



## Fundamental Equities Outlook Q4 2022

# Winter really is coming

- Inflation is draining consumer confidence with recession coming
- Defensive strategy required favoring value over growth
- EM is better placed than DM despite dollar strength

“If you think this has a happy ending, you haven’t been paying attention.” is a quote from Game of Thrones bad guy Ramsey Bolton, but it could easily be straight from the mouth of Federal Reserve Chairman Jerome Powell. In our last Quarterly outlook we asked for clarity on the size of rate rises and now we certainly have it. At the September Fed meeting Powell ruled out any lingering hopes of a soft landing, describing it with typical understatement as a “very challenging” prospect. Recession in the US and Europe is almost certain this winter.

“Companies with pricing power that aren’t over-leveraged are preferred”

At the moment the markets are rough and are recalibrating to a changing environment of higher rates and lower liquidity. In the last week of September numbers came out which have rarely been seen in the last 25 years. At the time of writing, inflation in The Netherlands was reported at almost 18%; during a few hours it was possible to make some 40% in UK gilts; spending on mortgage payments for an average American family has even spiked up to levels last seen in the early eighties.

Outlook  
For professional investors  
October 2022

Robeco Fundamental Equity Team

A rapid rise in interest rates, oil prices and the dollar is usually not a good cocktail for stock prices. The markets have adjusted lower since March with the S&P500 down 25% by the end of September from its peak at the end of 2021, and Investment Grade Credits down by about 15%. So far this year US bond and equity markets have seen a drawdown of more than USD 55 trillion from their recent peak. This wealth effect is reflected in consumer confidence. October is often a month when bear markets reach their nadir. However, even with the current decline behind us, our outlook for global equities remains cautious. Increasing financing costs combined with rising input costs and the threat of lower consumption puts pressure on corporate profitability. Shrinking market liquidity brings multiple expansion to a halt.

With regards to emerging markets for the coming quarter, we maintain our five factor scores as they are. It's important to note that central banks in many emerging countries have been tightening for a long time already, while the Fed is far from finished and the ECB in Frankfurt has only just started to raise interest rates. So, less inflation comes with potentially fewer interest rate hikes in the emerging world. The outlook for emerging markets is therefore significantly better from the point of view of inflation and interest rates than in developed markets.

### So what's a constructive way forward for equity investors?

The central line in the approach of our teams is that they focus on solid businesses with good earnings potential and strong cash generation, which can be bought at appealing valuations. Not just cheap stocks, but healthy stocks which will do well over a period longer than just an occasional quarter. We do not take a punt on the current macro events, but will factor in the consequences of a changing macro environment for our portfolio companies' prospects. Companies with pricing power that aren't over-leveraged, now available at much lower prices, are preferred. These value-oriented stocks will likely provide protection from inflation and have a good chance to outperform in this environment. We are positioning our portfolios to reflect that higher-than-average inflation could last for some time. 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. Though current markets are challenging, this is also a time of opportunity for stock picking.

**Audrey Kaplan (Portfolio Manager Global Equities)**  
**Wim-Hein Pals (Portfolio Manager Emerging Markets Equities)**  
**Kees Verbaas (Head of Fundamental Equity)**

October 2022

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“It’s great to be back” – Q&A with Kees Verbaas, Head of Fundamental Equity



***This month you returned to Robeco, as the new lead of the Fundamental Equity teams. Are you happy with your timing?***

It’s interesting timing for sure. At the moment the markets are volatile and investors are rightly being defensive. It is hugely challenging but this is also where active managers can really make a difference.

***How does it compare to previous periods of volatility like the financial crisis?***

It was an electrifying period, with big markdowns for stocks. I had just started at Hermes in London as captain of the Emerging Markets team, in the midst of the financial crisis. It taught me that during these difficult times you have to keep your eye on the big picture and be resilient. Markets tend to overshoot on bad news and looking at valuation of a company’s cashflow can be a good guide. Fundamental analysis pays off.

***So then you came back to the Netherlands?***

Yes, after three years of weekly commutes to London my wife sent me a subpoena to come back home, a bit to my despair but rightfully stating that I was married to her and not to the job. Positive memories about the competitive City spirit will always stay with me.

