Manulife Investment Management

Q4 2023

QUARTERLY REVIEW

Global Emerging Markets

Overview

2023 was another volatile year for emerging-market (EM) equities. Throughout the year, markets were hostage to the narrative of when U.S. interest rates might pivot lower and how low they could go. Expectations that rates had peaked globally lifted markets going into year end, but it wasn't until December that the U.S. Federal Reserve (Fed) at last signalled that it expects to cut rates in 2024. Although the MSCI Emerging Markets Index returned 9.8% for the year, it lagged developed markets (DM) considerably by 14 percentage points.

Global, regional, and EM index performance, December 2023.

GBP returns	3 Month (%)	1 Year (%)
Market Indices (in GBP):		
MSCI Emerging Markets	3.27	3.63
MSCI World	6.67	16.81
Regional Indices (in GBP):		
MSCI AC Far East ex Japan	0.72	(2.81)
MSCI EMEA	3.75	2.09
MSCI Latin America	12.55	25.22

Source: Bloomberg as of December 31, 2023.

Performance shown in GBP.

Looking at EM, 2023 was an annus horribilis for the Chinese market. Potential for strong growth after the lifting of COVID-19 restrictions that strangled the economy in 2022 brought much excitement and the market started the year strongly positive; however, this was dwarfed by the woes of the property market and the expected growth rebound failed to gain a sustainable footing and fizzled out in short order. Optimism was replaced by pessimism as consumers struggled under the twin burden of housing market weakness and job insecurity. Despite headwinds to consumer consumption, economic growth was sufficient to meet the government's annual target, which brought about a disappointing policy response that compounded equity market weakness. Mainland China was the worst-performing EM stock market, recording a third year of negative returns, leaving a number of high-quality companies extremely attractively valued. The performance of the Chinese market offset positive performance from India, South Korea, and Taiwan, and consequently, Asia was the weakest region within the EM universe in 2023.

On the other hand, Mexico and Brazil performed well, with Latin America becoming the top-performing region for the month, the quarter, and the year. As overstretched supply chains turned the tide on globalisation, it became clear that Mexico is a natural destination for nearshoring and the equity market was buoyed by this optimism. Brazil, having been one of the first EM to raise interest rates, had experienced a particularly sharp rate cycle. Adhering to the first-to-hike and first-to-trim narrative Banco Central do Brasil started cutting rates in August. The Brazilian equity market received a further boost in December when the country's central bank governor Roberto Campos Neto suggested that growth in 2024 could exceed expectations.

Looking at sectors, information technology (IT) was the best-performing sector in 2023 as fundamental indicators bottomed out and the ma rket looked to the beginning of a new cycle. This was further supported by considerable excitement around AI and the spike in demand it might spark. At the other end of the scale, the consumer discretionary sector struggled as inflation crimped consumer buying power.

Our overweight stance in Mainland China detracted significantly from performance. It was the main reason why the strategy underperformed the benchmark.

Market attribution—Q4 2023

BEST AND WORST RELATIVE PERFORMING MARKETS IN MANULIFE INVESTMENT MANAGEMENT EM EQUITY STRATEGY AND MSCI EM (NET) INDEX FOR Q4 2023

Best	Portfolio Average Weight (%)	Benchmark Average Weight (%)	Total Effect (in bps)	Worst	Portfolio Average Weight (%)	Benchmark Average Weight (%)	Total Effect (in bps)
Taiwan	12.8	15.5	85.9	South Africa	4.0	3.1	-70.1
South Korea	10.1	12.4	34.2	Mainland China + Hong Kong SAR	28.2	28.5	-69.8
Brazil	9.0	5.6	26.1	Saudi Arabia	2.1	4.1	-50.9

Source: FactSet, as of December 31, 2023.

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Markets in Brazil, Taiwan, and South Korea performed strongly over the quarter. Both the South Korean and Taiwan markets have large exposure to the IT sector where inventories and utilisation levels show signs of bottoming and valuations are attractive. In the Taiwan market, a chip-design company delivered strong share price performance on expectations of the smartphone cycle rebounding and future demand growth from AI. Similarly, positive sentiment on the semiconductor demand outlook also lifted shares of a Taiwanese semiconductor packaging and testing company. The positive sentiment in the chip sector also lifted the share price performance of a South Korean memory manufacturer.

