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INVESTMENT MANAGEMENT

Hidden Gems: Unearthing the Potential of Overlooked Markets

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The perfect storm of COVID-19, the conflict in Ukraine, high global interest rates and a strong U.S. dollar (USD) culminated in 2022 with the highest number of sovereigns facing distress in over 25 years.[1] Despite these challenging conditions, over the past two years, a number of small emerging and frontier markets have begun implementing significant reforms centered on orthodox economic policies, and now trade at attractive valuations.

While external shocks catalyzed economic turbulence, marked by double-digit inflation and currency devaluations ranging from 45% to a staggering 88%,[2] many of the upheavals stemmed from self-inflicted wounds due to years of unorthodox policies that eroded policy buffers *(Display 1)*. Factors such as high fiscal and current account deficits, loose monetary policy and overvalued currencies exacerbated the vulnerabilities of these economies.

Yet, history suggests that crises can create compelling investment opportunities. External creditors often push countries back toward sound policies, and local companies find ways to adapt. With equity markets trading at historically low valuations, these conditions present incredibly attractive entry points for investors. This dynamic is unfolding today in numerous small emerging and frontier markets like Argentina, Egypt, Nigeria, Pakistan and Turkey, that have generated significant earnings over time. Investors are starting to pay attention.

[1] Goldman Sachs "Global Markets Outlook 2024: Towards a Better Balance."
[2] Bloomberg, MSIM. Data range from Jan. 31, 2020, through May 31, 2024.

ARGENTINA: TAKING A CHAINSAW TO INFLATION

Argentina witnessed the effects of 300% inflation, an 88% currency depreciation and a painful recession stemming from years of excessive money printing to finance unrestrained government spending. But since his election last November, President Javier Milei has taken a "chainsaw" to inflationary public spending and, for the first time in 70 years, the country is set to run a fiscal surplus without the aid of commodity windfalls or one-off privatizations. Recent progress on reform (see our blog post from May 2024 "Drastic Moves by Argentina's Libertarian President, Javier Milei, May Bolster Economic and Regulatory Conditions") has helped Argentina's negotiations with the International Monetary Fund (IMF), and the country recently unlocked more than $4 billion of additional funding.[3]

EGYPT: BOOSTED BY FRIENDLY FUNDS

Egypt's economy has persistently relied on large fiscal deficits, loose monetary policy and a managed currency. A decline in tourism during COVID-19 and reduced Suez Canal revenues compounded the severe shortage of USDs resulting from the country's long-standing currency peg to the USD. To address these pressures, in February 2024 Egypt secured a $35 billion land deal with the United Arab Emirates, which provided a much-needed cash infusion. Subsequently, Egypt abandoned its currency peg, resulting in a 60% depreciation. This adjustment triggered the country's highest-ever inflation rate of 39.7%, and pushed interest rates over 27%. Egypt's adjustments unlocked an additional $15 billion in funding from the IMF, the World Bank and the EU as the country agreed to a series of reforms including deficit-reduction measures and a liberalized currency regime. This financial support is expected to address funding needs for the foreseeable future and stabilize the currency.

NIGERIA: THE BOLD REFORMER

Nigeria's naira currency experienced a 70% plunge in February 2024 as inflation spiked to 33%. Consequently, the central bank hiked interest rates to 25.25%, the highest in Nigeria's recorded history. These near-term challenges were the result of President Bola Tinubu's ambitious reform program, which included raising fuel prices and transitioning to a market-determined foreign exchange (FX) rate. In June of this year, the World Bank approved a $2.25 billion package to promote economic and fiscal sustainability. Tinubu's bold actions have laid the groundwork for Nigeria to attract greater private investment, a key pillar of his economic growth plan.

