ROBECO
The Investment Engineers

QUARTERLY OUTLOOK – JULY 2023

Into thin air: Earnings likely to blunt current exuberance

- Tech's AI bliss is camouflaging a vulnerable broader market
- Macro outlook still gloomy and earnings likely to rollover in developed markets
- Emerging markets poised to take lead, but still waiting for US dollar to falter

Five-factor DM summary

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

Source: Robeco Global Equities team

Five-factor EM summary

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

Source: Robeco Emerging Markets team

DM equities vulnerable

The recent tech-driven rally in US equities has been characterized by narrow breadth and has pushed valuations. With further Fed and ECB rate rises likely, and some economic indicators flashing red, we remain cautious on developed market equities. We have year-to-date adopted a more barbell approach to DM equities – defensive, high-quality companies at one side and high-growth value creation companies on the other side.

EM positioned to lead next cycle

In EM we are more constructive and consider it a good time to build long term positions. With China and DM set to slow in the second half of 2023, EM in general will also slow somewhat, but excess savings will likely continue to buffer domestic demand from the lagged impact of the large monetary tightening over 2021-2022.

Thus, EM growth could surprise on the upside in the second half of 2023. Headline disinflation has set in and should gather pace in the coming months. If the Fed goes on a prolonged pause after July, EM easing (LatAm and EMEA) is expected to start in the coming quarter, but is unlikely to be very deep. The timing of an eventual US (or global) recession is still uncertain but in the scenario of a modest US recession, EM growth should do reasonably well. In addition, the EM story is no longer catch-up growth and productivity gains – EM's macro fundamentals are transformed and we are taking exposure to companies within EM that have an inbuilt edge and are set to become regional or global leaders.

OUTLOOK JULY 2023

Marketing material for professional investors, not for onward distribution

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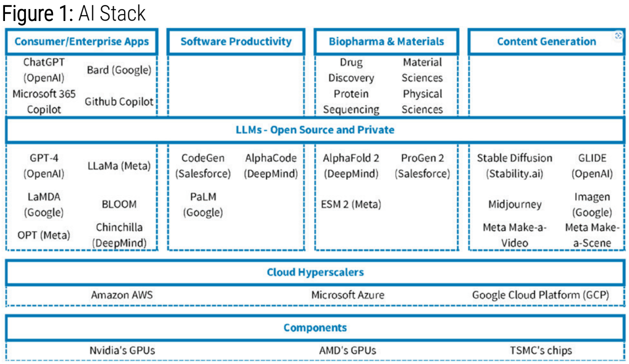
"AI mania" is a single engine alpha driver… we prefer multi-engine market breadth

Broadly speaking, year-to-date, investors have been lukewarm on the overall global equity market but have been piling money into the "AI-mania" trade. In fact, two-thirds of the MSCI World return is concentrated into market gains by only 10 of AI-related stocks[1]. Most experts agree that AI technology is transformative, but they disagree on the long-term implications of the expected regime shift. With prior technology (or industrial) revolutions, technology improved the physical capacity of what humans can achieve, while the AI technology proposition suggests extending humans' capability. Some would argue that AI (e.g. extended machine learning) is at the forefront of both replicating and surpassing human brain functions. This proposes new AI projects beyond what may be imagined applicable to any traditional development process, and this may have a profound impact on how we live and work.

Every sector of the economy will be impacted by AI from the defensive (some would say dull) slow-growth consumer staples sector to the cyclical auto industry. And everything in between, including Biopharma & Materials product development (Figure 1). For example, in the staples sector, we expect AI will be used to develop the best bacteria for yoghurt ingredients in order to maximize health benefits and in the latter, advancing capabilities of driving assistance technologies that allow fully automated driving and package transportation. Even service sectors such as insurance companies are already using AI to extract data from claims descriptions and writing code for statistical models to build better insurance pricing algorithms.

Figure 1: AI Stack



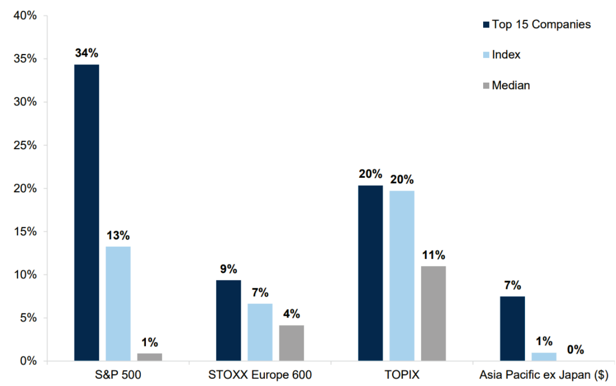
Source: Barclays

Along with the transformation capability of generative AI models across multiple business sectors, we can bucket the key company beneficiaries into a few main industry categories: (i) software companies that provide AI applications like ChatGPT but also includes many others like Bing, Bard, YouChat, Gen-2, etc., (ii) foundation models, these are companies that have significant quantity of data both available in closed and open sources like Alphabet and Meta, (iii) cloud computing companies like Google Cloud Platform, Amazon's AWS, Alibaba Cloud, and others and (iv) hardware and semiconductor companies like NVIDIA, AMD and several others.

Narrow global leadership is not a reason to sell the market

According to our research, while market breadth has been narrow in the US equities, it has not been narrow everywhere equally across Developed Markets. Gains have been more broad in both Europe and Japan (Figure 2). In the past, when US equity breadth is narrow (like recently), on average MSCI Global continues to rise modestly (~5%) over the next 12-months. As we've seen over the past year, we are experiencing a roller-coaster type market since the Fed began raising rates in March 2022 and therefore, we could see the cycle repeat with a pullback before a grind higher from here. Thus, we do believe markets can continue this roller-coaster style until we are clearly beyond synchronized global rate hikes. Last week alone we saw hikes from three major central banks (ECB, BOE, SNB) as well as more signals the Fed will continue hiking. According to Citigroup research, in periods after narrow US trading breadth, growth stocks outperform while defensives initially outpace cyclicals. Our main concern is that consensus EPS estimates are still high, especially as EPS growth remains concentrated in just a handful of sectors.

