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Inflation is fueling opportunities in emerging markets

Equity Insights offers research and perspectives from Putnam's equity team on market trends and opportunities.

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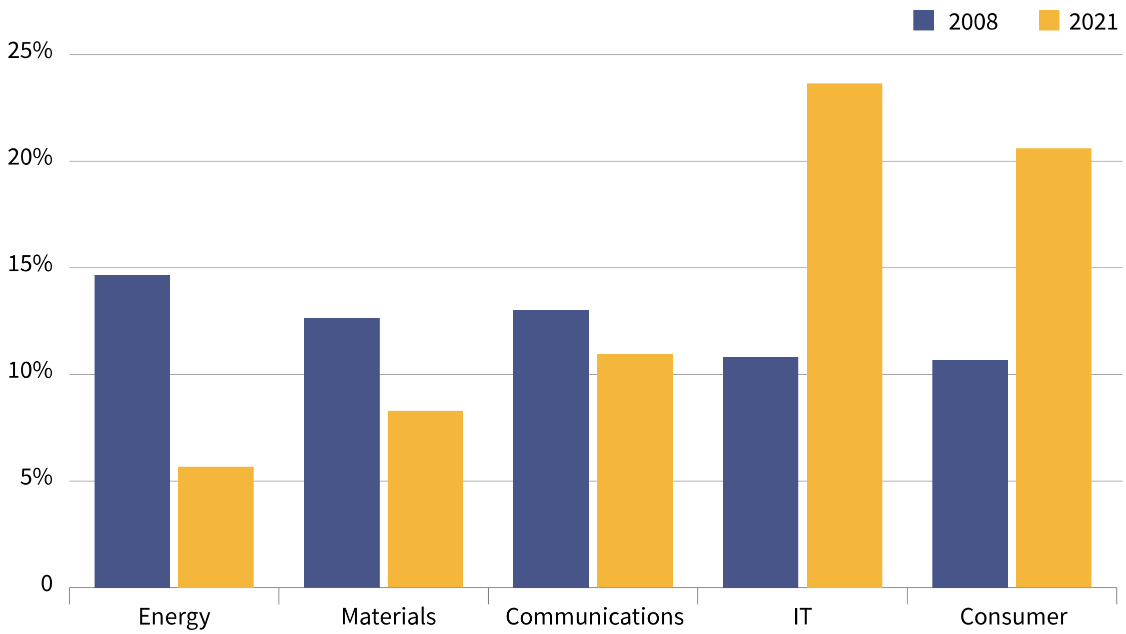
We believe emerging market equities have been unfairly characterized as high beta and too volatile. The asset class outperformed U.S. markets in the first half of 2022 despite a Russian market that overnight became viewed as "uninvestable," a resurgence in Covid-19-related lockdowns, and the typical EM headwind of a strong U.S. dollar. And we see the potential for outperformance in the second half of 2022 as well as next year, driven by attractive valuations, diverging central bank policies, and inflation beneficiaries such as Saudi Arabia and Indonesia.

Emerging market index 2.0: Higher quality, lower volatility

Over the past decade, the changing composition of the MSCI Emerging Markets Index has resulted in higher profit margins and returns on equity, and more resilient cash flows. Specifically, consumer and technology companies have become the largest sectors in the index, while weightings are smaller for the more volatile energy and materials sectors. Also, regional changes in the index have been important. Asia now dominates the index at 80%, while commodity-based markets such as Brazil and South Africa have shrunk in importance.