***So that became your first stint at Robeco?***

I then joined Robeco as a client portfolio manager for Emerging Markets. Interacting with clients around the world on a daily basis proved to be a very valuable and rewarding experience. However, I wanted to broaden my knowledge of investments beyond EM equities. Upon leaving I had the strong desire to come back to Robeco one day, as it proved to be a fantastic firm to work at. Main appeal was (and is) the smart people that work here and the firm’s ability to turn a strong research capability into products that meet today’s *and* tomorrow’s client demand.

***Where did you go next?***

The opportunity of a new learning curve was given to me by Blue Sky Group, manager of the pension strategies for KLM, where I became responsible for all externally managed investment solutions, across different asset classes. The beauty of manager selection is that you get to work with the best asset managers in the business. During those 5 years we invested significant amounts in private markets and turned the majority of the portfolio from passive to active strategies. My key take-away from that period is that active management does work, despite the adage that the average manager does not beat the market. A topic maybe worth a separate piece someday!

***And where were you before you came for your second stint at Robeco?***

I had switched to Altis, NNIP's manager selection specialist now part of Goldman Sachs. The broader platform offered the opportunity to work for multiple clients instead of only one, as the company services a range of pension strategies, insurance companies and private banks. Interestingly, when Altis makes objective comparisons, Robeco is up there with the very best, in Fundamental Equities but also in other segments such as Credits and Quant solutions. Sometimes to the surprise of clients, who wonder how it is possible that a worldwide search ends up in Rotterdam, 30 km down the road.

***What originally got you into investing?***

I got interested in stocks as a teenager after I had lost a large part of my savings in a silver trade. Hard earned money from years at tomato picking and newspaper delivery jobs was wiped out when the Hunt brothers cornered the market. It provided a good lesson about the difference between speculating and investing! Before entering the investment profession I worked for a number of years as a project manager for the World Bank in several countries and I headed the Trade Delegation of the Netherlands in Russia. From those years stems my passion for Emerging Markets and for entrepreneurial companies. Both offer fantastic investment opportunities. Unfortunately, recent developments in Russia/Ukraine show that not all positive change lasts forever. From there I was recruited by ABN Amro Asset Management for the Eastern Europe Equity Fund and teamed up with Dimitri Chatzoudis, now a colleague here at Robeco. That was 1999 and the start of my investment career. We both moved up to lead Global Emerging Markets, which we built out to a top-5 unit globally. Fortis took us over and that was that, we were all fired, so I went to London, heading the Emerging Markets team at Hermes.

***What do you want to achieve now you are back at Robeco?***

With the experience from my previous jobs I hope to bring challenge and perspective to the teams. Investment performance remains our key priority. At the same time we translate sustainability objectives to products in a way that combines risk awareness with opportunity thinking. Today's changing world brings plenty of investment possibilities for strong results. Also, I intend to listen carefully to our clients and our sales people who talk to clients all the time. We aim to develop solutions that meet a continuously evolving client demand. This also requires ongoing investment in our people, our key assets. Robeco's teams, processes, ESG integration and track records are at high level, so there is no need for radical changes. The intent is to further strengthen the proposition of Fundamental Equity.

***What have you found in your first weeks?***

It was a warm welcome, with still many familiar faces. At my previous companies we selected numerous Robeco strategies and built a firm belief in the teams' craftsmanship. Now that I see them in action on a daily basis, I believe in them even more. It is great to be back!

## Developed Market Equities | With persistent inflation and earnings declines: look for areas of resilience

- Sentiment factor remains neutral; stick with companies that generate strong free cash flow
- Economic outlook is downgraded as the longer rate increases persist, the longer the slowdown
- We have downgraded both our earnings (prior quarter) and valuation factors, but it is not all doom and gloom
- Overall, we have an increasingly cautious outlook for developed equities and recommend minimizing risk until the rate hike cycle is nearing completion
- Look for high-quality companies with pricing power and strong free cash flow

### Five-factor summary

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

Source: Robeco Global Equities team

### Sentiment: Slumping again after bear market rally

We are moving from the “Summer of Hikes” into a cold winter. The summer was about yearning for lower inflation. Three months on from our last outlook, we see increasing uncertainty over the likely persistence of inflation with confidence over any soft-landing evaporating in the summer heat.

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. The VIX peaked at around 40 in early March after Russia’s invasion of Ukraine before moderating. In early July, the VIX hovered at 28 before improving to 19.5 in mid-August at a time when sentiment appeared to be recovering. That was only a brief reprieve as the VIX signal has risen again to exceed 30 suggesting investors are worried about the winter to come.