Figure 2: YTD S&P 500 biggest 15 companies have risen 34% while median only 1% (YTD price return)



Source: Datastream, Goldman Sachs Global Investment Research.

[1] Alphabet, Meta, Tesla, Amazon, Advanced Micro Devices, Broadcom, NVIDIA, Microsoft, Salesforce, Apple.

Given that the market may continue to grind higher in the mid-to-long term, how do we know if we should buy today into the "AI mania"? Our answer is fundamentally with research on a company-by-company assessment basis. Select companies will likely improve productivity and generative AI could add incremental revenue, but then the question becomes, will the incremental revenue be a rounding error or a significant boost to future earnings? And how to distinguish the true opportunities from the hype? Search amongst the four main industry beneficiaries listed and you can find examples such as semiconductor companies that truly are enablers ensuring that novel AI workloads are distributed fast and efficiently. It is also possible to identify companies that can train AI models on their own internal data. These are two areas we are focused on, and we believe that in the same way the internet changed every business, so will AI. If we fundamentally, via bottom-up research, identify companies where AI capability allows for more productive and efficient growth and use of capital, isn't that worth paying for?

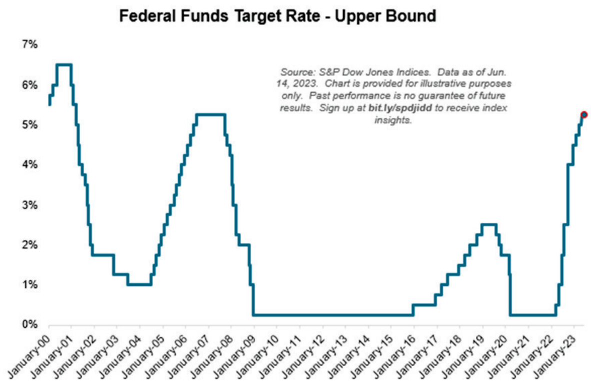
Developed Market Equities | Prefer multi-engine market breadth; meanwhile take a barbell position

- Sentiment factor remains neutral; stick with high quality, large cap, low leverage companies
- Technicals take a back seat to rate hike outlooks and increasingly restrictive financial conditions
- Inflation is still untamed despite the race to raise rates everywhere
- Expect more downgrades to global DM earnings despite some signs of strength (e.g. consumer discretionary sector)
- As the US hikes itself into restrictive territory, we have sought more opportunities in other regions

Sentiment: Indicators suggest stock market is narrowly climbing a wall of worry despite the Fed Target Rate rise

Despite the narrow market we described, where investors are pushed into high P/E growth stocks (aka "AI mania") stocks, risk-off sentiment, such as the BofA Sell Side Indicator, is nearly indicative of an extreme bearish reading, which contrarily indicates a positive market outlook. Investors are worried, but the market continues climbing. We'd prefer a broadening of industries/companies to classify this a long-term rally.

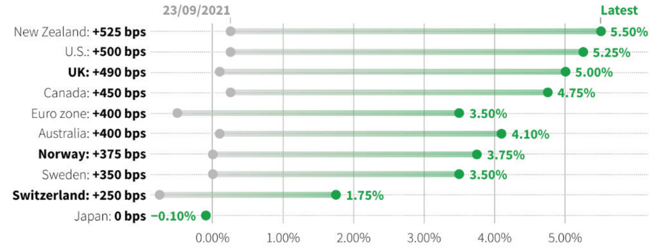
Figure 3: Federal Funds Target Rate – moves ever higher in upper bound



Source: S&P Dow Jones Indices. Data as of June 2023.

Historically when the Fed stops hiking, the S&P 500 gains 14% on average the next 12 months. However, this time we may need to see rates decline rather than just peak due to the rapid and steep record increase in rates (see Figure 4) – the most rapid since the 1980s.

Figure 4 - The DM race to raise rates as of June 22, 2023



Source: Datastream, Reuters. Data as of June 2023.

Several sentiment indicators we monitor suggest extreme bearishness (usually a positive market signal), but if you speak to any Wall Street trading team and view their screens it shows heavy trading in call options on the VIX Index (Cboe Volatility Index). Unlike call options on stocks, which are a bullish wager, investors buy VIX calls when they think the stock market may sink. VIX trading patterns paint a cautious picture that is at odds with the fear gauge's VIX level — around 15 — a level that suggests little to no fear about the future. Given the mixed sentiment indicators, we would recommend a continued focus on large cap, high quality companies which will be less affected by the tightening standards for business lending (Figure 4). We continue to hold the sentiment factor neutral in our scorecard.

Technical indicators continue to take a back seat to rate hike path and increasingly restrictive financial conditions

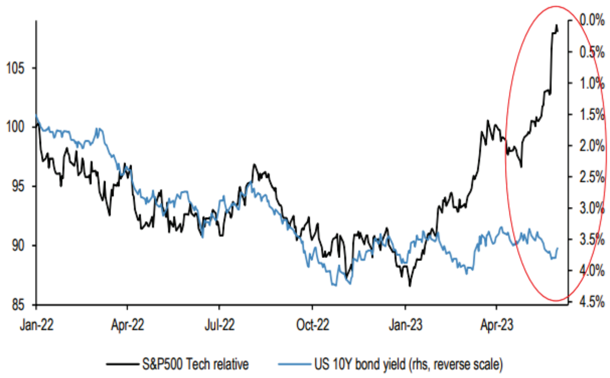
We have navigated through 10 Fed rate hikes over 15 months from an initial starting expectation (March 2022) of only six total Fed hikes. During this period, as shown in Figure 5, MSCI World (EUR) has been on a roller coaster ride with an essentially flat return achieved during these fifteen months, while both short-term and long-term bond yields have risen in the period (Figure 6).

Figure 5: Since the initial Fed rate hike (March 2022), world equity markets have been on a roller-coast…but the narrow market has supported tech companies

Source: Bloomberg, Robeco.