Less-volatile sectors have grown in the EM Index

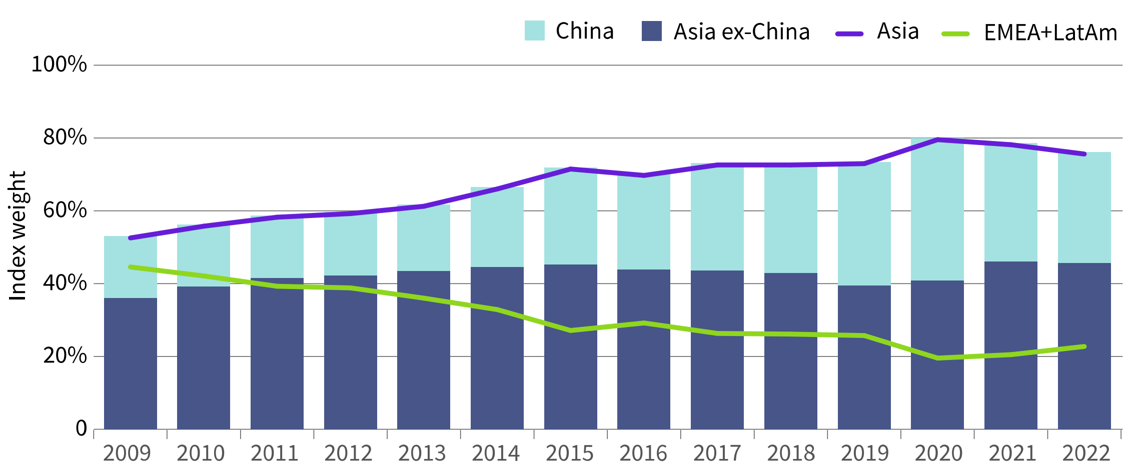
Sector composition of MSCI Emerging Markets Index



Source: MSCI.

Index has lower exposure to commodity-based markets

Geographic composition of MSCI Emerging Markets Index



Source: MSCI.

Near-term volatility has created an attractive entry point

Emerging market price-to-earnings ratios peaked 18 months ago at 16x. Since then, valuations have collapsed to trough levels of just 10.5x. At the same time, the risk/reward profile for EM equities is the most attractive since the height of the pandemic. Performance of EM equities peaked along with China's equity market top in February 2021. After tumbling 35% over 15 months, EM equities appear to have bottomed. While the rest of the world is hiking interest rates, China's central bank is easing, and the government has implemented stimulus packages in key industries like autos and infrastructure. Looking to the back half of 2022, the inflation outlook could be a key driver of equity returns. Unlike the U.S., several EM countries are benefiting from rising commodity prices and are witnessing much lower inflation. In the current environment, we believe Saudi Arabia and Indonesia are two potential winners.

Saudi Arabia has more to ofer than oil

We are bullish on the outlook for Saudi Arabia, and we have added meaningfully to positions in our portfolios this year. Saudi's currency is linked to the U.S. dollar, and its inflation level is just 2.5%. Its economy is expected to recover strongly, driven by high oil prices and the government's economic and social reforms. High oil prices are positive for the country's economy and drive consensus earnings upgrades. With oil prices trading around $100/barrel, the country is expected to have a large current account surplus and its GDP is expected to grow at 7.6% in 2022.

In addition, the government has introduced several social and economic reforms under "Vision 2030" to reduce its dependence on oil and diversify its income streams. Reforms include:

- Mortgage interest subsidies to increase home ownership
- The transition of Saudi citizens to a private health insurance scheme
- Government incentives to increase private and public sector capital expenditures
- Relaxation of social norms that could boost consumer spending (for example, allowing women to drive)

These reforms, along with higher oil prices, provide structural growth tailwinds. Today we see significant opportunity in the consumer, financials, and health care sectors.

> We see potential for EM equity outperformance, driven by attractive valuations, diverging central bank policies, and inflation beneficiaries such as Saudi Arabia and Indonesia.