During the U.S. equity market contraction in September, equity flows – particularly from private clients and corporate clients (especially in the form of buybacks) remained tilted toward buying while institutional selling was driving the market lower. However, according to Bank of America, year-to-date inflows are on pace to exceed 2019’s records and clients have purchased stocks across all but one sector (Utilities) for the first time in their data. While this implies long term confidence in equities, the IPO market is having its slowest year in more than a decade in the U.S, indicating negative sentiment and risk aversion.

The mixed sentiment data we monitor (including items such as flows, IPOs, buybacks) combined with the VIX’s snap back above 30 indicate that 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 suggests 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 believe in fundamental factors that measure free cash flow generation and free cash flow yield. These indicators have strong track records over multiple decades to identify companies with long-term favorable stock performance. We will provide more details on our positioning later.

### Macro: Downgrade to Negative from Neutral

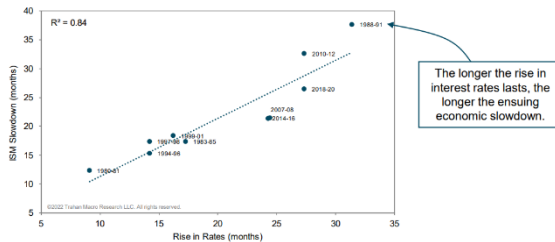
We lower our economic outlook for developed market equities as it's clear the "Summer of Hikes" will continue into winter as inflation is still elevated. We see Europe and the US continuing their attempt to tame inflation. Global growth forecasts have come down for both 2H 2022 and 2023 while inflation risks and policy-rate projections have risen. In addition to prolonged inflation, the war, the energy crisis, and lockdowns (Covid disruptions) in China have all contributed to derailing the post-Covid global recovery.

The global manufacturing PMI as reported by Deutsche Bank, a coincident indicator of GDP growth, is now slightly below the 50 mark, pointing to stagnating activity this summer. The risk is that global demand could ease further. In Europe, we have seen financial conditions tightening since early 2022 and they will continue to tighten in the coming months. We expect a more front-loaded ECB hiking cycle than we did just a quarter ago. Bloomberg reports that traders expect the ECB key rate at 3% by May, double the expectation from the start of September.

The post-Covid excess savings that have been underpinning household spending will likely wane in coming months. We see higher uncertainty and a more persistent real income squeeze. Combined with Consumer Staples companies taking price increases of 8-12% during the past quarter – with pricing taken on everything from cereal to coffee to fish sticks -- and preparing markets for more increases over

the balance of the year – we expect to see a real income squeeze on consumption. Overall, we see the chances of a recession rising, especially in economies with the most exposure to the gas supply shock such as Germany and Italy.

**Figure 1 |** Duration of tightening impacts duration of slowdown



Source: Trahan Macro Research

In the US the Fed is raising rates while the economy is slowing. In September the Fed raised rates by 75 bps for a third consecutive meeting and indicated the market would see another similar rate hike in November. The Fed is committed to reducing core inflation and signaled they're willing to accept a recession as a necessary trade-off for curbing inflation. But a problem is tightness in the labor markets with unemployment levels at a 50-year low and a hiring gap at near record levels which is at odds with reducing inflation. This points to rates rising for longer and higher than consensus expects, and we expect the hikes will continue into 2023, beyond consensus expectations. Economist models based on historical patterns suggest that the longer the rise in interest rates lasts, the longer the ensuing downturn (Figure 1). **We downgrade our macro outlook from neutral to negative.**

**Lower forecasts for global GDP offset by higher highs for USD**

What does this all mean for Global Developed Markets (DM) GDP? In aggregate using the most recent outlook relative to our July forecasts, we expect DM GDP growth to deteriorate further. The Bloomberg consensus forecasts imply a growth deceleration from 1.9% in 2022 to 0.9% in 2023. While the outlook for the global economy has disappointed the market, it has been strongly positive for the USD which is at record strength relative to other world currencies including GBP, EUR and JPY. We expect higher highs in global rates, higher highs in global yields, and conditions persisting for (yet) higher highs for the USD as we see increasing market and economic pressures that favor the USD. For example, in late September, the BoJ kept rate its policy rate unchanged, maintaining its strong easing policy stance. BOJ Governor Kuroda's dovish press conference triggered further JPY depreciation, which prompted a historic Ministry of Finance FX (forex) intervention.

