



Fundamental Equities Outlook Q2 2022

Time to look for bargains with pricing power

- Monetary authorities set to hike, while corporates see pressure on earnings
- Energy inflation hurting Europe more than the US
- Value and pricing power important to outperform

One crisis dealt with, straight onto the next one

Sitting here in Hong Kong it's hard to believe that most of the world has almost left the pandemic behind, having found a way to deal with the health risks and move on. Only in China is the fight ongoing, but even here a change in mindset is noticeable. This is a solid positive for the global economy.

It's even harder to believe the images of the human tragedies in Ukraine that we are seeing on our screens every day as innocent civilians are killed and refugees flood out of the country. What's going on in the financial markets pales into insignificance compared with the terror of the invasion. But it's our job to consider what it all means for investors.

As it stands, the world is faced with a geopolitical crisis that looks set to wipe out some of the benefits that have accrued since the end of the Cold War in 1989 as a result of globalization, cost efficiencies and international trade flows. This is clearly a negative and is resulting in considerable

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For professional investors
March 2022

Robeco Fundamental Equity Team

uncertainty for investors. The Western (NATO) response to the war is very much through economic sanctions, so prices in the financial market give us a good sense of the implications of war in today's interconnected world, and also what the implications for corporates may be from further deglobalization and higher commodity prices.

Of course it's not easy to set out a three-month outlook when we don't even know what next week is going to bring. To suggest that you should prepare yourself for more volatility is not particularly insightful, but it's probably the best advice anyone can give at present.

Lower margins could dent corporate profitability

For now, financial investors are mostly feeling the impact of events in Ukraine through higher input prices in general and commodity prices in particular. The big question is what the combined impact of higher inflation and higher rates will be on economic growth and profitability. At the end of 2021 it looked like earnings could remain strong, but in the first quarter we have already seen some companies signalling that pressure on their margins could dent their profitability. And let's not forget that corporate profitability is the linchpin that supports the global equity markets.

As well as lower margins, earnings may come under pressure from the slowdown in real economic growth that's likely to result from the prevailing uncertainty. This is particularly the case in Europe, where markets have suffered the biggest hit.

Asian equities have less to fear from tightening

The low interest rates that have been in place for over a decade have muffled a lot of volatility. But this era is coming to an end. Monetary authorities all over the world are longing for normality, just like ordinary citizens were longing for normality during the dark days of lockdown. The Federal Reserve has already started hiking rates and the ECB feels its hand is also being forced by what is viewed as scarily high inflation in Europe.

The situation in Asia is very different because in its biggest economies – China and Japan – increases in input prices have not yet resulted in much higher consumer price inflation readings. Historically, Asian equities have struggled under a tightening US dollar rate environment but this time may be different. Asian equities lagged during the liquidity-driven rally of the past few years, but will have less to fear from the Fed's moves because Asia's central banks don't need to tighten much in 2022.

Look for pricing power

As ever, our analysts and portfolio managers are carefully collecting data on prices and margins to make a call on where to reduce their exposures and where to remain invested. It looks to me that commodity producers have the most pricing power, but there is also plenty in the technology sector, where shortages are proving persistent. The healthcare sector may also be able to display its pricing power now that demand for treatment is normalizing and as governments look set to become more willing to provide funding having been confronted with the importance of a well-funded health system during the pandemic. Quality – the ability to generate returns above the cost of capital for a sustained period of time – is likely to remain an important determinant of success, and it will be defined by pricing power.

A supportive environment for Value stocks

Although I have been taught by our quant researchers that timing factors is nigh on impossible, I still like to think that value-oriented strategies will receive further support from higher bond yields in the second quarter. Bond yields are always important for equity investors to consider as they drive the discount rates used in stock valuation models – faraway cashflows are worth less when the discount rate rises.

As yields creep higher in Europe and Japan, it seems a good idea to tilt portfolios towards shorter-duration stocks – in other words, value stocks. Personally, I would add telecoms to the list too as these are firms with strong (albeit regulated) pricing power and are benefitting from very steady demand as they head into a phase in which less capex is required as most of the necessary investments in 5G have already been made.

Time to rethink globalization and energy supplies

What began in 2020 as a scarcity of containers in Asia to ship goods to the West had by March 2022 morphed into a series of supply chain disruptions. Aggravated by the recent run-up in oil and gas prices, these problems have resulted in a rethink about global interdependencies, with politicians clearly moving towards the need for national self-sufficiency. This trend started in the Trump era, when the US wanted to reduce (so far unsuccessfully) its dependence on Asian products – especially those from China.