A couple of stock-specific events led to South Africa detracting the most from performance. First, a mining firm surprised the market with significant production downgrades. Second, an internet company saw its share prices slump on the back of regulatory developments, which could affect the profitability of a firm in which it held a significant stake..

Contribution from the markets in Mainland China/Hong Kong SAR was negatively affected by an unexpected profit warning from a biotechnology firm. A Hong Kong-based financial services firm also detracted from performance over the quarter, due to subdued business and investor confidence. Saudi Arabia also detracted from performance due to our exposure to a quick-service restaurant operator. The firm, which ran U.S. branded food chains, saw its shares lose ground during the month amid heightened tensions in the Middle East. Finally, our exposure to a firm in the Taiwanese chip sector also detracted from performance as the company's share price was unable to hold the record highs it had reached earlier in the quarter.

Sector attribution—Q4 2023

BEST AND WORST RELATIVE PERFORMING SECTORS IN MANULIFE INVESTMENT MANAGEMENT EM EQUITY STRATEGY AND MSCI EM (NET) INDEX FOR Q4 2023

Best sector (GBP)	Portfolio Average Weight (%)	Benchmark Average Weight (%)	Total Effect (in bps)	Worst sector (GBP)	Portfolio Average Weight (%)	Benchmark Average Weight (%)	Total Effect (in bps)
Information technology	26.8	21.2	242.3	Consumer discretionary	13.0	12.8	-125.4
Consumer staples	10.7	6.1	24.9	Healthcare	2.0	3.8	-47.4
Real Estate	0.00	1.7	13.6	Materials	7.3	7.6	-24.2

Source: FactSet, as of December 31, 2023.

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The IT sector, in which the strategy has its largest overweight stance, performed strongly over the quarter. The sector's performance was boosted by strong showings from a Chinese PC manufacturer and a South Korean inspection equipment manufacturer. The former is expected to benefit from the PC-replacement cycle that is under way and optimism around the possibility of AI-fuelled demand while the latter is well positioned to break into the fast-growing advanced packaging inspection market. Within consumer staples, our holdings in India and Mexico, both beneficiaries of buoyant economies, were key contributors.

The strategy also benefited from having no exposure to the real estate sector, where the beleaguered Chinese property developers continued to perform negatively.

China's regulatory attempts to rein in the country's gaming sector, and underwhelming guidance from a prominent sportswear manufacturer and retailer were behind the negative performance of the consumer discretionary sector in Q4. Within healthcare, weakness in the aforementioned biotech firm weighed on the sector's performance. Likewise, our exposure to the previously mentioned South African miner contributed to the negative contribution in the materials space during the quarter.

Strategy positioning summary

Structural stance: Positive	
Brazil	Interest rates have peaked and the market is offering attractive real yields; fiscal concerns are gradually abating and valuations appear attractive
Indonesia	Strong growth outlook supported by policy reforms and strengthening external balance; valuations appear compelling
Technology	Emphasis on cloud-based software as a service solutions; specific focus on leading-edge chip foundries and manufacturers
Consumer staples	Profitability is recovering as input cost inflation moderates; defensive amidst slowing global growth
Financials	EM banks continue to post strong earnings as net interest margins expand in a high interest-rate environment; benign asset-quality trends

Structural stance: Negative	
Saudi Arabia/Gulf Cooperation Council region	Expensive markets with liquidity challenges; the region's reform agenda and demographics may hold promise, but there are few signs of earnings growth
Taiwan	An emphasis on leading technology companies; domestic consumer and financial stocks appear expensive while providing little top-line growth
South Korea	Focus on leading-edge technology companies; domestic stocks offer limited attractive growth opportunities
Communication services	Hardware/telecom operators remain challenged; dominant e-commerce service providers look attractively priced as policy environment stabilises
Real estate/utilities	Limited opportunities with respect to consistent, superior, and visible returns on capital in both sectors

Over the last few months, the Indian market has proved particularly strong, buoyed most recently by the performance of the incumbent Bharatiya Janata Party in provincial elections. With a general election looming in 2024, political and economic factors appear to be supportive, suggesting continuing support for the market from domestic investors. Against this positive backdrop, and following the investment team's decision to exit a position in the Indian healthcare sector, we've initiated positions in two new Indian mid-cap names. We met representatives from both firms during a recent research trip to the subcontinent and both companies stood out.

