William Blair

GLOBAL EQUITY/
EMERGING MARKETS DEBT

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Emerging Markets 2024:
Unlocking Value in Uneven Terrain

Rising global rates, a strong U.S. dollar, and tightening liquidity conditions have weighed on sentiment in emerging markets (EMs). But EMs may be regaining their footing as easier monetary conditions could drive growth in 2024 for both equities and debt alike. Any recovery, however, is unlikely to be uniform. As a new cycle unfolds, we expect the heterogeneous dynamics and secular trends that drove performance in 2023 to continue to shape market terrain in 2024. Among these trends are the divergent trajectories of China and India, surging demand for AI-related hardware, and the reshaping of global supply chains.

December 2023

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Macro | Economy Hits Cruising Altitude, But Beware of Bumps

Olga Bitel, Partner
GLOBAL STRATEGIST

In 2023, the global economy defied widespread expectations of a recession and falling interest rates. Instead, the United States, Japan, and, to a lesser extent, Europe delivered significantly better growth than was expected at the turn of the year, even as the U.S. Federal Reserve (Fed) and the European Central Bank (ECB) continued to raise policy rates through most of the year.

Underappreciated economic growth is powerful fuel for global equities: the performance of the U.S. "Magnificent 7" stocks (Apple, Microsoft, Alphabet, Amazon, Nvidia, Meta, and Tesla) is widely discussed, but as of November 30, 2023, German, Spanish, and Italian bourses[1] also returned 19.1%, 29.9%, and 34.4%, respectively, in U.S. dollar terms. This is in line with or better than 17.28% for the S&P 500 Index. Even Japanese equities[2] are up at double-digit rates in U.S. dollar terms, despite the Japanese yen depreciating to lows last observed in the early 1990s.

EM Growth Depends on Three Developed Demand Centers

The vast majority of EMs are small, open economies whose fortunes depend on what happens in the world's three principal demand centers: the United States, Europe, and China. Put another way, EMs are a high-beta play on developed market growth. Interest rates, exchange rates, and commodity prices are largely set by the economic and liquidity conditions in the three global demand centers. At the same time, these prices—interest rates, exchange rates, and commodity prices—set binding constraints on economic outcomes in most EMs.

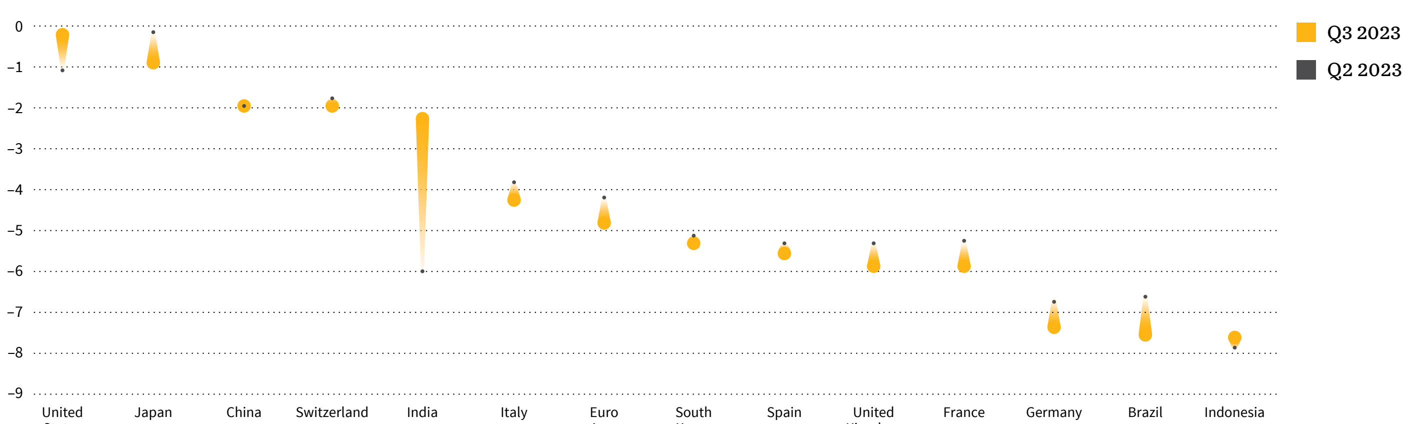
To be sure, the world economy has some ground to cover. At the end of 2023, many of the largest economies remain significantly smaller than their pre-COVID growth trajectory implies, as shown in exhibit 1.

1 Bourses are represented by the DAX Index (Germany), the IBEX 35 Index (Spain), and the FTSE MIB Index (Italy).
2 Japanese equities are represented by the Tokyo Price Index (TOPIX).

EXHIBIT 1

Difference Between Pre-Pandemic Output Trajectory and Third-Quarter GDP

Some of the largest economies in the world remain considerably smaller than their pre-pandemic output trajectories imply. The y-axis represents the difference in actual GDP from each economy's pre-pandemic output trajectory. The movement of the "comet" is showing if each economy moved closer or further away from their pre-COVID trend in Q3 2023.



Sources: Bloomberg and William Blair, as of December 2023.

The United States and Japan are the closest, while the United Kingdom, Germany, and Indonesia are among the furthest away from their pre-pandemic output trajectory.

