LONG-TERM TRENDS DRIVE EMERGING MARKETS

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- *Despite its huge impact, the Covid-19 pandemic has done little to disrupt the powerful structural trends driving growth in emerging markets. We expect these trends to gain momentum in the coming year.*
- *With a supportive macroeconomic environment and the promise of vaccines becoming widely available in 2021, we believe the trend from export-led growth to reliance on buoyant domestic demand will assert itself more strongly than ever.*
- *We see significant opportunities across consumer discretionary, information technology and communication services sectors — with global growth potential — as businesses develop products and services to meet evolving consumer tastes.*
- *There are a growing number of companies that exhibit quality growth characteristics, with strong, investor-friendly management teams and the ability to fund their growth internally while increasing returns on invested capital.*

As we enter 2021, the macroeconomic backdrop for emerging markets is extremely supportive. Several major economies, notably China and South Korea, were among the first to be hit by the pandemic. However, thanks to their robust approach to tackling its spread they have recovered strongly and are well positioned to continue their rebound. More generally, emerging markets are benefiting from the global wave of interest rate cuts and liquidity injections. They also have more scope than developed markets to apply further stimulus, thanks to their higher real interest rates.

With a supportive macroeconomic environment and the promise of COVID-19 vaccines becoming widely available during 2021, we believe the key long-term trend driving emerging markets — their transition from export-led growth to reliance on buoyant domestic demand — will assert itself more strongly than ever.

Nowhere is this clearer than in the shift in the center of gravity of the global middle classes. In October, the Brookings Institution pointed out that China is experiencing the fastest expansion of the middle class the world has ever seen,[1] adding that this was taking place "during a period when the global middle class is already expanding at a historically unprecedented rate thanks in part to some of its neighbors like India." The Brookings paper forecasts that the Chinese middle class will reach 1.2 billion people by 2027, representing a quarter of the global total. By comparison, in the 1950s more than 90% of the world's middle classes lived in Europe and North America.

This continuing shift will fuel strong domestic demand for goods and services, a significant proportion of which will be met by fast-growing domestic companies. We believe themes such as digital innovation, ecommerce and digital payments penetration, financial deepening and environmental development — all of which have been reinforced by the effects of the pandemic — will provide rich sources of investment opportunity through the coming year and beyond.

Our approach to capturing these opportunities will lead us to continue to focus on the emerging markets companies serving domestic demand. We see significant opportunities across consumer discretionary, information technology and communication services sectors, where there is global growth potential as businesses develop products and services to meet evolving consumer tastes.

Health care is another sector that has accelerated during the pandemic. With health care spending in China only around 5% of GDP, compared with 17% in the U.S.,[2] there is a clear trend indicating where this sector could go. In China, people are getting older, richer and sicker. "Big bang" reforms have been a key catalyst for the industry, with its membership of the International Council for Harmonization of Technical Requirements for Pharmaceuticals for Human Use (ICH)[3] helping to integrate China's clinical process and adherence to global standards. Consequently, drug approval and reimbursement times have fallen dramatically.[4] The market has opened up and now there is the demand and capability to realize its potential. We wouldn't be surprised if the health care sector doubles in weight over the next few years.

Elsewhere, there are pockets of growth in financials thanks to digital innovation. In Brazil, record-low interest rates[5] are driving investment in equities and creating opportunities. As financial deregulation, structural reform and technology adoption continue, we expect areas such as digital brokerage and payments to yield more prospects for high growth. And although the pandemic has slowed the reform agenda in emerging markets somewhat, the long-term trend is intact. We note that important reforms are progressing in countries including Brazil, Indonesia, India and China.

In our view, many investors remain under-allocated to emerging markets, but the case for owning this asset class is only becoming stronger. We have seen a growing number of companies with

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[1] https://www.brookings.edu/wp content/uploads/2020/10/FP_20201012_china_middle_class_kharas_dooley.pdf, October 2020.
[2] https://data.worldbank.org/indicator/SH.XPD.CHEX.GD.ZS, December 2020.
[3] https://www.biopharminternational.com/view/china-joins-ich-global-harmonization-efforts, August 2017.
[4] https://www.FT.com, Global drugmakers strike deal to slash prices in China, November 28, 2019.
[5] https://www.bloomberg.com/news/articles/2020-10-28/brazil-holds-key-rate-at-2-as-growth-woes-outweigh-fiscal-fears, October 2020.

quality growth characteristics; strong, investor-friendly management teams; and the ability to fund their growth internally while increasing their returns on invested capital.

The growth and diversification benefits of this asset class are compelling, and we believe the coming year will offer attractive opportunities to increase exposure.

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