The tech sector has rallied (Figure 6) despite rising or flat yields although it historically declines during yield hikes. This is contrary to technical patterns and is inconsistent with prior periods heading into the final 3-months of rate hikes before a pause. In fact, it is the opposite of historical patterns, where typically defensive sectors like Utilities, Healthcare and Consumer Staples were the leaders heading into the last Fed hike. Not only is sector leadership inconsistent with prior Fed pivot periods, but the market appreciation (AI-mania trade especially), since Q42022, indicates we are already in a new economic cycle. However, generally this phase only happens after a *period of rate cuts*.

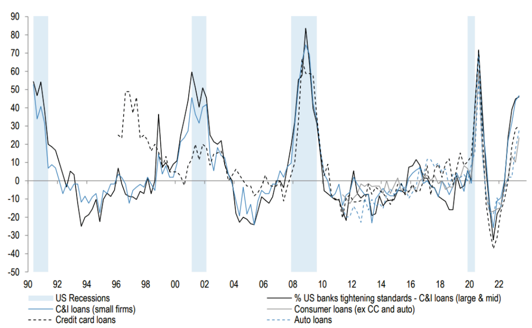
Figure 6: S&P 500 technology relative have rallied sharply especially in 2023 despite the modest rise in 10-year bond yields (RHS-inverted)



Source: Datastream, JPMorgan.

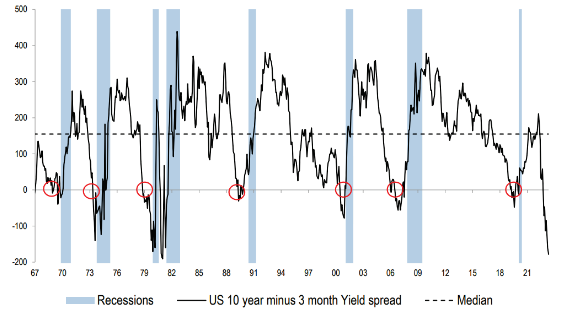
Technology shares may continue to lead the MSCI World higher as we conclude that investors consider these the high-quality, high growth segment of the market at this time, but until we see a broadening of industries/companies reaching new highs, we will remain cautiously positioned until the Fed pause. The increasingly restrictive monetary policy, combined with a tightening of lending standards (Figure 7) indicates the markets will stay in a trading range from here until there is clarity on (1) timing of a rate pause (the Fed, ECB, and others), (2) stabilization of bank lending conditions and/or (3) yield curve flattens from its current inversion (Figure 8). The current inverted yield curve suggests an impending recession and this signal has rarely been wrong.

Figure 7: Percentage of US banks tightening lending standards



Source: Federal Reserve Board

Figure 8: 10y-2y spread has inverted …the yield curve was never wrong



Source: J.P. Morgan Research.

Historically when the Fed stops hiking, the S&P 500 gains 14% on average the next 12 months. We believe we are in a trading range – where there will be no real bull or bear trends (despite the AI mania trade) – this market will likely gyrate between individual company news and macro news. We believe that sentiment, rate hikes, earnings, and valuation all matter more today than traditional technical signals. **We downgraded our technical factor from positive to neutral mid-year 2022 and we will hold it at that level.**

Figure 9: Market appreciation typically lags Fed pivot

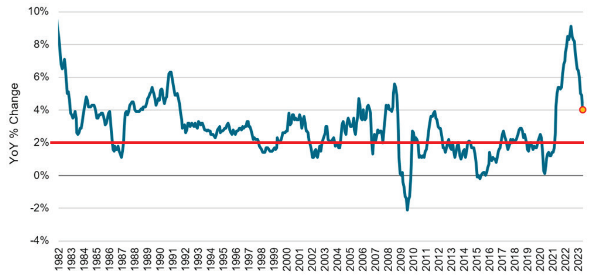
Fed last hike	Fed 1st cut	MSCI US Trough date	MSCI Europe (LC) Trough	#months from Fed last hike to MSCI US bottom	#months from Fed 1st cut to MSCI US bottom	#months from Fed last hike to MSCI Europe (LC) bottom	#months from Fed 1st cut to MSCI Europe (LC) bottom
Sep-87	Oct-87	Oct-87	Nov-87	2	0	2	1
Feb-89	Jun-89	Oct-90	Jan-91	20	16	23	20
Feb-95	Jul-95	Mar-95	Dec-94	1	-4	-2	-7
Mar-97	Sep-98	Aug-98	Oct-98	17	-1	19	0
May-00	Jan-01	Oct-02	Mar-03	29	21	34	27
Jun-06	Sep-07	Mar-09	Mar-09	33	18	33	18
Dec-18	Jul-19	Dec-18	Dec-18	0	-7	0	-7
			Average	**15**	**6**	**16**	**7**
			Median	**17**	**0**	**19**	**1**

Source: Bloomberg Finance L.P., JPMorgan.

Macro: The threat of persistent inflation has still not been tamed after 15 months of rate hikes and economic conditions are worrisome.

Our macro-outlook remains negative following our downgrade at the beginning of 2023. As noted last quarter DM central banks are indicating that financial stability (e.g. bank stability) and inflation mandates are separable based on their decision to continue to hike rates, and this implies their focus remains on stubborn inflation (Figure 10). In mid-June US inflation came in slightly below expectations, with the headline year-on-year CPI dropping from 4.9% in the prior month to 4.0% in May. Inflation has now been dropping for the tenth straight month, and the rate is now over five percentage points below its peak in last June. This is a modest improvement.

Figure 10: US CPI still a long way from 2%

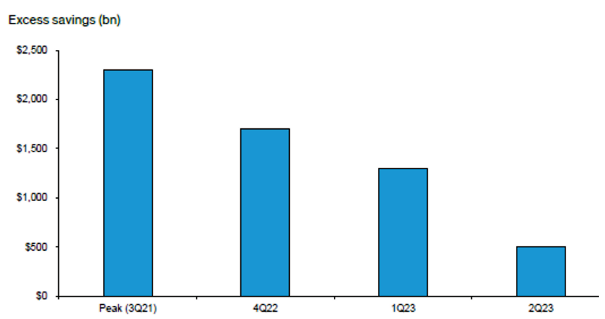


Source: S&P Dow Jones Indices, Robeco.