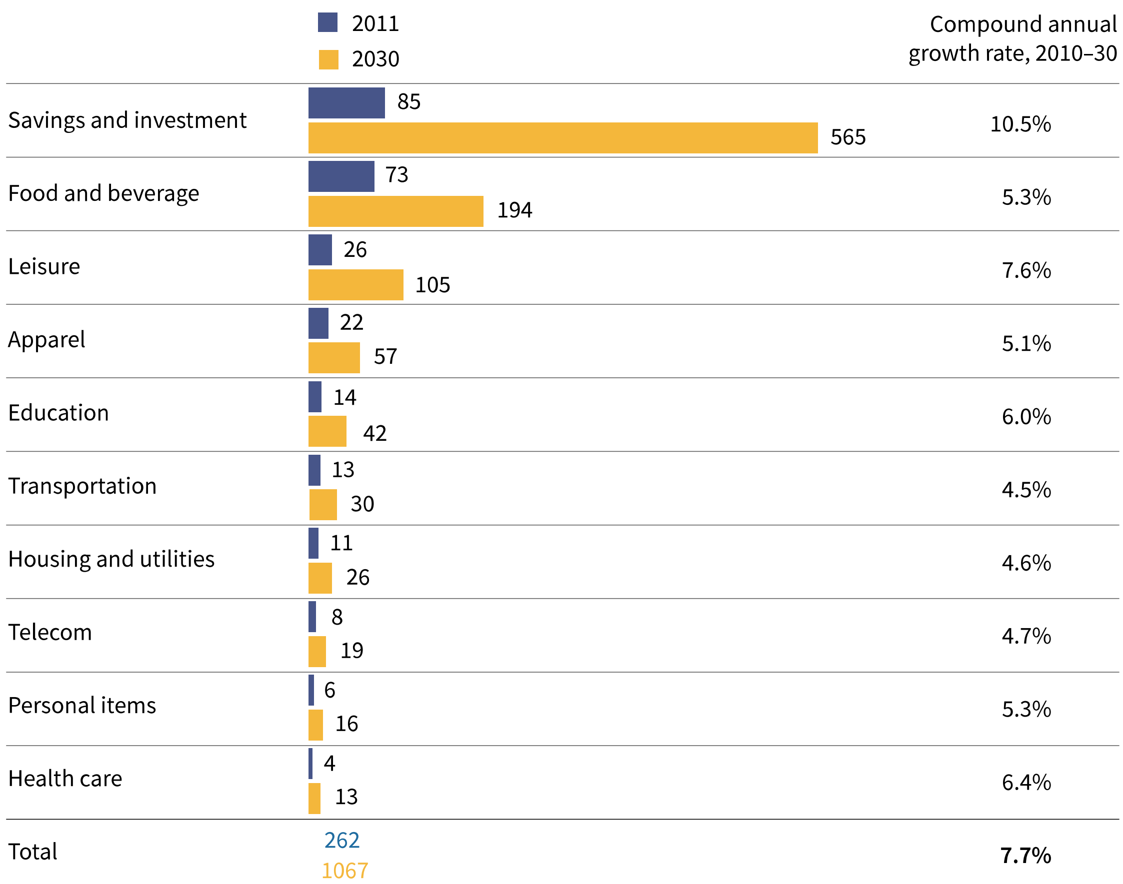
Indonesia may be the next Asian Tiger

We are also bullish on Indonesia, which is currently the top overweight region in our portfolio. Indonesian consumers are not being squeezed by inflation, as it remains under control at less than 4%. Also, due to subsidies, consumers are not being squeezed at the pump either, as gas prices are just under $2 per gallon.

Our long-term outlook for Indonesia is also positive, as it is expected to be one of the fastest-growing economies over the next two years. Indonesia has a population of 275 million, the fourth largest in the world, and it's young and growing. The working-age population is projected to keep increasing through 2030, which could bring a 60% to 100% increase in Indonesia's consuming class population. This could be a powerful driver for consumption growth.

Consumer markets are growing in Indonesia

Annual consumer spend, $ billions, 2010 prices



Sources: CSI Indonesia survey 2011; Indonesia's Central Bureau of Statistics; Canback Global Income Distribution Database; McKinsey Global Growth Model; McKinsey Global Institute analysis.

The country is home to many natural resources that have strong demand from both old and new economy industries. Indonesia is the:

- Largest coal exporter (slightly ahead of Australia)
- Largest producer of palm oil
- Ninth-largest copper producer

Indonesia is also home to the largest reserves of nickel, an important material for electric vehicle batteries. This has prompted many companies, such as Ford, LG Chem, Tesla, and Volkswagen, to secure long-term supply in the country. The recent commodity upcycle has helped Indonesia bolster its foreign exchange reserves and record a current account surplus for the first time in 10 years.

Finally, Joko Widodo has been president of Indonesia since 2014, and is one of the longer-serving leaders in the region. He is well-liked because of his commitment to improve the country's infrastructure, health care, and education. While not immune to the world's inflation, Indonesia has managed to keep its own prices in check with multiple strategies such as targeted subsidies for energy costs without interest-rate hikes. This has enabled the economy to continue growing strongly, with loan growth remaining solid and consumer confidence at an all-time high.

Exciting potential amid the headwinds

Despite naysayers and irrespective of the macroeconomic backdrop, we are excited about the tremendous long-term potential in emerging market equities. Today we are finding opportunities to own attractively valued high-quality businesses that, in our view, are effectively navigating macroeconomic headwinds and are positioned to double or triple — or more — in size over the next decade.

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