**Figure 2 |** U.S. Dollar Index (DXY Currency) reaches higher highs



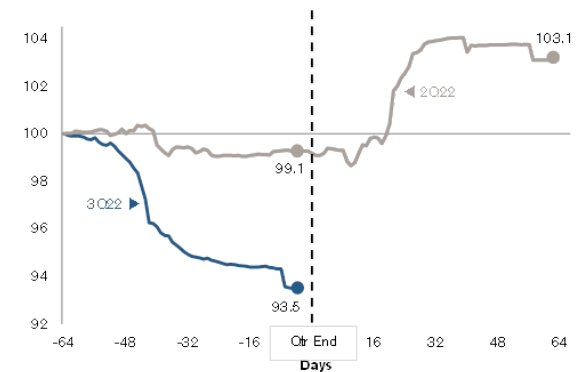
Source: Bloomberg

The record strength in the USD has cushioned non-USD priced portfolios YTD. Figure 2 illustrates the general value of the USD currency by comparing it to other major world currencies. As shown, the USD continues to reach higher-highs and is currently above its twenty-year high. In turn, the MSCI World priced in USD (at the time of writing) has declined (-24.5%) which trailed the MSCI World priced in EUR (-11.5%) by 13 percentage points as the latter benefits from non-US investors investing in USD assets.

**Earnings: Rolling over despite pockets of strength**

As we noted when we lowered our earnings outlook factor last quarter (Q3 Outlook), tightening monetary policy often triggers reductions in earnings forecasts. In the H1 through June global earnings expectations remained resilient, especially in the US. However, by midsummer, the market began to experience earnings forecast cuts as shown in Figure 3 for S&P 500 companies for Q3. **In August, global analysts cut earnings expectations in every region and in the majority of global sectors. We maintain our earnings outlook factor at negative.**

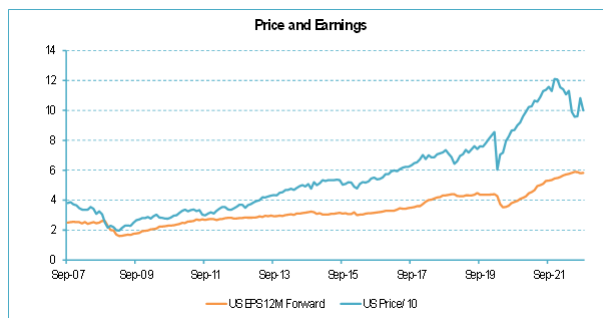
**Figure 3 |** Path of consensus S&P 500 EPS: 3Q22 vs. 2Q22



Source: Standard & Poor's, Refinitiv, FactSet, Credit Suisse

Globally, the Energy sector continues to have positive and improving revisions. Other sectors with more upgrades than downgrades include Banks, Insurance, and Telecom companies. In the US some industries look more favorable than others – broadly Financials and areas of the non-Discretionary economy such as (i) Utilities, (ii) Healthcare – Providers & Service companies, (iii) Consumer Staples (e.g. Food & Beverage companies). While downgrades are most pronounced in the Technology sector and specifically in Semiconductors.

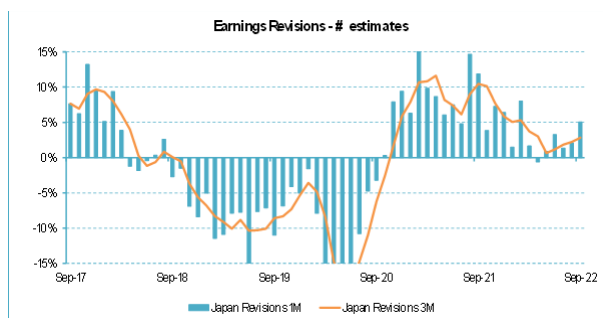
Figure 4 | US earnings growth expectations show resilience over the next-twelve-months, but we remain cautious



Source: IBES, MSCI, Robeco September 2022

It is not all doom and gloom however as although there have been more downgrades recently for Q3, at least in the US (Figure 4), S&P 500 EPS growth is still expected to be positive for the full H2 2022 as well as in H1 2023 in the 5-7% range per consensus while YoY Growth for Q3 forecast has been cut from 9.8 to 3.2% as of 23-Sept. Other positive highlights include Japan (Figure 5) and Europe achieving resilient upward revisions ratios – which are outperforming both the US and Rest of World (including EM and Asia ex Japan). During recent decades it has been rare to see Japanese earnings revisions positively exceed US ones. Research suggests that in times of USD strength and Japanese earnings momentum, it may be opportune to go shopping amongst high quality Japanese companies for bargains and price performance.