Governments are now talking about the need to develop their own computer-chip supply chains and of course to become less dependent on imported energy. This has shifted the focus from the long-term green transition to short-term energy security. It now seems likely that natural gas and nuclear energy are going to remain important fuels, at least in the medium term, to help us navigate the green transition to net-zero by 2050. The vilification of some energy companies looks likely to stop, and we must focus on those that are actually contributing to the transition by making investments in cleaner energy, including gas. Our engagement efforts are clearly paying off in this respect.

The US looks more attractive than Europe

The US scores well from the perspective of energy independence thanks to the shale oil revolution. What's more, American growth looks less vulnerable than Europe's at present, so the US seems a good place for equity investors to allocate to.

Within Europe, France has been relatively insulated from the energy shock as most of its energy comes from domestic nuclear plants, and this insulation should help President Macron's chances of re-election in April. Meanwhile, German Chancellor Olaf Scholz has been making a good impression with his mediation efforts in the Ukraine conflict. Strong and stable political leadership in Europe is welcome during tough times.

A lot rests on China

China is likely to be hitting the headlines in the second quarter. It has tried to stay out of the conflict and focus on its own internal battle against Covid so far, but can President Xi maintain that position? China siding with Russia would be explosively bad news for the markets, whereas any harmonization of China's relations with the US would leave Russia isolated. This could lead to a quick resolution of the conflict in Ukraine and possibly a breakthrough in the protracted trade war between the US and China at a later stage. That really would be good news for the world.

Equities still more attractive than bonds

With plenty of uncertainty around, investors may be thinking about looking for safety in the fixed income markets, but as bonds' nominal returns remain very low, they need to remember that allocating to the asset class will not generate enough returns to pay for one's pension. Equities remains thus the place to be, we believe.

The "rally of everything" that we spoke of last quarter clearly ended very early in 2022. Investors will need to be more selective, but we are not downbeat about equities' prospects. Stocks retain their appeal as equities are backed by real assets, which tend to move in line with inflation to a certain extent. What's more, companies generate a margin from these assets and adjust their prices when inflation bites.

In the following pages you can find more detailed views from our fundamental equity teams. These are challenging times in many respects, but rest assured that we are here to help.

Arnout van Rijn
CIO Asia-Pacific Equities
19 March 2022

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Developed market equities | Economic risks are rising, but that doesn't mean it's time to sell equities

- Fed hikes haven't historically signaled the demise of a bull market
- We are hopeful that central bank rate hikes can reduce inflation without resulting in a collapse in consumer demand in Q2
- Expected earnings growth over the next 12 months is still strong, especially in the US, where record buybacks should result in higher EPS and lower P/E multiples
- We are seeking companies with pricing power, which should help them perform well in an inflationary environment

Five-factor summary

Factors	Score
Macro	=
Earnings	+
Valuation	=
Technicals	+
Sentiment	=
Overall	+

Source: Robeco Global Equities team

The heartbreaking attack on Ukraine and the resultant geopolitical uncertainty have led to a surge in market volatility, with the VIX Index – a measure of the expected volatility of the S&P 500 – peaking at nearly 40 in early March. Historically, such levels have represented a tactical buy signal.

We believe the invasion has a number of implications for investors, including (i) revisions to the European growth outlook, (ii) impacts on both consumer and corporate confidence, (iii) adjustments to the outlooks for inflation and energy costs, and (iv) disruptions to the process of globalization. Despite these changes, we maintain our positive outlook for developed-market equities – especially those from the US – over the long term, although we have made some adjustments to our positioning based on the changing backdrop.

In the final quarter of 2021, we lowered the score for our macro factor from positive to neutral as the US Fed had announced quicker tapering of its bond purchases. We began this year watching for signs of a potential monetary policy mistake but, while this risk remains, the more urgent threats now are the ever-increasing concerns about inflation and the potential for stagflation in Europe. The

record inflation we are experiencing at present – US consumer inflation hit a 40-year high in February – could give rise to future financial and / or market stresses. Meanwhile, 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.

And even though it's not hitting the headlines as much, we mustn't forget coronavirus. Daily Covid-19 cases are rising across Europe – including in four of its five biggest economies – again, reflecting the spread of the highly transmissible BA.2 sub-variant of Omicron.

Over the past few months, fixed income investors have become rather pessimistic about the risk of inflation and its impact on the economic outlook. Bond markets often lead the way, so these warnings should not be ignored. While by no means a consensus view among economists for now, the actions of many credit investors are suggestive of heightened risk of a recession. For example, in late March the spread between five- and ten-year rates, otherwise known as the 5s10s curve, became negative or inverted. An inversion of the 2s10s curve has historically been an indicator of impending recession, although this curve remained positive as of late March. Meanwhile, the New York Federal Reserve's two recession probability models are currently assigning a probability of recession of under 8%, so they are still far from suggesting recession is imminent, but both indicate the chance is increasing.