As we come to the end of Q2, aside from the Fed, most DM central banks are still steadily hiking policy rates including BoE, ECB, and SNB signaling that recent interventions to stem deposit outflows and promote liquidity are sufficient to allow central banks to continue their rate hike campaigns for now. Forward guidance on rates has shifted more hawkish keeping us cautious on the rates outlook.

The consumer is also becoming more worrisome in most DM regions, especially the US. The excess savings built up during the pandemic are declining. Consumers are showing more signs of weakness as fiscal tailwinds fade (e.g. student loan repayment is expected to restart this September, a ~USD 10 billion monthly headwind) and the accumulated excess savings may be exhausted by October (Figure 11). In combination with less liquidity and tighter credit conditions over the summer months, we expect consumer spending to be a rising economic risk. Although US and European consumption has been better than expected since the start of the year, going into the second half of 2023 we fear this is a key macro risk. We also see consumption trends moving from branded products to white label, in Europe particularly.

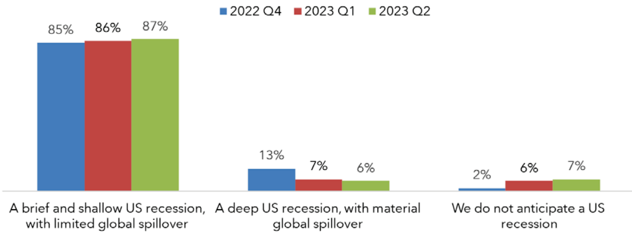
Figure 11: US excess savings are down from their 3Q21 peak, but are still estimated ~$500BN



Source: Federal Reserve Board, Robeco, June 2023.

Aside from the market focus on central bank hikes, right now macro is having an outsized impact on micro. For example, the Conference Board's Measure of CEO Confidence says the majority of CEOs are preparing for a brief and shallow US recession, with limited global spillover, in the next 12-18 months. CEO confidence was down slightly in Q2 and remains firmly in negative territory," said Dana M. Peterson, Chief Economist of The Conference Board. "CEOs' view of current economic conditions continued to be negative, with 55% of CEOs still reporting general economic conditions are worse than they were six months ago." This outlook risks creating a negative economic feedback loop increasing the risk of recession as CEOs are actively reducing hiring plans, introducing selective hiring freezes, as well as reducing headcount (20%) and taking other actions to face the economic challenges on the horizon.

Figure 12: Over the next 12-18 months, are you preparing for ….

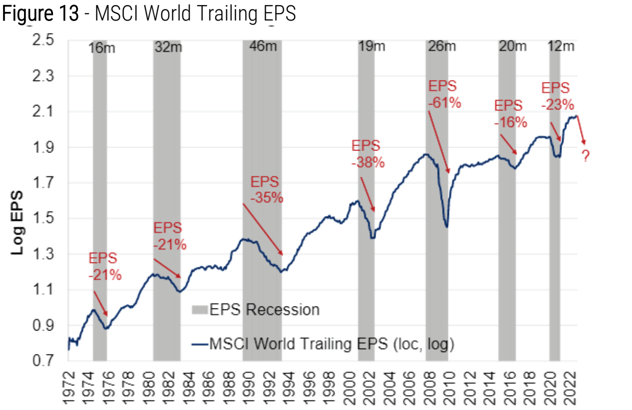


Source: The Conference Board; The Business Council

Most companies we speak to are preparing for a recession. FactSet counted that 107 companies in the S&P 500 (those with 1Q2023 earnings conference calls from Mar 15 through May 18) cited the term "recession" during their earnings calls for the first quarter, well above the 5-year average of 77 and the 10-year average of 59.

Earnings: Europe earnings revisions holding up better than US, but is it sustainable?

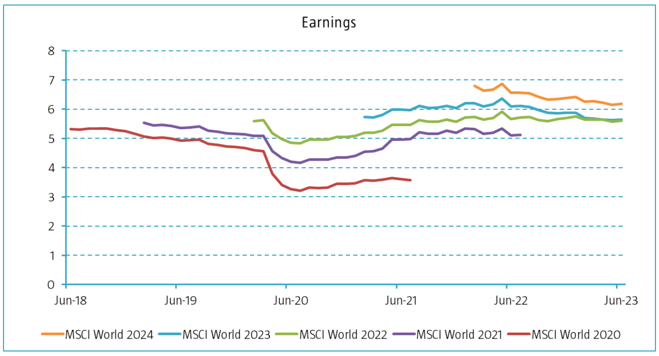
Figure 13 - MSCI World Trailing EPS



Source: Citi Research, DataStream December 2022

As Citi Research reported in December, the MSCI World trailing EPS (Figure 13) generally trends higher, with earnings growing at a compound 6% per annum over 50 years, but there have been significant setbacks along the way, usually coinciding with global recessions. On average earnings fall 31% over 2 years in a recession. The biggest drop was in 2007-10 when MSCI World EPS fell by 61%.