Figure 5 | Japan earnings revisions were the most improved during the summer months



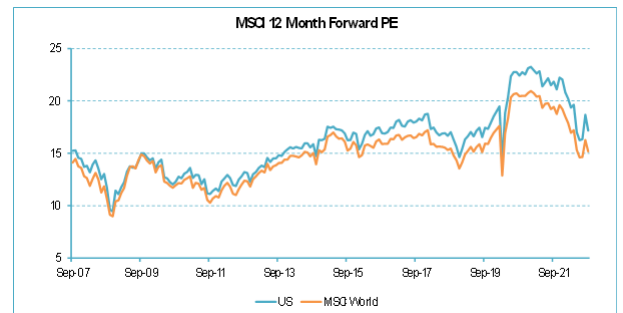
Source: IBES, MSCI, Robeco September 2022

## Valuation: Beware The Fed (which wants to avoid a repeat of the 1970s)

One year ago, the DM economies were recovering from the Covid-induced global slowdown and monetary policy was loose. Now the prevailing viewpoint is that we will have a cold winter (both due to the energy shock and slowing growth). Moreover, the market has accepted that most central banks will continue to hike to ease inflationary pressures. In particular, the Fed will look back to the history of the 1970s. In that stagflationary era, the Fed famously declared victory far too early, when inflation dropped from 11.7% in February 1975 to 5.9% in November 1977, only to see it reaccelerate towards double-digits in the early 1980s. When this happened, it took even more drastic policy tightening, and two difficult recessions, to finally bring inflation under control.

With the ECB, the Fed, the BoE and other central banks unlikely to pivot from the “Summer of Hikes” to easing anytime soon (in order to avoid a repeat of the 1970s), we think hikes will extend beyond expectations and valuations will become even more challenged. Figure 6 suggests forward P/E multiples for both the U.S. and the World have contracted back to the pre-pandemic range, but we expect more pressure on valuations in the near-term. **We are downgrading our Valuation Factor from Positive to Neutral.**

Figure 6 | P/E multiples (U.S. and World) have come down but rising bond yields may pressure valuations further



Source: IBES, MSCI, Robeco September 2022

## Technical indicators take a back seat to risk

We posited last quarter that technical factors were supportive of USD investments as there were no real signs that the EUR or JPY were bottoming, and indeed this came to pass. We continue to believe that risk remains high and that sentiment is dominant. In these kinds of conditions, we watch CDS indices and credit spreads closely – both continue to widen. 10-year bond yields are heading higher. Risk remains high and some argue it is heading higher. There is concern over deteriorating credit markets and widening spreads, but we believe corporate delinquencies are likely to stay under control (at least for the next 6-to-12-months).



We met with several large-cap global banks at a recent financial institution conference in New York. While the single largest investor concern raised was asset quality, the CEO's affirmed that net charge-offs remain low with no signs of normalization in the near-term.

We must consider the possibility that some major institutions, banking systems or even countries are under rising stress due to rising global rates. It is possible that something will blow up – for example, an overleveraged hedge fund or over indebted country, or some other surprise. This should signal that a bottom for equities is near and other trends could reverse in tandem. Meanwhile, we are searching our technical signals for signs of significant changes in trends as we move into winter, but do not see any yet. We **downgraded our technical factor from positive to neutral last quarter. And, our current technical indicators remain neutral.** While technical indicators remain cautious, there are some signals within the factor that have improved such as the AAll Bull-Bear signal which is at an all-time low. As a contrarian signal this suggests excessive bearishness, but this is just one indicator of many, and we reiterate our Technical factor neutral.