Meanwhile, global liquidity is still expansive, and the world's largest central banks remain accommodative overall, even though more of them started or continued to hike rates over the past few months. For example, the Bank of England raised rates by 25bp in March despite the uncertainty about the near-term economic outlook after the invasion of Ukraine. The bank's nine-member monetary policy committee voted 8-1 in favor of raising the bank rate to bring inflation under control, referring to 'tightness of the labor market' and 'continuing signs of robust domestic cost and price pressures' as reasons for its third successive rate hike since December. The bank rate is now at 0.75%, which is still accommodative relative to historic levels. Other central banks, including the Fed and the ECB, are rethinking their policy on the back of continued strong inflation readings.

Figure 1 | Bank of England Official Bank Rate remains low compared with its levels over the past 50 years

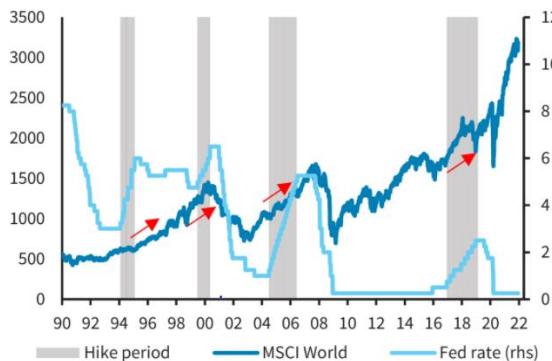


Source: Bloomberg

It will be vital to monitor whether central banks' tightening measures are able to help bring down inflation without derailing growth, especially as the Federal Reserve, which increased rates from zero at its March meeting, is indicating it needs to move rates higher more quickly after not hiking rates since 2018. Interest rates and the pace of growth are vital factors in deciphering the future direction of the markets.

We continue to highlight that in past economic cycles, rate hikes have not necessarily resulted in bull markets ending. 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.

Figure 2 | Past Fed hiking cycles did not usually end bull markets.



Source: Bloomberg, Datastream, Barclays Research, Robeco, January 2022

There is evidence that consumption patterns are beginning to pick up, in a sign that things are starting to return to normal. For example, sales at food services and drinking venues in the US rose by 2.5% month-on-month in February and are likely to rise further as the summer approaches. Sales at clothing and accessory stores increased by 1%

month-on-month in February, which means they have now increased in five of the last six months.

Even though their growth moderated in February, US retail sales remain well above pre-pandemic levels. Continued strong payroll employment growth and tight labor markets are likely to boost nominal wage growth, and households still have a significant pool of excess savings, which should support consumption growth in the near term. However, measures of consumer confidence have fallen sharply over the past two months and surging headline inflation driven by rising energy prices is dampening real purchasing power. Elevated uncertainty, further falls in consumer confidence and the risk of even higher energy and commodity prices could weigh on consumption in the coming months.

Consumer strength is moderating, especially in the US, but it remains an important reason for optimism. US households still had USD 2.5 trillion of cash on their balance sheets at the beginning of the year, while there was USD 500 billion of cash on US companies' balance sheets. We will continue to monitor tail risks, especially inflation and supply-chain bottlenecks.

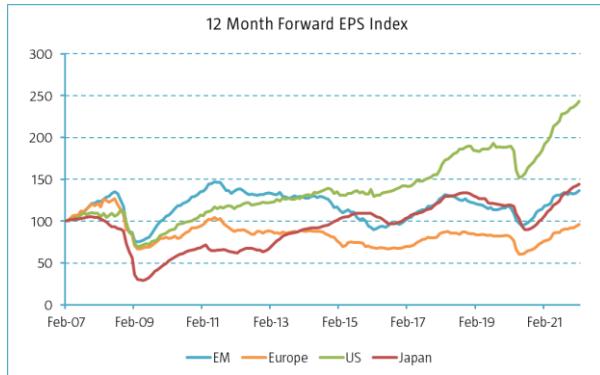
Despite the risks, we maintain our score for the macro factor at neutral as consensus 2022 GDP forecasts for the World (4.0%) and its different developed regions (US 3.5%, Eurozone 3.4% and Japan 2.4%) are suggestive of a robust economic outlook.

Moderating global earnings

Economic growth and earnings growth are likely to continue to moderate over the course of the year after their post-pandemic rebound. 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 solid 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 (Figure 3). Consensus 2022 EPS estimates continue to be revised upwards for all regions of the world, albeit more slowly than last year. Energy, technology, materials and healthcare companies are leading the positive revisions this year.

We would also highlight that it is usual to see P/E compression around the time of initial rate hikes, and forward EPS estimates usually increase after the first hike – and indeed most of the time during most rate hike cycles. This gives us further optimism about the outlook for global earnings.