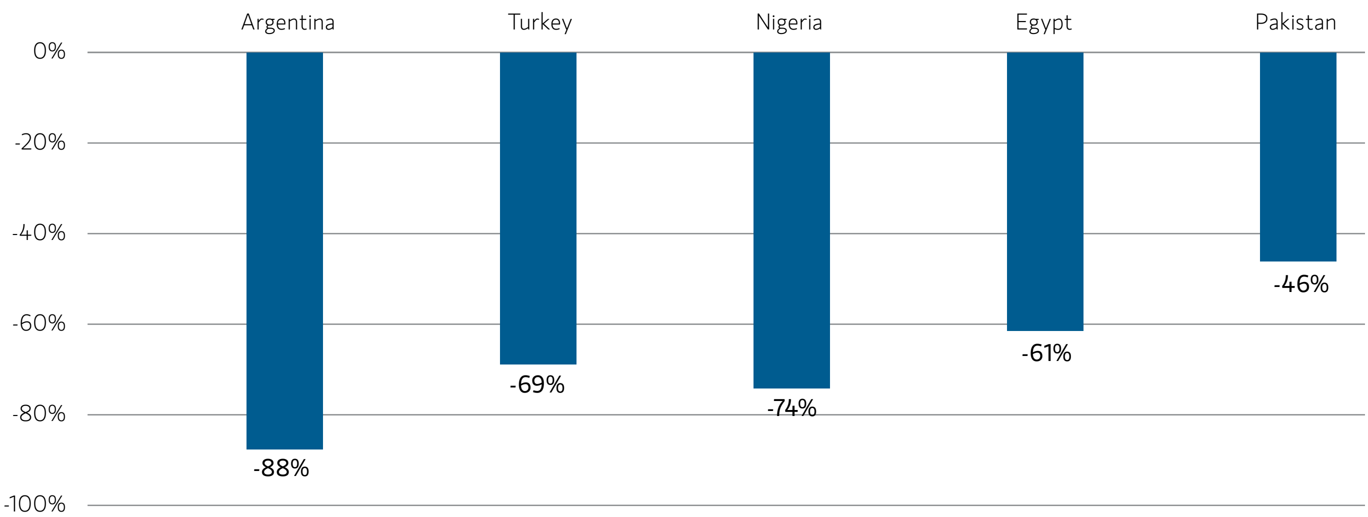
PAKISTAN: FROM POLITICAL INSTABILITY TO REFORM

Political uncertainty, dwindling foreign exchange reserves and unsustainable debt levels led to a sharp 46% depreciation of the Pakistani currency, with inflation peaking at 38% in May 2023. On the political front, the Pakistan Muslim League (N) party was successful in forming a coalition and bringing some stability, despite the February elections being anything but free and fair. Under

DISPLAY 1

Policy Missteps Fuel Currency Devaluations

Currency depreciation across select small emerging and frontier markets



Source: Bloomberg, MSIM. Currency decline from Jan. 31, 2020, through May 31, 2024.

[3] Inflation, fiscal deficit, interest rates and FX depreciation stats for all countries come from Haver analytics and MSIM calculations, IMF stats come from IMF.

Prime Minister Shehbaz Sharif, Pakistan has embraced a number of orthodox policies including fiscal adjustments, energy sector reforms and adopting a freely floating currency. The country recently secured over $1 billion from the IMF and we believe is likely to secure a new program agreement in the $6-8 billion range.

TURKEY: THE ORTHODOX CONVERT

For years, Turkey had pursued a loose monetary policy under President Recep Tayyip Erdogan's unorthodox belief that lowering interest rates was the key to combatting high inflation. Not surprisingly, this approach resulted in inflation soaring as high as 85%, while the currency experienced a 69% decline. However, following his reelection last year, Erdogan made a dramatic turn toward monetary orthodoxy, appointing credible officials to head the central bank and Ministry of Finance. The shift led to a sharp increase in interest rates in March 2024 from 8.5% to 50% and an increase in foreign reserves by more than $50 billion, both of which are restoring economic stability.