Figure 14: MSCI World 2023 forecast earnings at risk to fall below 2022 levels

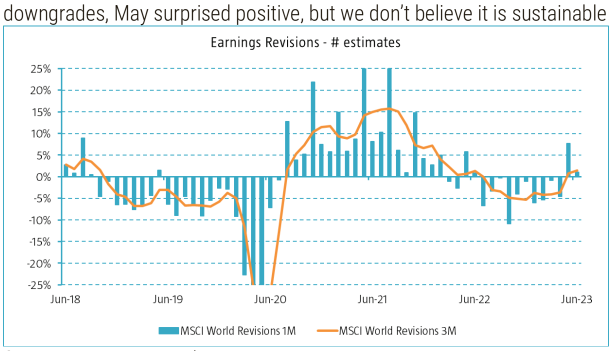


Source: IBES, MSCI, Robeco June 2023

As we noted when we lowered our earnings outlook factor in 2022, tightening monetary policy often triggers reductions in earnings forecasts, but in Q1 2023 results season, MSCI World actual earnings remained resilient. The current full-year 2023 consensus earnings growth forecast for US and Europe are hovering near flat at 1.0% and 2.0% respectively – despite the Q2 2023 US consensus earnings growth forecast of –6.8% year-on-year. This is a disconnect we are monitoring closely, and we believe Q2 upcoming results season may be the trigger for re-rating MSCI World 2023 earnings forecasts to decline below 2022 actuals (Figure 14) as banking crisis events combined with lending deceleration typically create a weak EPS environment.

The US is lagging in earnings revisions over the quarter despite improving trends globally in Tech Hardware, Software, and Semiconductors. The global energy sector lagged all other sectors over the quarter. The Consumer Discretionary sector is expected to report the highest (2023 year-over-year) earnings growth rate of all eleven sectors at 26.1%.

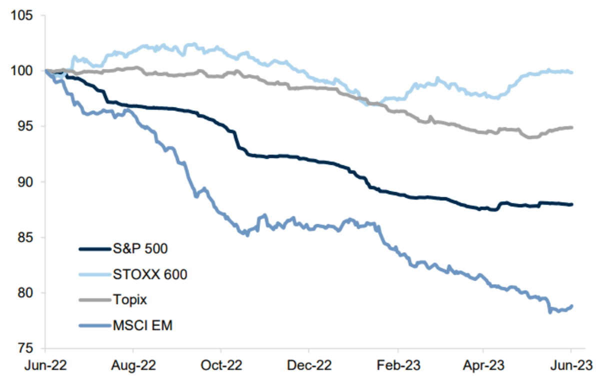
Figure 15: After seven consecutive months of MSCI World earnings downgrades, May surprised positive, but we don't believe it is sustainable



Source: IBES, MSCI, Robeco June 2023

Over the past month, Europe is the only region achieving more upgrades than downgrades (Figure 16). We are monitoring closely whether earnings expectations can remain resilient as the impact of tighter monetary policy and reduced bank lending ripples through the economy, but overall, we expect more downgrades in developed markets versus upgrades as companies have yet to fully reflect the negative impact of tightening monetary policy.

Figure 16: Europe's the region with the best earnings revisions (2023 EPS revisions over the past 12 months, indexed to 100).



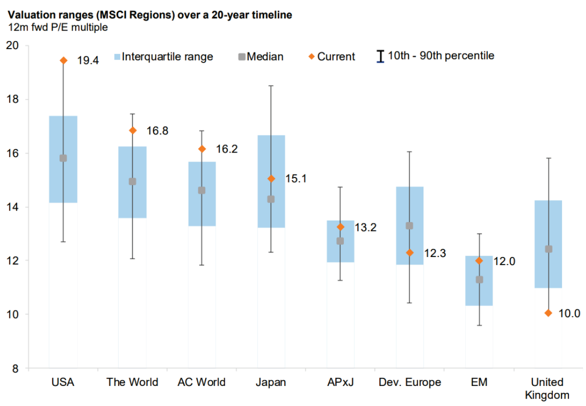
Source: Datastream, Worldscope, FactSet, Goldman Sachs Global Research

Valuation: Developed Europe and UK look cheap; other regions are expensive relative to history

Risk-free rates and credit markets now offer an attractive alternative to equities. As shown in Figure 17, US valuation is at the top of its 20-year range and The World is above neutral. Too many pockets in the global markets have not seen real multiple compression while earnings risk remains to the downside as we progress to 2024.

With the ECB, the Fed, the BoE and other central banks unlikely to pivot to easing just yet (in order to avoid a repeat of the 1970s), we think hikes and tighter credit conditions will drag on earnings and valuations may become even more challenged. **Overall, valuations look stretched for The World and especially the US, so we lower our valuation factor from neutral to negative.**

Figure 17: MSCI Regions Valuation ranges (20-years); 12-Month Forward P/E

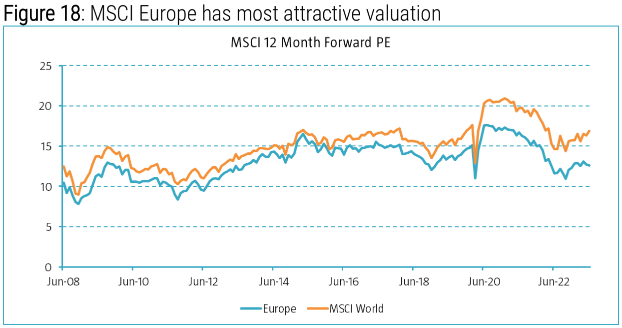


Source: FactSet, Goldman Sachs Global Investment Research, June 2023

Europe appears most attractive relative to MSCI World (low P/E relative to its 15-year range). It normally trades at a 11-

12% discount, but as of June MSCI Europe now trades at a 25% discount to MSCI World. In addition to Europe, the UK is also attractive (Figure 18).

Figure 18: MSCI Europe has most attractive valuation



Source: IBES, MSCI, Robeco June 2023.

Implications for positioning (Global Equity Portfolios): Emphasis on high quality barbell approach

We remain cautious in general but have year-to-date adopted a more barbell approach – defensive, high-quality companies on one side and high-growth value creation companies on the other side. Despite YTD outperformance, we think Growth could continue to outperform given its high-quality characteristics.

In these roller-coaster markets, continuously sharpen your pencils to selectively trim (for profit taking) to divert into more attractive firms

As we wrote last quarter, we added high quality global technology companies to the portfolio early in the year aiding our performance. On the growth side of our barbell, aside from our technology weight (25%), other industries we are finding growth opportunities include: the broadline retail technology industry which falls in the Consumer Discretionary sector. These providers of online retail shopping services will also benefit from AI technologies. In case of a mild slowdown in late 2023 or 1H 2024, these stocks should recover quickly. We also continue to have a large industry overweight within the Communication Services sector and especially within Interactive Media & Services (weight 8%) where we see several long-term opportunities from AI arising for increased profitability and cashflow. We are also seeing luxury retail growth pick-up via increased European tourism and the Chinese tourist rebound which provide future growth opportunities that may indicate a strong retail sales recovery in China and other Asian countries.