Figure 3 | 2022 global earnings growth expectations remain resilient and above pre-pandemic levels, especially in the US



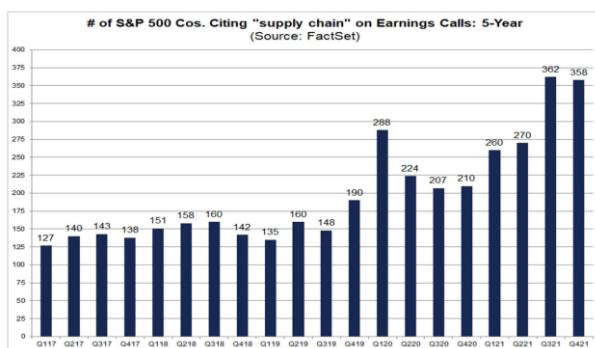
Source: IBES, MSCI, Robeco, March 2022.

We remain positive about the earnings outlook

Consensus expectations are for S&P 500 constituents to report earnings growth of around 9–10% on average in 2022. Expectations for European companies are only slightly lower at 8–9%, and firms in some countries, including France and Italy, have been seeing slight upwards revisions since the start of the year. However, inflation surprises and central bank policy are likely to be more important for stock market returns than valuations and growth, in our view. Inflation, including the effects of supply-chain issues, could dent the rosy earnings forecasts. Overall, we are positive on growth.

We will monitor supply-chain problems closely as many companies have been referring to them on their quarterly earnings calls (Figure 4). Despite these concerns, ten out of 11 sectors in the US are still projected to increase their year-on-year earnings in 2022. What's more, valuation multiples continued to fall during the first quarter. This is positive from an investment perspective, as earnings growth has been outpacing stock price appreciation in recent months.

Figure 4 | Supply chain issues at the forefront of company executives' concerns



Valuation tailwind boosted by continued earnings strength in the post-pandemic recovery

A key highlight of 2021 was the strength of the economic recovery, which, combined with loose monetary policy and a record amount of share repurchases, provided a strong boost to corporate earnings. This environment was supportive of stock valuations, with global P/E multiples falling from their recent highs (Figure 5). For instance, the S&P 500's forward P/E is now close to 20 times, partly due to double-digit growth earnings over the past seven quarters. Year-on-year earnings growth for companies in the S&P 500 and most European indices continued to rise in early 2022.

Global real GDP growth of 6.0% in 2021 was the highest level since 1973, and saw economic activity move above pre-Covid-19 levels. Although current stock market valuations remain above their five- and ten-year averages, they have compressed this year on the back of strong earnings, and 2022 looks better than 2021 on a P/E basis alone. However, history shows that high P/Es tend to contract as yields rise, although the P/Es of some sectors, including financials, energy and industrials, tend to rise as yields move upwards. We therefore remain neutral on valuations.

Figure 5 | Absolute valuations in the US and developed markets



Source: IBES, MSCI, Robeco, March 2022.

As we have noted, developed equity valuations are high across the world (Figure 5), at least from a historical perspective, but we believe they are neutral taking into account the current rate environment. The MSCI World Index is trading at close to 17.0 times 12-month forward earnings, down from 19.2 at the end of 2021. The US market, which has greater exposure to technology and services stocks, is trading at a higher forward earnings multiple – 19.4 times – than Europe's 13.2 times and Japan's 12.4. These two markets may start to attract value-oriented investors as a result. While equity valuations have normalized somewhat, they are still high. Despite this, inflation angst has resulted in investors cutting their fixed income exposure, reinforcing 'TINA' (there is no alternative) as a good reason to own equities. Money keeps flowing into the stock markets, which remain relatively attractive.

compared with corporate and government bonds as rates are beginning to rise from their historic lows.

Corporate signals that shares are fairly priced

Corporate management teams also seem to be confirming that shares are fairly priced. We can see this as US companies spent another record amount on share buybacks in the fourth quarter of 2021, in which one in seven companies increased their EPS by at least 4% by reducing the number of shares in circulation. This was up from one in thirteen in Q3. We expect Q1 2022 buybacks to hit a new record, with a wider range of companies benefiting from the increase in EPS. This will reduce share count even further, resulting in higher EPS and lower P/E multiples.

The buybacks, coupled with low corporate inventories, are supportive of the valuation premium relative to long-term history for the moment, but as the economic recovery moves into its later stages we expect to see valuations continue to contract. This suggests to us that it is wise to move towards higher-quality sectors and stocks. In particular, we are looking to position ourselves in highly profitable companies with strong cashflows.

Prefer the US to the rest of the world; technical indicators are mixed

Technical factors are still supportive of developed markets overall, although we are concerned about increased volatility. We still rate technical indicators as positive for developed equities, and more favorable than for emerging equities. Despite the S&P 500 hitting 70 new highs in 2021 and notwithstanding its single-digit pullback in Q1, especially during the early days of the invasion, market sentiment indicators are not excessively bullish or bearish overall. Some short-term data is weak, but some technical indicators are showing signs of improvement.