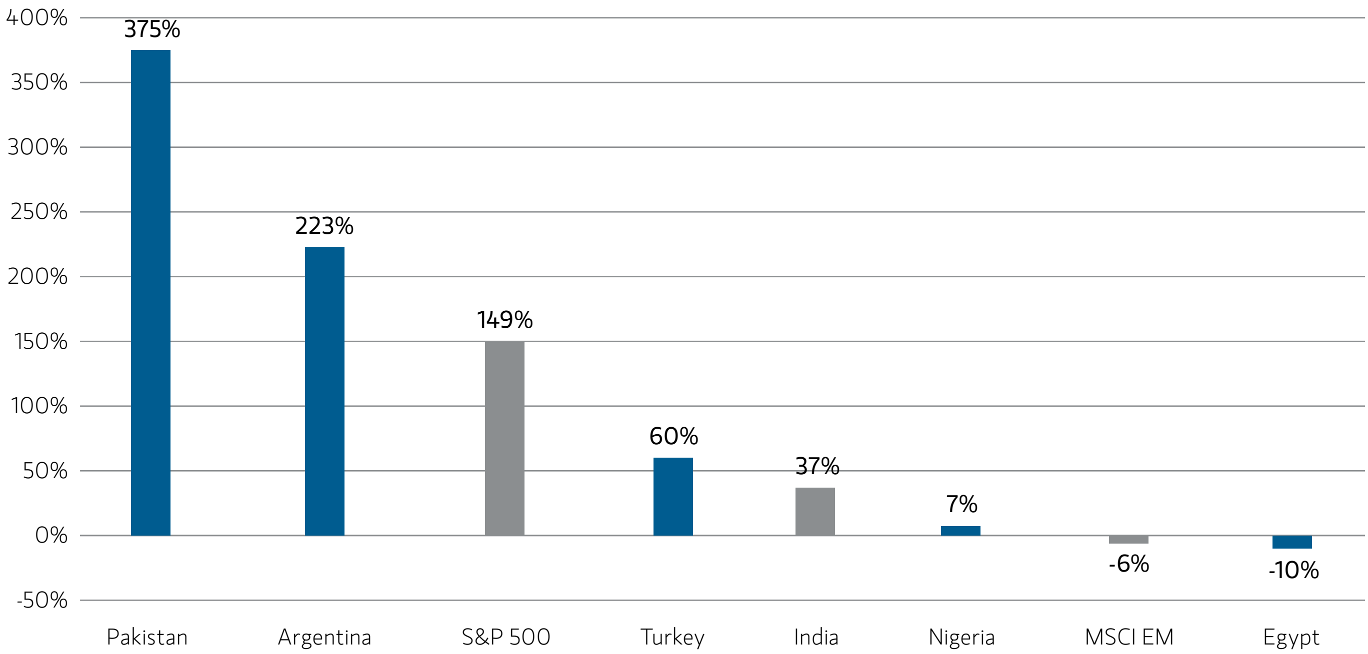
The Silver Lining of Currency Depreciation

While the significant currency depreciations experienced by these countries may initially be painful, historical data suggests that they can actually set the stage for favorable equity returns. Our analysis[4] of MSCI Emerging Markets and MSCI Frontier Markets, stretching back to the MSCI EM index's inception in 1987, indicates nations experiencing significant FX depreciation typically outperform the broader emerging market index by an average of 64% in USD terms over the subsequent two years. Moreover, the distribution of returns suggests limited downside risk due

DISPLAY 2

Unexpected Winners: Dollar Earnings Growth in Key Small Emerging and Frontier Markets Outpace Major Global Markets