The experience in 2023 has defied the commonplace view of an inevitable trade-off between inflation and unemployment. Many continue to argue that for inflation to decline to the 2% range, the economy needs to shrink and unemployment needs to rise. This view assumes that the run-up in inflation over the last two years is due mainly to excessive demand growth.

In exhibit 2 below, analysis by the Federal Reserve Bank of Chicago shows just how differently U.S. economic variables are behaving in the aftermath of the Fed's tightening policy and makes a powerful argument that inflation this time was primarily due to pandemic-induced supply constraints. Viewed in this light, it is hardly surprising that both the United States and Europe have defied dire predictions of an imminent recession so far.

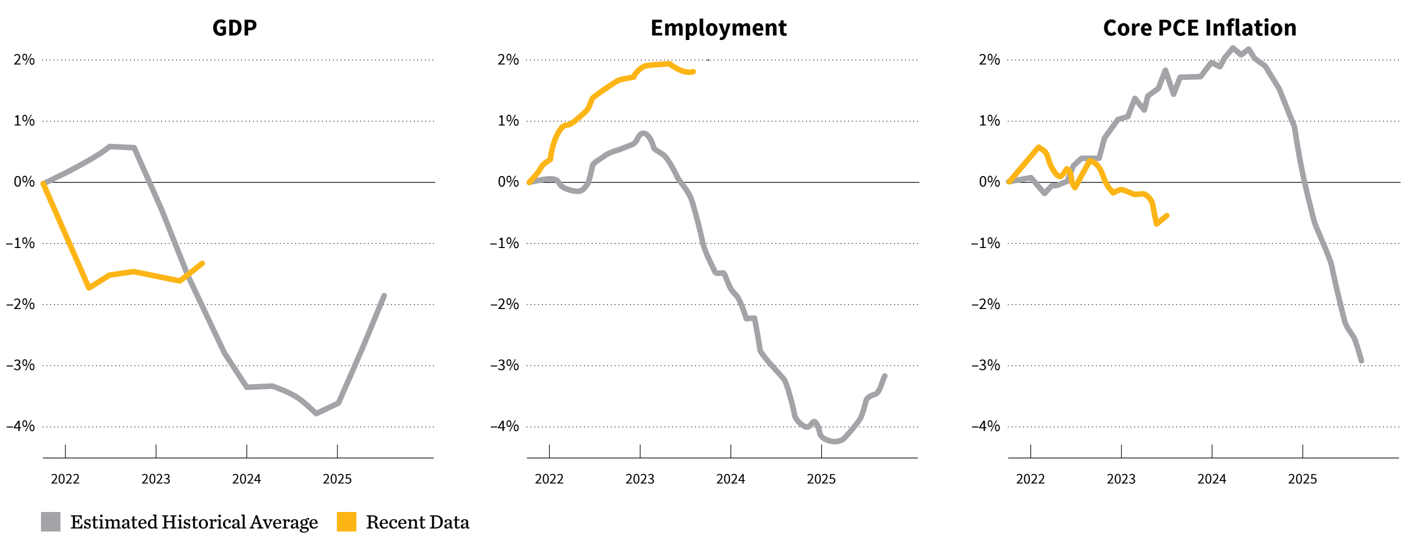
> "We expect the Fed to begin to lower the nominal policy rate as early as the first half of 2024, even as domestic economic growth remains resilient."
>
> **Olga Bitel, Partner**

The Fed's monetary policy stance is becoming de facto more restrictive, as stable policy rates amid rapidly falling inflation imply rising real rates. Our outlook for 2024 hinges on whether the Fed and the ECB can begin to lower policy rates early enough to prevent high real rates from meaningfully dampening economic activity. As annual price inflation converges back to a 2% rate in the early months of 2024, current monetary policy, as measured by real interest rates, will become de facto more restrictive,

EXHIBIT 2

Monetary Policy Responses and Recent Data

The gray line in each panel represents historical evolution of the economy during prior episodes of rising policy rates. The orange line represents the actual data in the current cycle. Differences in the historical trend versus the current data highlight a different economic response this time.