The US is essentially self-sufficient in terms of its energy needs, so it should feel less direct impact from the Ukraine conflict than other regions. As such, we are slightly overweight the US. Within our US exposure, we continue to focus on quality companies with strong operational track records and high free cash flow generation.

As of mid-March, the sentiment indicators we monitor were suggestive of a mid-single-digits return for the MSCI World in 2022. We also see technical signs suggesting that value could outperform growth over the year.

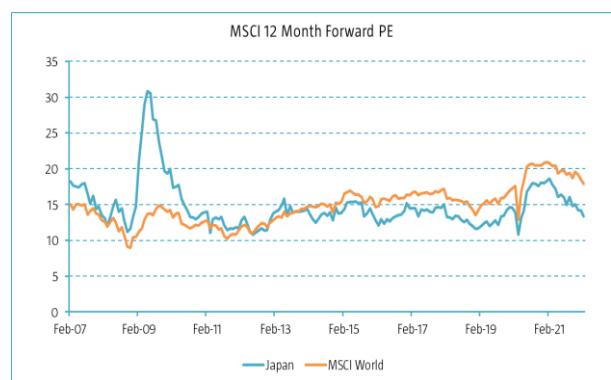
More cautious towards European equities

With little evidence at the time of writing that there will be a de-escalation of the Russia-Ukraine conflict, we remain cautious about the outlook for European equities. The risk of stagflation looms, with a potential negative impact on growth. Higher inflation is likely even if Russia and Ukraine agree a truce in the near term. While the ECB has become more hawkish on the back of rising inflation, so far it has

only resorted to reducing quantitative easing rather than hiking rates like the Fed, Bank of England and other central banks. Given the heightened geopolitical uncertainty in Europe and its potential knock-on effects, we have moved underweight in European equities in the global equity portfolios.

We believe that Japanese equities could benefit from a shift into value. Overall, Japanese companies have improved their profitability, as measured by return on equity, over the past 20 years, but we still find the highest-quality, most profitable companies in the US. We will continue to search for high-quality companies in Japan as we await a turn in the performance of its equity market, into which cumulative flows from domestic Japanese investors ended 2021 at a ten-year low.

Figure 6 | Japanese equities look increasingly cheap relative to other markets



Source: IBES, MSCI, Robeco, March 2022.

Main risks to our outlook

We see three primary downside risks to our earnings and valuation outlook: inflation risk, central bank policy risk and the Russia-Ukraine war. Collectively, they could increase concerns about the US or Eurozone economies entering recession. As energy prices have an outsized impact on inflation in Europe, inflation is the most immediate risk.

Rising inflation is clearly a headwind to global consumers. The key question is whether it will cause households to reduce their spending, which would in turn impact the economic growth outlook. Consumers have strong balance sheets, measured in terms of excess savings or debt service ratios. This is confirmed by analysis of data from some of our bank holdings. We are monitoring household debt ratios – an aggregated measure of households' debt burden. They remain at multi-decade lows (Figure 7), so there are minimal signs of household financial stress at present.

Figure 7 | Federal Reserve US Household Debt Service Ratio suggests levels of leverage remain manageable



Source: Bloomberg, Robeco, December 2021.

Global central bank policy is likely to remain a key risk, especially after US Fed Chair Powell raised the prospect of accelerated Fed hikes in the near term on 21 March. He repeated that the Fed is willing to hike by more than 25bp per meeting and to tighten at a more restrictive pace if deemed appropriate. When asked what would prevent the Fed from hiking by 50bp in May, he replied “nothing”, before noting that the decision was not yet made and would depend on how the FOMC assesses the paths of inflation and policy.

Research firm Bernstein Research notes that the European equity market already seems to be pricing in a scenario of stagflation. This is reflected most strongly in the hit to European bank stocks since the Ukraine invasion. While the effects of higher energy and commodity prices on inflation seem certain, the potential impact on growth is less clear. We are still in a high-growth period, but higher energy and commodity prices could trigger a slowdown from here.

Implications for portfolio positioning

Since the invasion, we have moved slightly underweight in European equities, while we remain modestly overweight in North America in our global equity portfolios. 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.

For example, we have been investing in certain high-quality healthcare and other services companies. Healthcare-related companies have good pricing power as spending by seniors is forecast to grow substantially. Seniors spend more on health insurance, medicine and medical services than the average person. One of the areas of services that we currently like is insurance, as property & casualty insurance rates are rising faster than inflation.

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 pandemic levels and higher than their long-term averages.