Since 2011 in USD



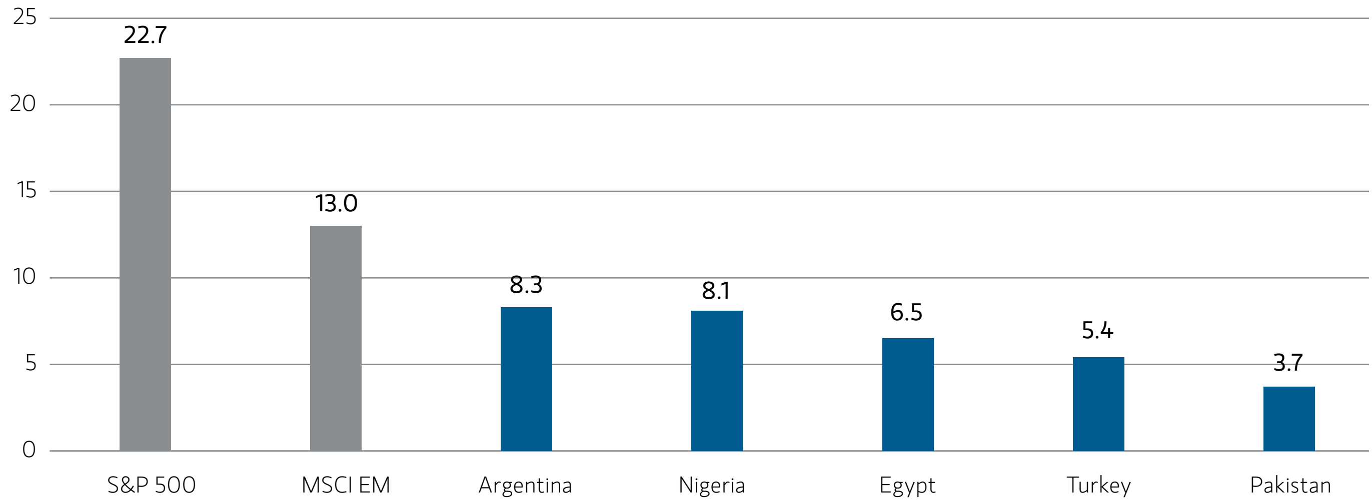
Source: Bloomberg, MSIM. Data range from Jan. 31, 2011, through May 31, 2024. Data provided is for informational use only. **Past performance is no guarantee of future results.** It is not possible to invest directly in an index.

[4] MSIM Research, using Bloomberg, Haver, MSCI. Data as of May 31, 2024. EM index refers to the MSCI Emerging Markets Index. The research included all countries included in the MSCI Emerging Markets and MSCI Frontier Markets indices going back to the MSCI Emerging Markets inception in 1987. Using monthly data, we identified 20 examples of significant depreciations by these countries, defined as a local currency depreciation against the USD by 45% or more over any 24-month rolling window. In the case(s) where a country had multiple 45% depreciations over any two-year period, we only use the first depreciation episode, so as not to have overlapping episodes. We then used an event study approach to understand how different financial and economic indicators evolved over the following two years from the point at which a currency surpasses the -45% threshold (i.e. t=0). We only include countries for which a full two years has passed since the 45% depreciation so as to ensure the results are not "in sample." Therefore, none of the more recent episodes discussed in this paper are included in the results, since these episodes are ongoing. For equity market performance, we measured the country equity index relative to the MSCI Emerging Markets index, both in USD terms in order to study whether a country tends to "outperform" or "underperform" the index, following the large depreciation. Our results found that two years after a 45% currency depreciation, the country in question outperformed the index by an average of +63.9%, with a median return of +23.9%. The 75th percentile is +67.4% outperformance, while the 25th percentile episode was -9.7% underperformance. As such, the returns have a positive skew.

DISPLAY 3

Valuations Look Attractive in Certain Small Emerging and Frontier Markets

2025 P/E estimates



Source: Bloomberg, MSIM. Data range from Jan. 31, 2011, through May 31, 2024. Forecasts/estimates/projections are based on current market conditions, subject to change, and may not necessarily come to pass.

to positive skewness, with the top quartile of episodes delivering returns as high as 68%, whereas the bottom quartile sees a modest decline of just 10%. Despite the challenges posed by currency depreciation, there is a potential silver lining for investors in terms of future market performance.