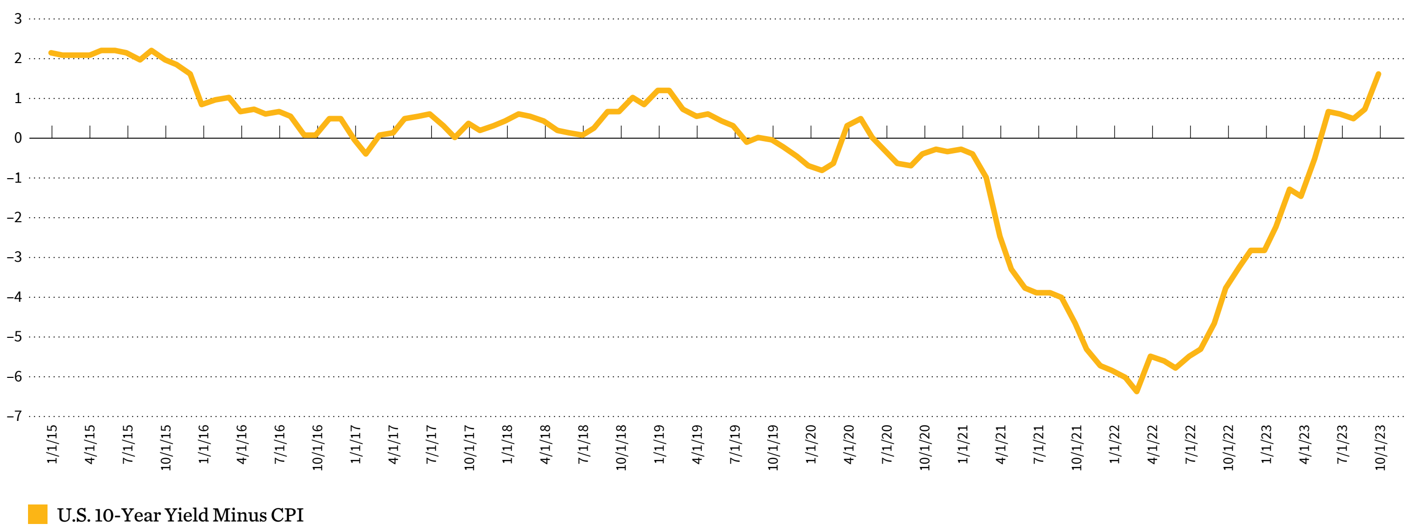


Source: Federal Reserve Bank of Chicago staff analysis, reproduced with permission. Log levels of GDP and nonfarm payroll employment and the 12–month change in core personal consumption expenditures (PCE) prices. Recent data are quarterly since 2021: Q4 for GDP and monthly since November 2021 for employment and core PCE inflation.

EXHIBIT 3

U.S. Real Rates

As inflation moderates, real rates will continue to rise—and become more restrictive—if the Fed chooses to maintain their current policy rates.



Sources: Macrobond and William Blair, as of December 2023.

as shown in exhibit 3. The real interest rate is nothing more than nominal rates minus inflation. Thus, lower inflation automatically means higher real rates if the Fed chooses to maintain current settings. Therefore, we expect the Fed to begin to lower the nominal policy rate as early as the first half of 2024, even as domestic economic growth remains resilient.

The disinflation process in the United States and Europe is already well advanced. At the beginning of 2023, consumer prices rose by 6% year-over-year. By the end of the year, the Consumer Price Index (CPI) registered year-on-year increases of 3.2%. Nevertheless, the Fed's preferred gauge of domestic inflation—PCE excluding food and energy, which tend to be volatile—is still growing at 3.8% as of September 2023, nearly twice the 2% stated goal of the Fed.

A closer look at the components of the price increases suggests that the principal offender remains housing. It is the single largest component of the CPI basket, weighing roughly one-third of the index. The housing component of the CPI is an imprecise blend of housing prices and rent costs. Online platforms for home purchasing and rents now make more current pricing information readily available, and these price trends suggest that the contribution of housing to the CPI is likely to diminish significantly in the first half of 2024, as shown in exhibit 4.

> "Falling inflation is likely to remain a powerful tailwind to consumer spending and, by extension, overall economic growth."
>
> **Olga Bitel, Partner**

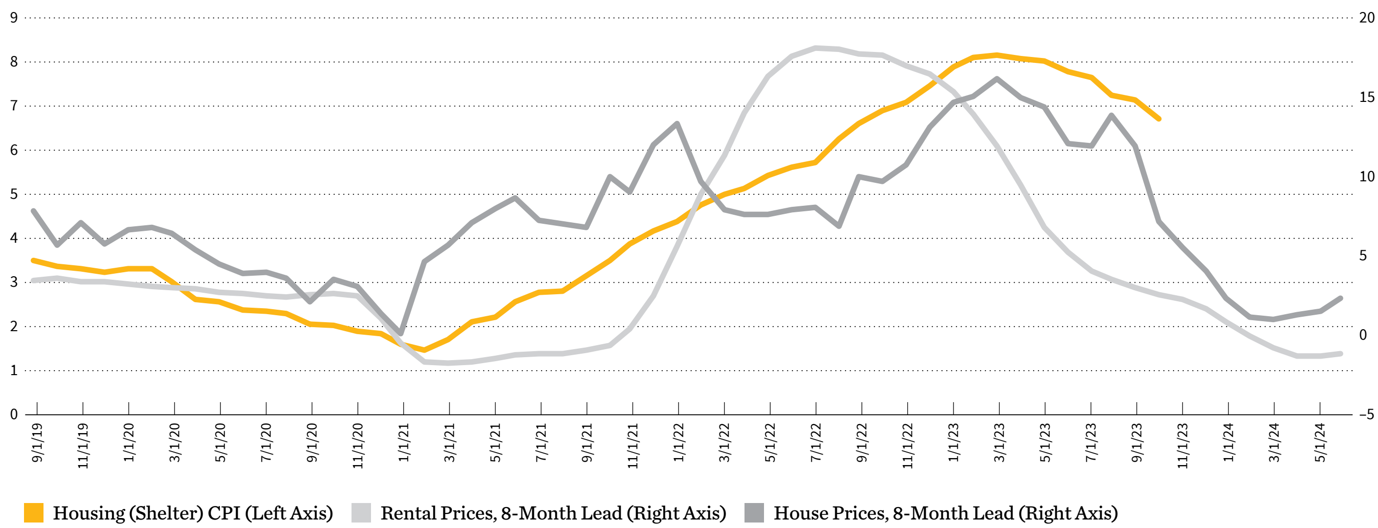
Recent house price increases have motivated more building: residential investment has returned to growth after two years of continuous declines, as shown in exhibit 5. Over time, this is likely to support more housing market activity and mitigate future price increases.