However, as with last quarter, we are not sitting back, but are again ensuring we take profits in any large cap or technology names which we believe have become too expensive, in order to divert investment back to the defensive high-quality baskets of our barbell such as consumer staples (weight 7%) where we are overweight in personal care product companies and health care, especially pharmaceutical companies (weight 9.5%) where valuations are compelling today for the long-term. We are also shifting towards the more defensive high-quality companies in traditional cyclical sectors. For example, we added weight to an industrial global provider of information-based analytics and decision tools across multiple sectors as the company fits nicely into our defensive high-quality basket while underweighting traditional heavy industrial corporates. Similarly, within the Materials sector, we own a high-quality solutions industrial gas company rather than a traditional materials resource company.

We continue to seek high-quality, profitable companies in both cyclical and defensive sectors that 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.

Emerging Market Equities | More appetite for EM

- EM equities continue to look appealing, as macroeconomics are solid compared to DM
- China has no inflation at all, easy monetary policy and a massive surplus on the current account
- Coming quarter might see more Chinese stimulus, improving geopolitical climate between China & US, and start of monetary easing in Latin America

Benign background for EM

EM economies, once again, demonstrated remarkable resilience in the first half of 2023. Just as they had helped to withstand the impact of three unprecedented global shocks in 2022 (Russia's war in Ukraine, US Fed aggressive tightening and zero-Covid in China), excess private savings will likely continue to provide support to EM over the next couple of quarters. While last year's global shocks are fading, China reopening has underwhelmed with the recent loss in growth momentum. With China and DM set to slow in the second half of 2023, EM in general will also slow somewhat, but excess savings will likely continue to buffer domestic demand from the lagged impact of the large monetary tightening over 2021-2022.

Thus, growth could surprise on the upside in the second half of 2023. Headline disinflation has set in and should gather pace in the coming months. If the Fed goes on a prolonged pause after July, EM easing (LatAm and EMEA) is expected to start in in the coming quarter, but is unlikely to be very deep. The timing of an eventual US (or global) recession is still uncertain but in the scenario of a modest US recession, EM growth should do reasonably well.

Although some EM economies are still going to see slowdowns in their real economies, tailwinds are apparent. One of the most important events in the third quarter of 2023 might be the end of the Fed's monetary tightening cycle. This could mean that we have seen the peak in the US dollar already in late 2022, after the strong run it had against all major currencies in the world.

The earnings backdrop is mixed. Earnings revisions have strengthened recently, with earnings revision ratios for both developed and emerging markets below 1. 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. Emerging equities' derating has led to the price/earnings (P/E) ratio of the MSCI EM Index falling to 11x 2023 expected EPS. By contrast, MSCI World's P/E ratio is 16x. Meanwhile, the technical picture for emerging markets is still negative, compared to that of the developed markets. Our sentiment factor remains neutral as there have been strong, though decelerating, inflows into EM equities since October 2020. Investors are increasingly looking for "value" opportunities. So, we expect continued inflows.

Asian economies are showing wider growth differentials with the rest of the world, even with a slowing China. Growth drivers are turning increasingly domestic as external factors – both export demand and global monetary conditions – drag on economic activity. Softer China growth, combined with a likely prolonged Fed hiking cycle, is generally not great news for EM flows. But dis-inflationary trends in EM should allow the start of rate-cutting cycles, creating opportunities for EM equities.

Latin America has shown resilience despite a series of global shocks, other concerns and non-negligible idiosyncratic risks. This has been possible on the back of fiscal consolidation (albeit to varying degrees), institutional strength and, for some, timely and decisive restrictive monetary policy.

In conclusion, falling inflation, and thus an expected peak in the USD and a reversal in global monetary tightening are likely to enhance the prospects for emerging market assets. Structurally strong commodity demand will create some winners, while depressed valuations will give rise to value opportunities over the longer term. For the coming quarter, we keep our overweight stance in emerging markets.

EM monetary easing will precede DM

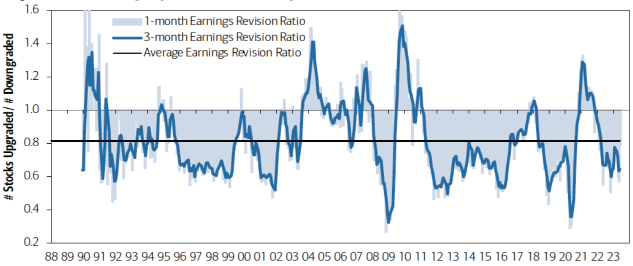
In EM in general and in Latin America in particular the central banks should be close to the end of the tightening cycle. In Brazil for instance real interest rates are over 8%, and thus not sustainable in the long run. For the second half of 2023, there is ample room to cut policy rates in Brazil.
China has been easing monetary policy already by cutting rates and reducing the required reserve ratio. It has more room to engage in further monetary stimulus, and with inflation not a problem at all in the country – the latest reading came in at a very benign 0.2% – we expect further monetary easing in the second half 2023.

As a group, emerging countries have a substantial current account surplus, whereas developed countries run a combined current account deficit. This is the main reason why we expect a better environment for emerging market currencies as the Fed will likely pause tightening after their July hike. The currencies of the countries' with the strongest trade accounts and large forex reserves might appreciate the most versus the US dollar.

Earnings expectations are getting more constructive

In June, the earnings revision ratio rebounded in China from 0.46 to 0.82 based on a broad improvement in almost every China sector. In EM the ratio improved from 0.57 to 0.79. In contrast, the ratio moderated in most DM countries.