Earnings Resilience With Low Valuations

Investors are often wary of investing in frontier and small emerging market countries because of perceived elevated political risk and economic turmoil. Despite various risk perceptions, historical data suggests that local companies can be quite resilient. In fact, since 2011, despite a high degree of economic volatility and massive currency depreciations, many of the equity markets in these countries generated stronger earnings per share—in dollar terms—compared to the broader MSCI EM Index *(Display 2).*

For example, Turkey's earnings in USD terms have grown +66% more than the index since 2011. Argentina's have grown +229% more than the EM Index, and Pakistan has outpaced the index by a staggering +381% more, while Nigeria and Egypt generated earnings roughly inline with the EM Index.[5] Many may be astounded to learn that since 2011, Pakistan equities have generated significantly higher earnings per share in USD terms than even India's (+375% versus +37%). While India's equity market has outperformed Pakistan's over that period, this reflects the rising multiple that investors were willing to pay for India's earnings (and a declining multiple for Pakistan); it has nothing to do with the actual earnings growth in dollar terms, which was vastly superior in Pakistan.

That brings us to our final point: Many of these small emerging and frontier markets are trading at historically low valuations *(Display 3)*. On a forward price-to-earnings (P/E) multiple, Argentina is trading at 8.3 times consensus 2025 earnings, while Nigeria trades at 8.1x. Egypt is at 6.5x and Pakistan at 3.7x.[6] By comparison, the EM index is trading at 13x and U.S. stocks are at 23x. We think these mid-to-low single-digit P/E ratios provide an attractive margin of safety for investors.

The Case for Overlooked Markets

There is no denying that it has been an incredibly turbulent period for small emerging and frontier markets, but as is often the case, the darkest hour comes just before dawn. Each economic crisis carries the potential to seed new reforms, setting the stage for improved conditions over the coming years. To be clear, these countries are not fully out of the woods, and some may falter in their efforts to fix underlying vulnerabilities. Still, the shift toward more orthodox economic policies, coupled with currency adjustments, support from multilateral organizations,

[5] Bloomberg, MSIM calculations. Data as of June 3rd, 2024.

[6] Bloomberg, MSIM calculations. Data as of May 31, 2024.

strong historical USD earnings growth, and attractive valuations, signals the potential for strong equity returns in these markets.

Furthermore, given that global stock market concentrations have risen to their highest level in decades and the correlation between stocks and bonds is near an all-time high, these markets offer returns which are historically uncorrelated to global equities. Therefore, we think many overlooked "next generation" emerging markets, like Argentina, Turkey, Egypt, Pakistan and Nigeria, in addition to Vietnam, Bangladesh and Indonesia, merit a closer look.

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There is no assurance that a portfolio will achieve its investment objective. Portfolios are subject to market risk, which is the possibility that the market values of securities owned by the portfolio will decline and that the value of portfolio shares may therefore be less than what you paid for them. Market values can change daily due to economic and other events (e.g. natural disasters, health crises, terrorism, conflicts and social unrest) that affect markets, countries, companies or governments. It is difficult to predict the timing, duration, and potential adverse effects (e.g. portfolio liquidity) of events. Accordingly, you can lose money investing in this portfolio. Please be aware that this portfolio may be subject to certain additional risks. In general, **equities securities'** values also fluctuate in response to activities specific to a company. Investments in **foreign markets** entail special risks such as currency, political, economic, market and liquidity risks. The risks of investing in **emerging market countries** are greater than the risks generally associated with investments in foreign developed countries. The risks associated with ownership of **real estate and the real estate industry** in general include fluctuations in the value of underlying property, defaults by borrowers or tenants, market saturation, decreases in market rents, interest rates, property taxes, increases in operating expenses and political or regulatory occurrences adversely affecting real estate.

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The **MSCI Emerging Markets Index (EM)** is a free float-adjusted market capitalization weighted index that is designed to measure equity market performance of emerging markets.

The **MSCI Frontier Markets Index** is a free float-adjusted market capitalization index that is designed to measure equity market performance of frontier markets. The MSCI Frontier Markets Index currently consists of 24 frontier market country indices. The performance of the Index is calculated in U.S. dollars and assumes reinvestment of net dividends. "Net dividends" reflects a reduction in dividends after taking into account withholding of taxes by certain foreign countries represented in the Index.

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