Crucially, the labor market has healed as the post-pandemic supply constraints have all but unwound.

EXHIBIT 4

Year-Over-Year Percentage Change in U.S. Housing Prices

Shelter CPI is highly correlated with house prices and rental costs, both of which have decelerated already.

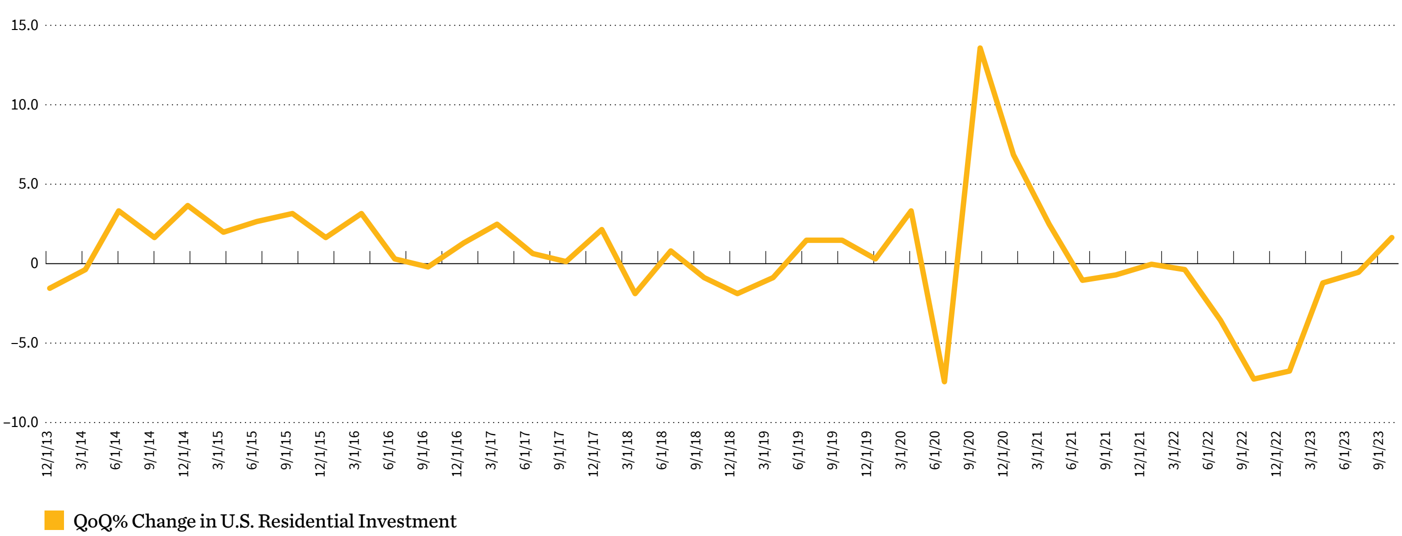


Sources: Zillow, Apartment List, BLS, and William Blair, as of December 2023.

EXHIBIT 5

Quarter-Over-Quarter Percentage Change in U.S. Residential Investment

The U.S. housing market is behaving as expected, with new residential investment accelerating in response to higher home prices.



Sources: Bloomberg and William Blair, as of December 2023.

Wage growth continues to moderate; hourly earnings are now growing at 4%, down from nearly 6% a year ago. The number of job vacancies has continued to decline as the economy has added 150,000 net new jobs per month for most of the second half of 2023. In other words, the returning workers and resumption of immigrant inflows resolved the severe worker supply shortage without any meaningful pick up in unemployment.

Falling inflation is likely to remain a powerful tailwind to consumer spending and, by extension, overall economic growth, as moderate wage gains in excess of falling inflation boost real incomes. This dynamic is also playing out in Europe, where the disinflation process commenced later and has further to run. Economic growth is likely to remain more moderate in Europe than in the United States, not least due to significant geopolitical tensions on its borders and meaningfully higher energy prices compared to pre-pandemic levels.

With goods and services prices already converging to pre-pandemic trends, it is not a stretch to assume that U.S. inflation will normalize to its long-term 2% rate in the first half of 2024.

As the disinflation process progresses, current monetary policy will de facto become more restrictive, suggesting that some moderation in the federal funds rate will become necessary even if economic activity remains resilient. The ECB is just as likely to face low inflation and underwhelming growth in Europe within months. Relying on today's or, more accurately, last month's indicators of price movements, risks keeping monetary policy too restrictive and punitive for future economic activity. We expect the Fed to bring policy rates down to the 3.5% range on an 18-month view and to begin this process in the first half of 2024.

So, if the Fed adjusts its "neutral" monetary policy stance to be in line with meaningfully lower inflation and does so in a timely manner, and if the ECB follows suit in Europe, the world's principal demand centers can maintain modest but sustainable economic growth in 2024.

In other words, 2024 may be the first year of "normal" economic expansion post-COVID.

"2024 may be the first year of 'normal' economic expansion post-COVID."