We continue to find what we view as high-quality companies in our favoured sectors, including health care, technology and financials. We continue to prefer these areas to the more bond-like sectors, such as utilities and consumer staples. We remain on the lookout for companies with a good or improving sustainability profile that also have a strong long-term track record of return on invested capital, and that have an attractive valuation as measured by high free cash flow.

Emerging Markets Equities | Emerging markets struck early against inflation, whereas the US has only just started its tightening cycle

- We remain cautious against a backdrop of geopolitical uncertainty
- Key topics for the remainder of 2022 will be:
 - the humanitarian disaster and geopolitical challenges in Ukraine
 - high inflation around the world and its impact on the real economy and monetary policies
 - the economic recovery in combination with tighter monetary policy as a potential catalyst for “value” asset classes such as emerging equities

Five-factor summary

Factors	Score
Macro	=
Earnings	=
Valuation	+
Technical	-
Sentiment	=
Total	=

Source: Robeco Emerging Markets Team

We maintain our neutral overall stance on emerging market equities as they are very attractively valued on one hand, but on the other their technicals are less appealing.

As we set out in our Q1 outlook, the economic rebound we've seen in recent quarters has translated into strong earnings across emerging markets. However, earnings revisions have weakened recently, with the 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 remains positive, and it became even more compelling in Q1. Emerging equities' derating has led to the price/earnings (P/E) ratio of the MSCI EM Index falling to close to 12 times 2022 expected EPS. By contrast, the MSCI World's P/E ratio is 18 times 2022 expected EPS.

Our sentiment factor remains neutral as there have been unprecedented inflows into emerging markets of over USD 180 billion since October 2020. We expect continued inflows, but at a slower pace than in recent quarters. We

expect supportive sentiment to persist as investors are increasingly looking for value opportunities that will benefit from the reopening of the global economy.

Emerging markets continue to face headwinds, including geopolitical uncertainty

In our last quarterly outlook we referred to the credit concerns in the Chinese property sector and the potential for the problems to spill over into the broader Chinese economy as the main headwind facing emerging markets. We also saw the upcoming taper in the US as another risk factor for emerging markets. This quarter, the tragedy in Ukraine has added to the uncertainty and might remain an issue for months.

Our base case is that coronavirus has become less dangerous. In combination with higher vaccination rates around the world, there should be less pressure on healthcare systems. As a result, further lockdowns look unlikely in 2022.

The headwind represented by rate hikes could also fade, but not until the Fed has hiked rates a few more times. Inflation is likely to fall back from the high levels it has hit recently, but the jury is still out if this headwind is likely to weaken or disappear in the second half of the year. We anticipate more tightening in the US until at least Q4.

We have become more positive on 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 China, Korea and India.

Next quarter there's also going to be a lot of attention on monetary tightening in the developed world. Later in the year, when inflation is more likely to have come under control, equity markets could prosper. But we need to remember that after the Fed's first rate hike in March, there could still be six more to come.

Periods of growth-inspired monetary tightening are typically good times for value asset classes and stocks. Q2 may come too soon for emerging equities, but we believe they could start to outperform developed equities later in the year. Emerging market equities have discounted a lot of negative news over the past couple of years, whereas developed equities have responded to any good news by hitting all-time highs. The good news came in the form of economic reopening and strong corporate earnings, both in developed and emerging markets. But while developed equities prospered, emerging markets were essentially flat in 2021, and thus derated substantially.

Russia's invasion of Ukraine in Q1 has added to the negative news. In addition to the human tragedy, the geopolitical backdrop in the region looks set to remain uncertain for some time, which could result in global equity investors adopting a cautious approach: both developed and

emerging equities fell by around 5% in the first three months of the year.

The invasion of Ukraine triggered the US, EU and their allies to impose coordinated and unprecedented sanctions against Russia. China has tried to take a neutral position, but it is coming under mounting pressure to try to persuade Russia to make a peace deal. Chinese trade with Russia looks set to come under closer scrutiny, with the possibility of sanctions being imposed on Chinese firms. We believe the direct impact of the conflict on trade should be manageable, but the geopolitical risks need to be closely monitored as the conflict has increased the risk premium.

Emerging markets have been tackling inflation better than the developed world

Inflation spiked around the world in 2021, but more recently it has only been increasing modestly in emerging markets. In developed markets, by contrast, inflation continues to accelerate and is now three times as high as in early 2020.

We prefer the monetary policies being implemented in most emerging markets to those in developed markets. For example, Figure 8 shows how the Brazilian central bank has adopted a hawkish approach over the past 12 months to try to contain rising inflation.

