies are likely to be most resilient. We are maintaining the value tilt in our emerging market equity

portfolios, which have a lower average P/E ratio than the MSCI Emerging Markets Index.

The portfolios will remain overweight in South Korea, Brazil, Indonesia, Taiwan, Greece and Hungary as we believe their economies have a strong chance of rebounding and as corporate profit expectations are high. Current valuations do not reflect the earnings recovery we expect in these countries.

At the sector level, we are overweight in consumer discretionary and information technology and remain underweight in the expensive consumer staples sector. We are also overweight in financials.

### Focus on China

We are optimistic about the outlook for Chinese equities in the third quarter. We believe the Chinese economy probably bottomed in Q2 and that its prospects are now brighter thanks to the reopening of Shanghai and the pro-growth policies announced by the government, such as increased infrastructure spending, subsidies for auto purchases, easing of the property sector and a conclusion of crackdowns on internet companies. What's more, the fact that China is easing monetary policy while developed markets are tightening should provide further support.

The biggest problem China faced in Q2 was the strict lockdowns that resulted from its zero-Covid policy. Although China will stick with this policy, which could limit the pace of recovery, its implementation will probably involve a combination of mass testing and quicker, smaller lockdowns. While this is still not ideal, it should have much less economic impact than the recent lockdown of Shanghai.

Although the domestic economic outlook remains challenging, green shoots are emerging. Supply chains are recovering from earlier disruptions, while infrastructure spending will be the main driver of GDP growth in Q3.

On the geopolitical side, long-term tensions between the US and China are unlikely to subside, but there are signs that things could improve slightly in the near term, with the US reducing or delaying some trade tariffs with China in order to contain inflation.

We expect earnings revisions to find a near-term bottom soon and start to improve over the coming quarter. We are seeing signs of a fundamental turnaround in the internet sector as most companies are accelerating monetization and aggressively cutting costs. Beneficiaries of infrastructure spending and a resumption of work will also see improved earnings.

Valuations have fallen below their historical average. This time, investors may find China a better market compared to other countries thanks to its inflation and the fact it is easing policy. Investor sentiment is improving, probably

influenced by China's recent outperformance following what seems to be the end of "severe lockdowns" against a backdrop of weak global equity markets.

The Robeco Chinese A-share portfolio is currently overweight in materials, industrials, utilities and consumer staples, and underweight in financials and healthcare. Robeco Chinese Equities is overweight in utilities, industrials, IT and real estate, and underweight in financials and consumer discretionary. It is also underweight in communication services, mainly via an underweight in the internet sector.

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