Olga Bitel, Partner

EM Equity | Markets Diverge as a New Cycle Unfolds

Todd McClone, CFA, Partner
PORTFOLIO MANAGER, EM EQUITIES

EMs have regained their footing in 2023, but the recovery from October 2022 lows has been anything but uniform across individual markets. As a new EM cycle unfolds, we expect that the heterogeneous dynamics and secular themes that have driven performance in 2023 will continue to shape market behavior in 2024. Among these trends are the divergent trajectories of China and India, surging demand for AI-related hardware, and the reshaping of global supply chains.

Favorable Macro, Valuation Backdrop Despite Monetary Headwinds

Macroeconomic fundamentals are improving throughout most of the EM universe, and EM central bankers are eager to transition to a more accommodative monetary policy now that inflation concerns have faded. Their ability to stimulate, however, was constrained for much of 2023 by a surprisingly resilient U.S. economy, which produced higher interest rates and a stronger U.S. dollar. Outside of Brazil and Chile, EM central banks have shied away from cutting rates to avoid collateral damage from the resulting devaluation of their local currencies.

In the coming months, we believe flows into EM markets will be determined by the extent to which the U.S. economic expansion continues. Although a higher-for-longer interest rate scenario in the United States would create a more challenging environment for EM equities, the recent decline in U.S. inflation and a softening U.S. dollar suggest that a more constructive backdrop for EMs is developing.

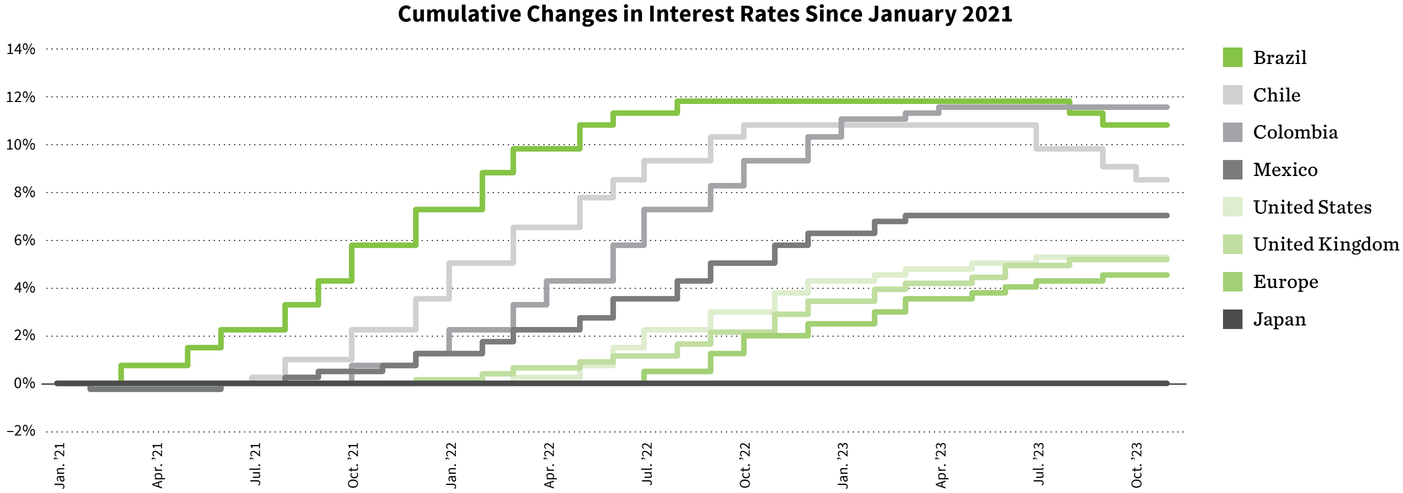
In any case, relative valuations in EMs appear attractive, and we believe EMs remain the prime avenue to tap into many of the world's most potent secular trends. Looking beyond the initial recovery phase, where deep value and highly cyclical names have historically and predictably led the way, we believe a rotation toward quality growth is likely to be the next chapter of the story.

EXHIBIT 6

EM Central Bankers Have Adopted a Wait-and-See-Approach

Accommodative monetary regimes in emerging markets are unlikely to begin until there are more obvious signals that the U.S. economy is softening.

Cumulative Changes in Interest Rates Since January 2021



Sources: Bloomberg and William Blair, as of October 31, 2023.

Performance Highlights from 2023

Spurred by the optimism surrounding the reopening of China's economy, EMs were able to find solid ground in early 2023, following a 20-month bear market in which the MSCI EM Index fell 41.7% peak to trough. However, the China revival story did not play out as anticipated. Down 9.01% year to date through November 30, China has been severely challenged by greater-than-expected COVID-related effects, including higher unemployment, psychological damage across the consumer base and the corporate sector, weakness in the property sector, and deteriorating relations with the United States.

Although China failed to meaningfully reignite global growth, formidable bull markets developed elsewhere. India—a country we continue to overweight in our portfolios—emerged as a standout performer in 2023, with year-to-date gains of 11.75% through November 30. Indian industrials and financials have been particularly strong, bolstered by a robust capex cycle, solid GDP growth, and favorable demographics.

Elsewhere in Asia, the surge in demand for all things AI has been a significant boon for Korea (up 15.52% year to date through November 30) and Taiwan (up 23.81%), both of which play pivotal roles in the global AI hardware supply chain.