## Emerging Market Equities | Inflation is not impacting EM with the same intensity

- Although some EM in our view look very appealing, we remain cautious against a backdrop of geopolitical uncertainty and global monetary tightening
- China is at a different stage of the cycle given its benign inflation and has ample room for stimulus
- Economic resilience combined with DM rate hikes could still be a catalyst for “value” asset classes such as EM equities

### Five-factor summary

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

Source: Robeco Emerging Markets Team

### Too early to be brave

Winter may be causing trepidation in developed markets but the macroeconomic outlook for emerging markets is relatively benign in comparison. However, we have not upgraded our macro factor just yet. Although some EM economies are currently in the welcome position of having more monetary policy flexibility than DM, the economic recovery in China is not yet convincing enough to justify a positive overall macro conclusion. Unfortunately, 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 to get 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.

The Chinese 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 2.5% in September. The largest and most important emerging nation has a relatively benign macroeconomic backdrop, it also has abundant foreign exchange reserves, and is running a large current account surplus every month.

Commodity exporting countries like Brazil and Indonesia will also benefit from still high dollar denominated commodity prices, helping cushion any secondary inflation effects from higher import prices.

Some other countries, however, are still struggling to get inflation under control and have only just started to hike interest rates. For instance, the India and South Africa 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 positive, and it became even more compelling in Q3. Emerging equities’ derating has led to the price/earnings (P/E) ratio of the MSCI EM Index falling to close to 11x 2022 expected EPS. By contrast, the MSCI World’s P/E ratio is over 15x.

Meanwhile, the technical picture for emerging markets is similar 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. This 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. Structurally strong commodity demand will create some winners, while depressed valuations will give rise to value opportunities over the longer term. Nevertheless, for the coming quarter, we maintain our five factor scores as they are, and our neutral stance in emerging markets relative to developed markets.

### Where is the inflation in EM?

Let’s ask ourselves this somewhat provocative question; provocative, since we see it all around us in Europe. When

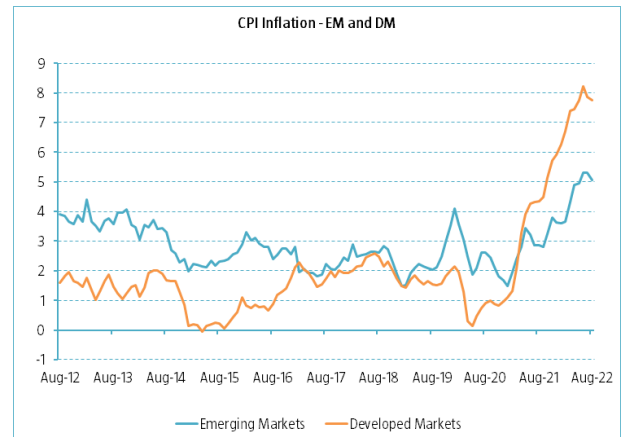
we pay for our daily groceries, fill up our old-fashioned ICE car with dirty petrol or diesel, or tick off our overnight stay in a hotel. I was shocked recently when I checked out of a hotel in Paris. I knew that prices in the eternal city were high, but I was surprised when I had to pay twice as much as I had for a similar hotel in London the previous month.

This is an interesting bridge to the inflation backdrop in emerging markets. In China, inflation is weakening and is currently 2.5% and in Taiwan the inflation rate hovers around 2.7%. In South Korea, we are talking 4.4% core inflation. The "notoriously high inflation country" Indonesia, has seen an increase in consumer prices of 4.7%. None of these countries exceed five percent while in Europe we are dealing with an inflation rate that is in the double digits and the latest CPI figure in the US was 8.3%. Brazil has an inflation level of roughly 9%, but even in this other "notorious inflation country" it is therefore lower than in the EU.

The point we would like to stress with all the above figures is that inflation is much more a problem of the rich industrialized countries (G7) than of the emerging countries in Asia, Africa, the Middle East and even Latin America. We should consider the fact that central banks in many emerging countries have been tightening for a long time already, while the Fed is far from finished and the ECB in Frankfurt has only just started to raise interest rates. So, less inflation comes with potentially fewer interest rate hikes in the emerging world. The outlook for emerging markets is therefore significantly better from the point of view of inflation and interest rates than in developed markets.

Other than Turkey, only in Brazil is inflation currently slightly higher than in the US. But again, 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 7 makes clear the current discrepancy between inflation in emerging and developed markets.

Figure 7 | Inflation estimates in EM and DM



Source: Bloomberg, Robeco

Central banks in almost all emerging countries are still tightening, though in Latin America they should be close to the end of the cycle. China has even been easing monetary policy already 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 2.5% – we expect further easing in the fourth quarter of 2022.