Figure 8 | Interest rates and inflation in Brazil



Source: Bloomberg, Robeco

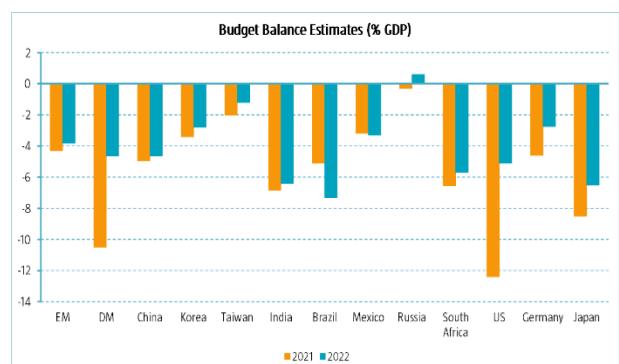
Most emerging markets started tightening earlier than their developed-market counterparts. Latin America has been most aggressive, with Brazil having hiked rates from 2% last March to 11.75%. The Bank of Korea started hiking in August, with rates rising from 0.50% to 1.25% by early 2022. Meanwhile, Taiwan's central bank surprised the markets with a larger-than-expected hike of 25 basis points in mid-March. Turkey is the exception, having actually cut rates with inflation running at 54%; this does not look to be a sustainable situation. China also recently began monetary easing by cutting rates and reducing the required reserve ratio. With inflation not currently a problem in the country – the latest reading was 0.9% – we expect further easing in 2022.

Most other central banks in the major emerging markets have started hiking cautiously. It remains to be seen how hawkish they become.

Tailwinds from budget and current account balances

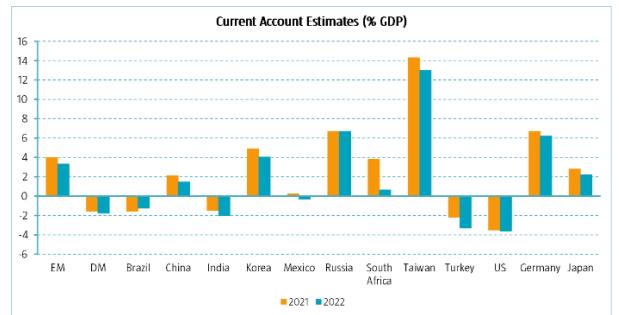
We still think the macroeconomic backdrop in emerging markets is positive overall as we expect GDP growth in the low single digits in 2022, with large current account surpluses and relatively low fiscal deficits. In fact, economies in South Asia and most of Latin America and EMEA could grow in the high single digits; most of these economies also have resilient current account balances, although their fiscal deficits are larger. Emerging markets' current account balances look much better than those of developed markets overall, and the same goes for fiscal balances, as Figures 9 and 10 show.

Figure 9 | Budget balance estimates



Source: Bloomberg, Robeco

Figure 10 | Current account estimates



Source: Bloomberg, Robeco

Earnings expectations slowing down

Figure 11 | Emerging-market earnings revisions



Source: IBES, Robeco, March 2022

The one-month earnings revisions ratio for emerging equities fell to 0.9 in March, as we can see in Figure 12. However, it remains comfortably above its long-term average, which is a positive sign for emerging-market corporate earnings.

Figure 12 | Emerging-market earnings revisions ratios



Source: Bank of America, March 2022

Earnings revisions in emerging markets are lower than those in developed markets. After emerging-market earnings 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 13 | MSCI World earnings expectations



Source: IBES, Robeco, March 2022

Valuations positive for emerging equities

Valuations remain, in our view, positive for equities. Their 12-month forward P/E ratio approached a ten-year low in early 2020 and then rebounded sharply before falling back again, as Figure 14 shows.

Figure 14 | Emerging equity valuations look attractive



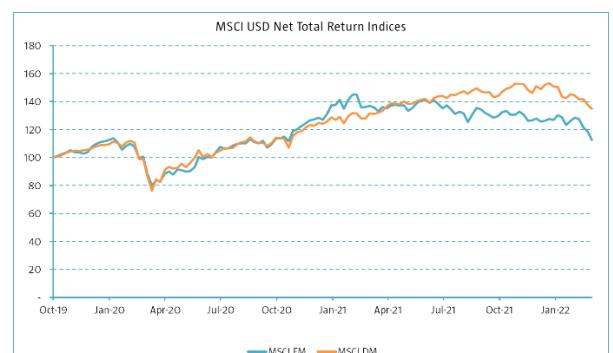
Source: MSCI, Robeco, March 2022

The average P/E ratio of emerging equities is close to 12 times – well below the 18 times for the MSCI World, and equivalent to a 33% valuation discount. By contrast, the average historical discount is closer to 20%. From a price-to-book perspective, emerging equities are trading at a discount of around 30% relative to developed markets.

Technicals still negative

Emerging markets have been lagging their developed counterparts recently: over the past 12 months, emerging equities have underperformed developed equities by 20 percentage points. As a result, our assessment of emerging-market technicals is still negative.