Mexico has also thrived in the current landscape, posting gains of 28.73% year-to-date through November 30. The country has become the poster child for the COVID-related reshoring theme, which has been amplified by rising geopolitical tensions between the United States and China and the war in Ukraine.

South Africa—a country we have minimal exposure to—is down 4.7% year to date through November 30 and has suffered from rampant corruption and flagging infrastructure. The poor conditions are underscored by the scandal in the state utility Eskom, which has led to rolling brownouts across the country and crippled the economy.

Divergent Paths in Dominant EMs

Together, China and India comprise 44% of the MSCI EM Investable Market Index (IMI). The stark differences between the two markets are becoming increasingly pronounced, and although much of the pessimism around China is currently reflected in valuations, we continue to have a more constructive view of Indian stocks.

From a leverage perspective, India's economic health is considerably more robust than China's: non-financial corporate debt to GDP is 51% in India, compared with 165% in China, and household debt to GDP is 19% in India and 65% in China.

On a fundamental level, India's demographics, politics, transparent monetary policy, and alignment with the West stand in contrast to China's, which we believe should continue to support the momentum of India's stock market. China's market, on the other hand, is becoming more difficult to navigate due to an increasingly prohibitive and unpredictable regulatory environment. In our view, an increasing portion of the MSCI China Index are companies with asymmetric risk profiles. If one excludes from the index companies that fall under the Common Prosperity umbrella, which are subject to potential regulatory pressure, state-owned enterprises (SOEs), and technology companies the United States has attempted to limit access to critical U.S. technology, what remains is a relatively small subset of the index that we consider to be viable investments.

In the aftermath of China's Draconian and protracted COVID-related lockdowns, Chairman Xi has conspicuously prioritized politics over economics, and little has been done to repair the long-lasting psychological damage inflicted on the population. Consumers have been reluctant to spend, and businesses have hesitated to invest.

Property-sector problems have been an intensifying concern, highlighted by the high-profile failures of Evergrande and Country Garden. At the time of this writing, 25 of the largest 50 residential property developers in China are currently in default. Many families have paid for new residential units, whether outright or in installments, that are likely to never reach completion, further damaging confidence in the property market. Given that real estate represents the largest portion of household wealth for most of the population, falling property values have produced a negative wealth effect. It will be challenging for the economy to gain momentum until pressures on property prices dissipate.

China's latest round of stimulus hasn't been nearly sizable enough to reignite confidence in the household and business sectors. Furthermore, the opacity of monetary and fiscal policy has created uncertainty in the minds of investors around the economic outlook. What is clear is that the magnitude of the impact of China's total social financing (general lending activity into the economy) has been diminishing each successive round of easing the country has implemented since 2008, which we believe can be explained by already elevated debt levels and Xi's increasing reluctance to promote consumerism. An unexpected rescue of the property market or an outsized stimulus package would surely curtail the bleeding, but so far all announcements have fallen short of expectations and initial bouts of investor enthusiasm have been short-lived. In any case, the long-term fundamentals in India appear considerably more promising.

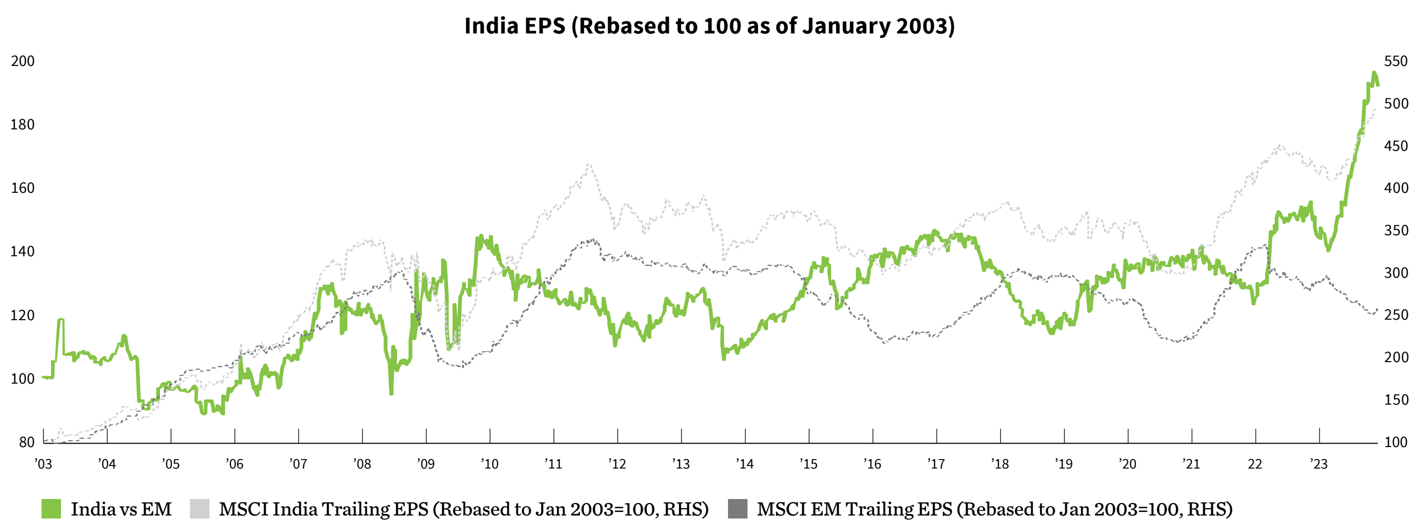
With a share of global GDP growth approaching 20%, India is one of the strongest markets in the emerging world, and we believe its story continues to improve. As a matter of fact, the country has surpassed Taiwan and Korea to become the second-largest component of the MSCI EM Index. Inflation has cooled, interest rates are no longer rising, GDP growth is robust, and both public and private sector capex appear to be entering an upcycle. The first leg of India's multidecade growth story—characterized by an emerging consumer—has evolved to "version 2.0," centered on building out housing and critical infrastructure. India's residential real estate market is booming, and we expect decades of growth given the massive demand and short supply of housing. The country has announced a $35 billion railway expansion plan, substantial investments in power infrastructure, 220 new airports by 2025, and numerous other initiatives that support our positive stance on midcap industrials.