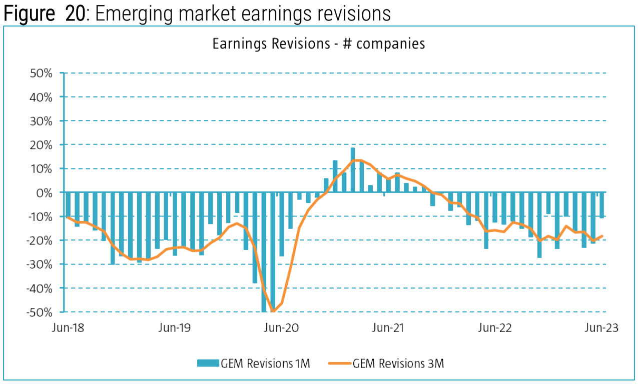
Figure 19: Emerging market earnings revisions ratio



Source: Bank of America, June 2023

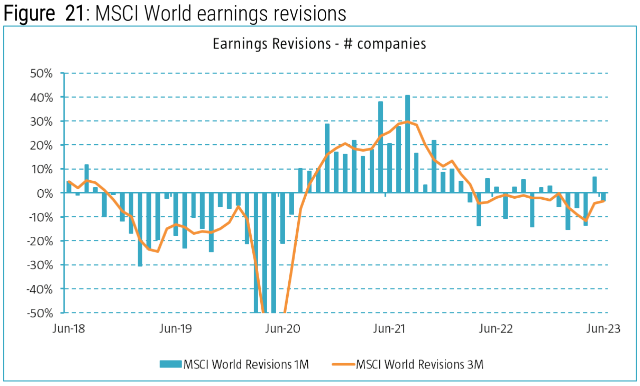
For 2023, IBES consensus earnings growth hovers around 2% to 3% for both the group of emerging countries and the group of developed countries. Overall, we view earnings as neutral for EM equities.

Figure 20: Emerging market earnings revisions



Source: IBES, Robeco, June 2023

Figure 21: MSCI World earnings revisions

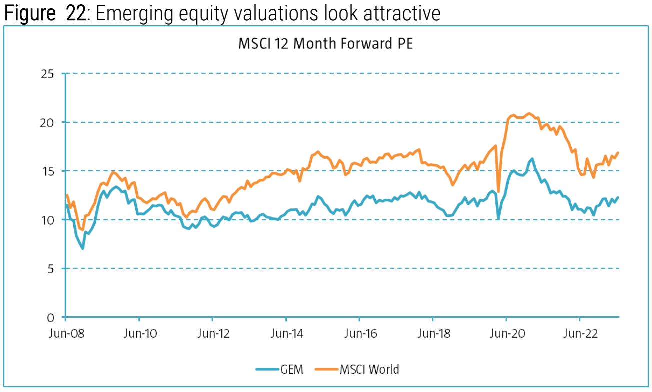


Source: IBES, Robeco, June 2023

Valuations positive for EM 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 the metric rebounded sharply, but has since fallen back again, as Figure 22 shows.

Figure 22: Emerging equity valuations look attractive



Source: MSCI, Robeco, June 2023

At the time of writing the P/E ratio of emerging equities is at 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.

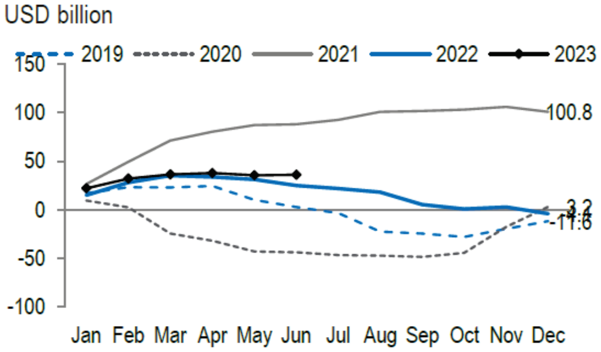
Technical picture still negative

Emerging equities underperformed developed equities year-to-date, as MSCI EM increased 2.5% and MSCI World was up 10.5%. On a twelve-month basis emerging markets underperformed developed markets as well. 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.

Sentiment remains neutral

Our assessment of sentiment towards EM equities is neutral. We expect inflows to continue as investors look for attractively valued asset classes. However, inflows slowed down since the second quarter of 2022, as Figure 23 (overleaf) shows. We think inflows are unlikely to accelerate until tightening in the developed world reaches its conclusion in the second half of 2023.

Figure 23: Cumulative flows into EM equities by year



Source: EPFR Global, June 2023

Friendshoring boosts Korea while AI will be a slow-burner

After a recent visit to South Korea Robeco's Asia tech analyst Sejung Seo says reshoring from China is starting to gather momentum in both South Korea and Japan, while the market for AI server chips will be a long-term opportunity for Korean DRAM makers.

The US Inflation Reduction Act (IRA) is already driving rapid change in the Electric Vehicle (EV) battery supply chain says Seo, after visiting 20 EV and technology companies in South Korea in June 2023.

"The catalyst for the Friendshoring trend is recent US legislation but the rapid adoption is due to automation, which means the cost-structure really isn't any different whether you invest in Korea or China. EV really isn't a labor-intensive sector anymore," he says.

Figure 24: POSCO Future M cathode plant in Gwangyang, South Korea

Source: POSCO Future M

Seo says while the implications of IRA are well-known[1] the pace of change on the ground is impressive, with battery materials maker Posco Future M flooded with orders in the first half of 2023 as battery makers expand production in South Korea. While China accounts for 60% of EV battery demand at the moment this proportion will decline as EV adoption in the US and Europe accelerates, says Seo.

"Europe's automakers are also scrambling to build long term supply and South Korea is perfectly placed. This is a trend that will play out over one or two decades so even if valuations look rich this shouldn't put off long term investors," says Seo.

CHIPS act driving semiconductor Friendshoring

The US CHIPS act is also encouraging investment in semiconductor manufacturing in both South Korea and Japan, says Seo. Although the CHIPs act is ostensibly focused on encouraging US domestic production, restrictions on the export of technology to China specifically are helping alternative manufacturing locations.