### 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.

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 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 second half of the year might be a lot better than the first half from a GDP growth perspective, all else being equal. From a geopolitical perspective, the relationship between China and Taiwan deteriorated after the controversial visit of Nancy Pelosi to the island. Thus, the geopolitical uncertainty has only increased over the course of Q3.

### Commodity exporters well placed

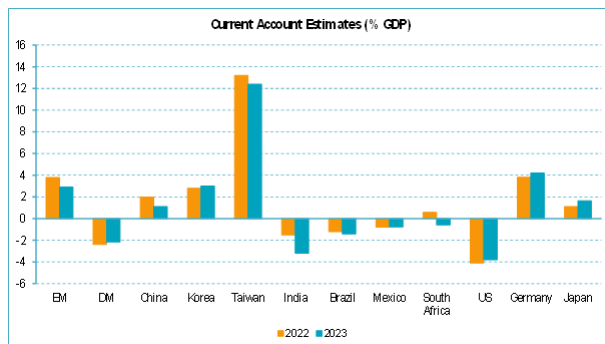
During the first three quarters we have been adding to our positions in Latin American and southeast Asia as these markets' commodity exposure means they tend to act as better inflation hedges than large markets such as South Africa and India. Another argument in support of these portfolio positions is that some Latin American and Asian companies can 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.

### 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.

As a group, emerging countries have a substantial current account surplus, whereas developed countries run a combined current account deficit, as Figure 8 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 8 | 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 stabilized around 0.7 in September, as we can see in Figure 9. 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 similar to that of developed markets.

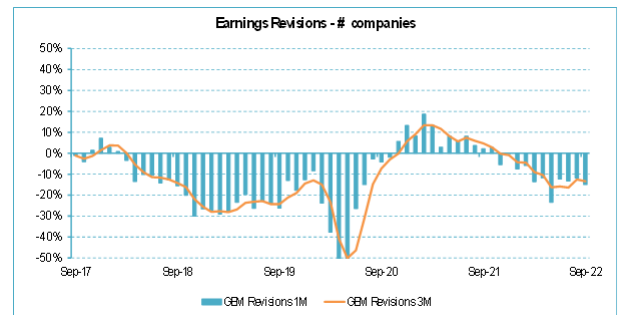
Figure 9 | Emerging market earnings revisions ratio



Source: Bank of America, September 2022

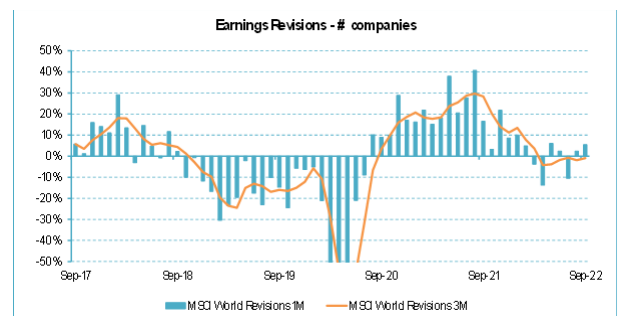
After earnings in emerging markets rose by around 40% in 2021, expected earnings growth is likely to fall to around 10% this year. Overall, we view earnings as neutral for emerging equities.

Figure 10 | Emerging market earnings revisions



Source: IBES, Robeco, September 2022

Figure 11 | MSCI World earnings revisions



Source: IBES, Robeco, September 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 12 shows.

Figure 12 | Emerging equity valuations look attractive



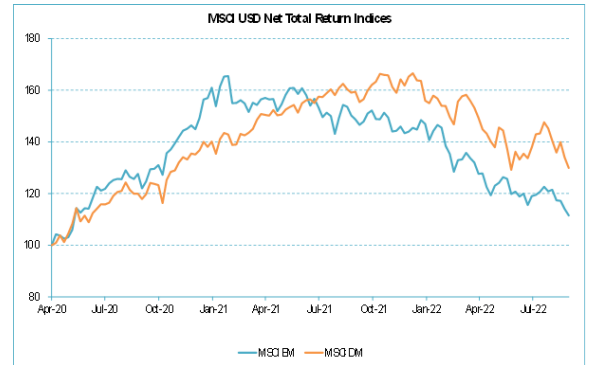
Source: MSCI, Robeco, September 2022

At the time of writing the P/E ratio of emerging equities is close to 11x – well below the 15x of MSCI World. This is equivalent to a circa 30% valuation discount – a significantly larger discount compared to its historical average discount of close to 15%. Emerging equities are also trading at a 30% discount to developed markets from a price-to-book perspective. The emerging markets’ P/E- and P/B ratios relative to developed markets are currently at 15-year lows.