Along with industrials, we maintain our positive outlook for the Indian financial sector. Since 2005, Indian banks have quietly but significantly outperformed the MSCI AC

EXHIBIT 7

India's Long-Term Earnings Outperformance Has Accelerated

Demographics and a positive capex cycle could continue to fuel impressive earnings growth in India.



Sources: Datastream, MSCI, IBES, Morgan Stanley Research, and William Blair, as of November 29, 2023. EPS refers to earings per share.

World Banks Index, and there are reasons for continued optimism. Penetration rates for financial products are trending higher and remain very low relative to the rest of the world on an absolute basis. The population is under-levered and beginning to increase borrowing to finance home purchases. Per capita income recently exceeded the $2,000 threshold—in our opinion, a key signal that demand for durable goods of all varieties is poised to inflect higher.

Although India is trading at a premium to the EM universe, we believe valuations are justified by impressive levels of earnings per share (EPS) growth, driven by the powerful tailwinds in the financial and industrial sectors.

Beyond India, Select Bull Markets May Have More Room to Run

Beyond India, we are seeing opportunities in several other markets.

A Virtuous Cycle Unfolding in Mexico

The poster child of the global reshoring story, Mexico has been one of the strongest performing equity markets of the past three years. Its low labor costs and the growing consensus in the United States to bring supply chains closer to home—catalyzed by COVID-19 and spurred on by geopolitical tensions—has created a powerful trend of factories being relocated from China to Mexico. In fact, Mexico recently surpassed China as the No. 1 exporter to the United States, according to Bloomberg, with U.S. exports increasing from $385 billion in 2021 to $455 billion in 2022.

> "Korea and Taiwan are the main beneficiaries of the growing demand for all things AI."
>
> **Todd McClone, CFA, Partner**

Social Reforms Unleashing Potential in Saudi Arabia

A newcomer to the MSCI EM Index, Saudi Arabia is already approaching the size of Brazil in the index. A 2023 survey by *Ipsos* suggested 91% of Saudi Arabians believe the country is heading in the right direction, the highest percentage of any country in the world. The Saudi government, supported by the sovereign wealth fund, the PIF, is steering the country's transition from oil into other industries. The Vision 2030 plan encompasses $3.1 trillion in investments to help drive that transition. A flurry of capital markets activity is on the horizon, with approximately 50 initial public offerings (IPOs) planned for the next 12 to 18 months. In addition, Saudi Arabia is benefiting from growth tailwinds stemming from social structural changes: women can now drive, they are spending more, and they are also entering the workforce in large numbers. Despite the positive momentum in the country, about half of active global equity market funds (largely U.S. based) don't own a single Saudi Arabian stock, and more 90% are underweight the country, according to FactSet and Morgan Stanley Research as of June 30, 2023. We see some of the most attractive opportunities in Saudi's small- and mid-cap equities.

EM: An Efficient Way to Play the Surge in AI Demand

Korea and Taiwan are the main beneficiaries of the growing demand for all things AI. Across all applications—cloud, automotive, consumer, PC, smartphone, etc.—AI semiconductor revenues are forecast by Morgan Stanley to increase 31% annually between 2023 and 2027.

We believe AI hardware-focused small- and mid-cap equities, almost all of which operate in Korea and Taiwan, are the purest way for investors to participate in this burgeoning market. Taiwan's mid-caps are critical to NVIDIA's supply chain, and Korea is well-positioned with its companies that exclusively design high-end DRAM memory cells, key components in AI chips.