Our other new position is a China-based contract manufacturer for many leading global brands in the athleisure space. The company's share price has long reflected the management's excellent record for delivering returns. COVID-19's impact on international procurement affected the company's share price valuation, creating an entry point for us. Part of the funding of this position came from proceeds arising from our decision to exit a Chinese sportswear manufacturer and retailer. Finally, we continued to add to positions in a Greek financial firm and a Mexico-based retail giant, reflecting our conviction in the strength of their local economies.

Outlook

Moving into 2024, we continue to be constructive on EM equities. In our view, the global macroeconomic context appears favourable for this asset class. Although December's Fed minutes revealed that the rate-setting committee considered the upside and downside risks to inflation and interest rates were balanced and indicated that it would be unrealistic to expect rates to return to the low level of the last decade or so, it's reasonable for markets to look forward to measured rate cuts and moderately slower global growth this year. Against this backdrop, we expect the U.S. dollar to weaken, traditionally a powerful catalyst for EM.

Crucially, the Fed isn't alone in its forecast: Many central banks are expected to remain on hold or cut interest rates this year. A number of EM central banks have already begun reducing rates and although global growth is set to slow, EM growth is widely expected to continue to outpace DM growth by a considerable margin, a development which will support a recovery in company earnings. Furthermore, valuations in EM are compelling and positioning is light.

Geopolitics has played an increasingly important role in EM and 2024 is exceptional in that sense, given the number of elections that are scheduled to be held during the year. Some 40 countries will go to the polls, representing 41% of global population and 42% of global GDP, culminating in the U.S. presidential election in November. Notable elections within EM include India, South Korea, Mexico, and Indonesia. What this means is that the year ahead is unlikely to be plain sailing for EM despite the broadly supportive macroeconomic backdrop. Elections will affect market volatility and aggravate tensions in EM.

The juxtaposition of political and economic forces makes for a market suited to long-term investors. This is an environment that creates the opportunity selectively to accumulate high-quality companies in areas of structural growth that have the potential to enjoy outsized returns over the long term.

We remain positioned for a sustained rally in Brazil and Mexico. In Brazil, the positive impact of ongoing interest-rate cuts, potential higher-than-expected GDP growth, and a gradual deleveraging of the consumer point to recovering earnings. Our Mexican holdings, meanwhile, should continue to deliver good results as the country rides the nearshoring wave.

Our enthusiasm toward the structural potential of India has been expressed through a gradual increase in exposure over the course of the year, taking advantage of periods of consolidation in an otherwise expensive market. The Indian economy has digitalised and formalised at a rapid pace; it's also benefitted from a capex cycle driven by government spending and a buildup of manufacturing capabilities as policymakers seek to establish a larger share of global supply chains. We're capturing this opportunity primarily through well-funded Indian private banks and select consumer franchises that cater to the burgeoning middle class.

Shifts in Mainland China relating to economics, politics, regulation, and geopolitics warrant the need to apply a higher risk premium and a lower terminal growth rate for which we remain cautiously optimistic. There are signs the economy is bottoming out. Encouragingly, pro-growth policies are being incrementally rolled out even though stock valuation remain depressed. Long-term structural themes such as automation and robotics, AI, energy transition, domestic consumption, and import substitution remain intact. We continue to consolidate our positioning around companies in which we have conviction, particularly those that continue to provide good visibility on earnings delivery and, despite reduced exposure, are positioned to participate in a market recovery.

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Manulife Investment Management

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