### Technical picture still negative

Year-to-date, emerging equities performed roughly in line with developed equities, as both regions declined by 12%. On a twelve-month basis emerging markets underperformed developed markets. The share price momentum remains quite dire in almost all global equity markets. As a result, our assessment of the technical picture for emerging markets is still negative.

Figure 13 | Relative performance of MSCI EM and MSCI DM

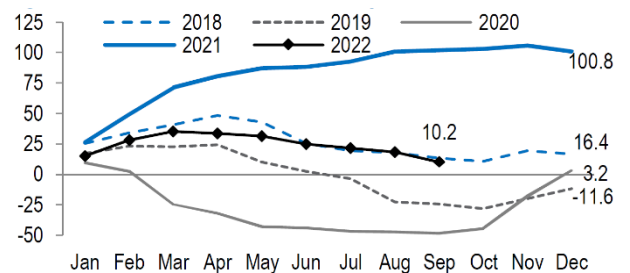


Source: MSCI, Robeco, September 2022

### Sentiment still neutral

Our assessment of sentiment towards emerging equities is still neutral. There have been USD 200 billion inflows into emerging equity strategies 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 so far in 2022, in which there have been USD 10.2 billion inflows into emerging equity after more than USD 100 billion inflows in 2021, as Figure 14 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 14 | Cumulative flows into emerging equities by year



Source: EPFR Global, September 2022

### Focus on China

We have a cautiously optimistic view on the Chinese equities market for 4Q 2022. Valuation is at a trough level, but we need catalysts such as a confirmed exit strategy from Covid control and a step-up in efforts to stabilize the property market, with more policy clarity expected from the highly anticipated China 20th party congress in October. There are reasons to believe the worst is now over, but we still expect significant volatility in China's equity markets before a more sustained recovery can take hold.

The latest Covid wave likely peaked in mid-August and the number of high- and medium-risk areas also peaked in early September. Despite a much larger number of risk areas than previous waves, the latest wave is still much more modest than the most severe situation in April-May. The Covid situation has stabilized with 'Dynamic Zero Covid Control' the policy until the year-end, with measures likely to be less restrictive over time and China will likely gradually open from early 2023. This is underpinned by a more aggressive vaccination program with 80% of over-60s to be vaccinated by the year-end, and therapeutic solution availability improving, supporting the healthcare sector. China is also conducting data analysis to gauge the likely virulence of the various Covid variants in the coming winter to guide policy.

The property market slump does not present any systemic risk yet as the China banking system is well-buffered to absorb this shock. However, stronger government support is needed to reverse the trend of declining home sales and property investment. Given it was a central government decision to finally rein in developers which prompted the correction in housing prices, and developers' current financing issues, we are hopeful that the central government will ultimately step in with targeted policy support.

Meanwhile the government is continuing pro-growth policies including accelerating infrastructure investments. A resurgence in infrastructure spending through new provision for local government special bonds will be supportive. Alongside a moderate easing in monetary conditions, this will encourage economic growth into 2023, a contrast to tightening monetary policy in Europe and the US.

Geopolitical risk remains high since Nancy Pelosi, the US House of Representatives Speaker, visited Taiwan in August 2022. At the same time the US Senate pushed forward the Taiwan Policy Act, which could designate Taiwan as a "a major non-NATO ally", and more semiconductor technology export restrictions were announced. To balance these negatives, the recent ADR auditing deal is a positive sign that in some areas progress can be made.

We are looking for more de-escalation signs after the 20th party congress in October and the US mid-term elections in November, or after a potential Xi-Biden meeting, also slated for November. However, long term US-China tension is unlikely to subside in our view. The hawkish stance of the Fed also continues to support the strength of USD and put pressure on the CNY. The prospect of global recession could also negatively impact China's exports.

With negative macro-economic developments recently, earnings revisions could face further downward pressure, but will likely start showing signs of stabilization towards the year end. Valuation has come back to an attractive level as seen in March. Globally, China is a relatively better placed market thanks to low domestic inflation and an easing policy cycle.

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