"52% of semiconductors made in China are produced by South Korean or Taiwanese companies. They can't or won't expand capacity in China, so new investment is being redirected to South Korea and Japan," he says.

Japan, a key supplier of semiconductor manufacturing inputs, is subsidizing semiconductor manufacturers including TSMC and Micron, aiming to increase the annual value of its chip production from USD 37 billion now to USD 108 billion by 2030.

In South Korea, Samsung has announced a USD 230 billion semiconductor investment through to 2040, while memory chip maker SK Hynix is investing USD 95 billion to build out capacity in the next decade.

Memory majors positioned for AI

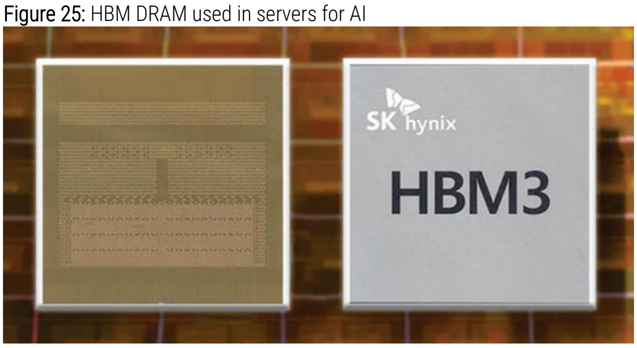
The investment frenzy in tech mega-caps in the US has seen some positive spillover to semiconductor stocks in Asia but the real AI opportunity will be slower to unfold, says Seo.

"Nvidia is dominating semiconductors for the training server market for Large Language Model development, but the longer-term opportunity is when there's widespread usage of AI, which will drive growth in inference servers," says Seo.

Korean memory makers are developing inference server solutions with High Bandwidth Memory (HBM) DRAM and a small CPU combined, which will raise margins.

"It's all about speed once AI models have mass adoption, so memory chips will key," says Seo

Figure 25: HBM DRAM used in servers for AI



Source: SK Hynix

HBM is only a small market but will grow rapidly in coming years and is projected to account for 5% of DRAM demand by 2025 from 1% in 2022, says Seo.

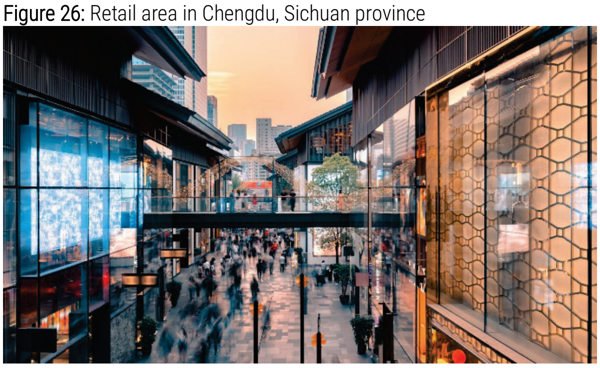
China on the ground: less growth and more value

China's steady rather than spectacular post-Covid recovery has dragged on market sentiment, but long-term investors should not be put off, says Robeco Emerging Stars Equities portfolio manager Jaap van der Hart.

Bearish investors meet sanguine corporates

In early June, I was in Hong Kong and Shanghai for an investor conference and to meet our colleagues based in these cities. It was great to be back in China and directly meet with management at multiple companies after doing only virtual meetings during the Covid years. At the same time, sentiment on the Chinese equity market was strikingly bearish. People from the conference were happy that there were still foreign investors coming, and comments among investors about weak growth, the weak equity market and US-related geopolitical risk were quite common. However, the Chinese companies themselves were actually not that bearish. Although growth this year may be lower than expected, there is a clear post-Covid recovery and China still has plenty of growth opportunities in many sectors. Nevertheless, I do think that China is transitioning. The decades of 10% GDP growth are over, and the new normal growth rate is no longer 8% and maybe not even 5%. The market needs to adapt to structurally lower growth.

Figure 26: Retail area in Chengdu, Sichuan province



Source: Getty images,

Stimulus awaited

One other element, and this may be one that affects sentiment the most, is that the state seems to be reluctant to come to the rescue with a big stimulus package whenever growth is slowing down a bit. Given relatively high debt levels for local governments a more cautious approach seems sensible. Also the old way of growing has reached its limits. Property has been an important part of China's economy, yet its share should come down as so many houses have been built in recent decades. Many market participants still hope for policy support from the government for the property sector, but in my opinion this should be less relevant as the structural demand for new housing will gradually decline.

China leading key sectors

This does not mean the end of growth in China. Look for example at renewables and electric vehicles (EV). The country is the dominant producer of solar equipment, and the leader in EV batteries. It's one of the countries with the highest share of electric vehicle sales, and its EV companies like BYD and several others are increasingly successful in selling overseas. China will continue to develop, however, expect to see growth in different areas than past decades.

Geopolitical drag

One contentious issue that is a concern for many investors is US-China relations. This is likely to remain an important factor for the foreseeable future. There are mutual economic and political benefits in maintaining good cooperation at many levels yet given the political climate and attitudes in both countries there will be ongoing tension.

Valuations are attractive

Notwithstanding the negative sentiment, I still came back with a relatively positive attitude towards the Chinese equity market. As mentioned, there is still an economic recovery, and several sectors still have good growth opportunities. In addition, less focus on growth may come together with more focus on profitability. This is currently happening with several big internet companies, that show more focus on the bottom-line and have started with several share-buybacks. This is also happening with state-owned enterprises. In the recent SOE reform, more weight is being given in management evaluation to profit-oriented KPIs like Return on Equity, profit growth, operating cashflow and limited debt growth. Lastly, as share prices have come down for many companies, valuations have become more attractive. Expectations are now reset to a lower level. In conclusion, China may generate less growth going forward, and its equity market now provides more value.

[1] South Korea can be stealth winner in EV arms race – Robeco – May 2023

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