Figure 15 | Relative performance of MSCI EM and MSCI DM

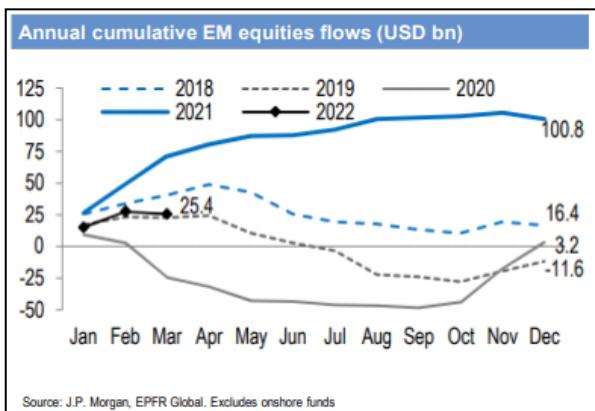


Source: MSCI, Robeco, March 2022

Sentiment still neutral

We are maintaining our assessment of sentiment towards emerging equities as neutral. There have been more than USD 200 billion of cumulative 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. That said, we expect the current deceleration in inflows to continue as tapering accelerates in 2022. So far in 2022, there have been USD 25 billion of inflows into emerging equity funds after USD 100 billion of inflows in 2021, as Figure 16 shows.

Figure 16 | Cumulative flows into emerging equities by year



Source: EPFR Global, March 2022

Implications for portfolio positioning

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. 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 more and more 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.

The portfolios will retain their overweight positions in South Korea, Brazil, Indonesia, Taiwan, Greece and Hungary as we believe their economies have strong chances of rebounding and as corporate profits in these countries are high. Current valuations do not reflect the earnings recovery expected 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. Valuations fell the most in this sector during the pandemic.

Focus on China

We are neutral on the Chinese equities market overall, but more positive on the prospects of A-shares. While we expect the government to accelerate policies that are supportive of growth, such as easing regulation of the property sector and a further increase in infrastructure investment, economic growth is likely to bottom out in H2. Geopolitical risks and a rising number of Omicron cases could lead to further market volatility in Q2.

The annual National People's Congress (NPC) has set this year's growth target at "around 5.5%", close to the upper bound of the market's expected range. Although there are doubts about how China can achieve this kind of growth this year, the 5.5% target represents a strong pro-growth message to align expectations and actions from all levels of government. While it is not necessarily strictly binding, we expect Beijing to unleash enough easing measures to ensure actual growth this year is reasonably close to the target.

So far, counter-cyclical policy easing has been the main tool to stabilize growth. Now, there could also be faster fiscal spending, new tax cuts and accelerated infrastructure investments, which could be larger than had been expected. Monetary policy will remain prudent but ample liquidity will be provided, especially in the form of increased support for small- and medium-sized enterprises, innovation initiatives and green development.

The Chinese property sector is still struggling. Liquidity remains tight for developers, especially those that are highly leveraged. We believe there is still room for supportive housing policies besides city-specific tweaks in home purchase policies. For example, there could be a relaxation of restrictions on home purchases and accelerated construction of social housing, with more financial support.

Meanwhile, China is likely to be more pragmatic when it comes to decarbonization, with targets that accommodate both conventional and renewable energy.

The NPC reiterated Beijing's view on anti-monopoly to safeguard a fair and orderly internet marketplace, but also emphasized the importance of strengthening the internet content ecosystem. The top platforms are likely to remain under scrutiny.

China is currently making major efforts to curb the spread of Omicron in what has been the most widespread Covid-19 outbreak in the country in two years. In the near term, China will stick to its bottom line of "no meaningful spread of disease", but it will look to make gradual changes to this policy to avoid significant damage to the economy. We believe that the Omicron outbreak has probably peaked and lockdown could end in May. The launch of an mRNA vaccine and attaining a sufficient supply of affordable

tablets against Covid will be important in getting life back to normal later in the year.

We expect further downwards earnings revisions for both onshore and offshore companies as consumption could be affected by the Omicron outbreak. The A-share market's earnings should be relatively resilient as it has little exposure to the internet sector, which is still under regulatory scrutiny. Chinese equity valuations are now back below their historical average, but even though value is emerging in China once again, it may take time for investors to regain their confidence in the market. We are positive on alternative energy sectors as valuations have become more reasonable after recent falls and high energy prices are likely to lead to an acceleration of the energy transition.

Robeco's Chinese A-shares portfolio is overweight in industrials, utilities, consumer staples and materials and underweight in financials and healthcare. Robeco Chinese Equities is overweight in utilities, industrials, IT and real estate, and underweight in financials, consumer discretionary and communication services.

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