Selectively Tapping into Secular Themes Across EM

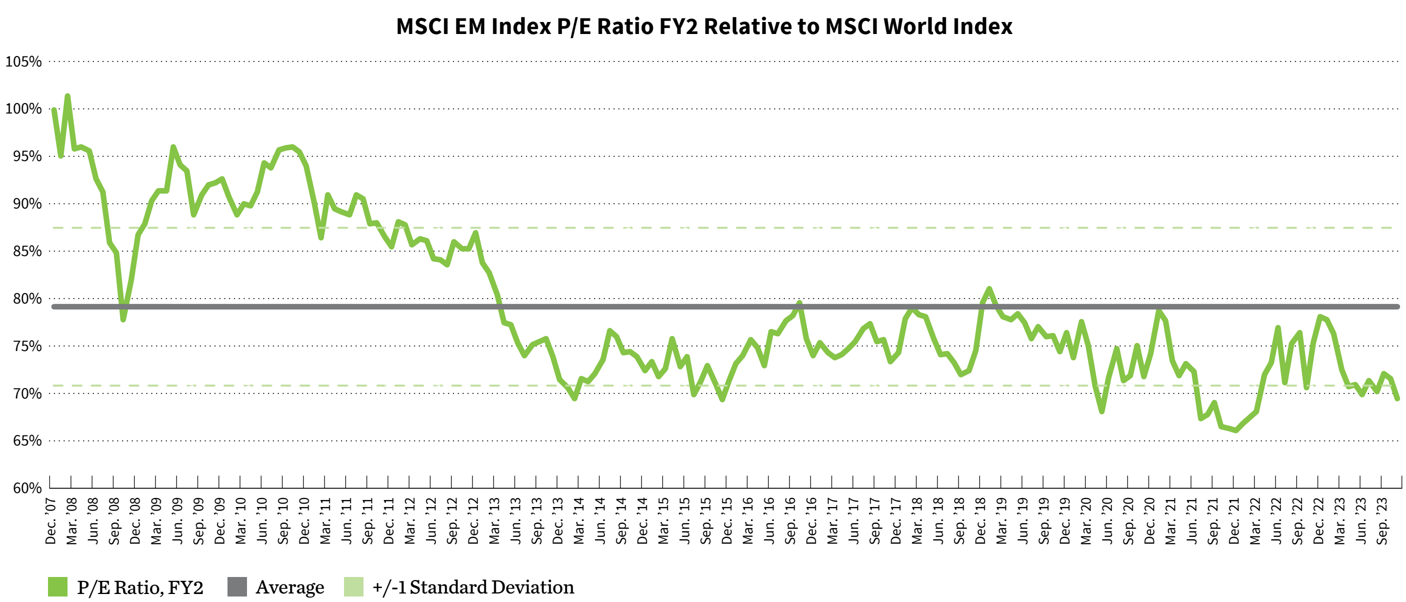
Recent developments only reinforce the adage that EMs shouldn't be considered one big, homogeneous asset class. Monetary, economic, and political conditions vary widely from country to country, and despite the significant headwinds for EM's largest constituent, China, we believe compelling valuations and select bull markets support an optimistic outlook for well-constructed EM portfolios.

We believe EMs are the most efficient way to access some of the world's most powerful secular themes: India's emerging middle class, surging demand for artificial intelligence, and the near-shoring of supply chains. Now that the asset class's early recovery phase is in the rearview mirror, we think quality growth is poised to outperform. Within this backdrop, we believe stock selection and the ability to identify high-quality companies with strong management teams, sustainable competitive advantages, and strong balance sheets remain paramount.

EXHIBIT 8

Attractive Forward Price-to-Earnings Multiples

Despite improving fundamentals, relative EM valuations are currently around one standard deviation below the long-term average.



Sources: Factset, MSCI, and William Blair, as of November 30, 2023.

Marcelo Assalin, CFA, Partner
HEAD OF EM DEBT

Over the past couple of years, solid economic activity and stubborn inflation led central banks to hike interest rates to levels not seen in decades. In 2023, these rising global rates, combined with a strong U.S. dollar and tightening liquidity conditions, weighed on fixed-income returns and wider market sentiment. This proved particularly challenging for EM debt. However, after a few years of lackluster investment performance, we anticipate a strong 2024 for the asset class. Below we review some of the factors contributing to that assessment, then discuss the outlook for hard currency, local currency, and corporate debt across EMs.

Normalizing Growth and Policy Easing

We expect a significant improvement in the global macro backdrop in 2024, characterized by still-resilient economic growth, lower global rates, and improving global liquidity conditions.

While it appears likely that the global economy will continue to gradually decelerate, growth should remain close to its long-term potential.

In that environment, central banks in advanced economies have likely reached the end of their hiking cycles, with monetary policy easing a predominant theme in 2024.

Many EM central banks have already started cutting policy rates, and we expect this process to continue into 2024. Recall that in the global fight against inflation, EM central banks hiked interest rates sooner and faster than their counterparts in the developed world. As a result of such a timely and assertive policy reaction, inflation started to fall sooner and faster in EM countries.

In our opinion, easier monetary conditions will be one of the factors supporting economic growth in the EM world in the next year.

> "Inflation started to fall sooner and faster in EM countries, and many EM central banks have already started cutting policy rates."
>
> **Marcelo Assalin, CFA, Partner**

Stable Credit Fundamentals

Additionally, credit fundamentals should remain well supported in most EM countries, in our opinion. We believe real GDP growth for our investment universe will be 3.5% in 2024, only marginally lower than in 2023. We also expect stable fiscal and debt dynamics. In our opinion, the budget-balance deficit and total government debt should remain relatively stable at approximately 5.2% and 57.5% of GDP, respectively. From an external account perspective, we expect a basic balance (current account plus foreign direct investments) surplus of approximately 1.5% of GDP in 2024.

Supportive Commodity Prices

Commodity prices should also remain supportive of EM economic growth, in our opinion. Consider, for example, energy and industrial metals.

In energy, supply and demand factors are currently expected to balance themselves out into 2024 amid historically low inventory levels, average speculative positioning, and a latent geopolitical risk premium. On the supply side, we expect OPEC+[1], in particular Saudi Arabia, to continue restraining supply in 2024; at the same time, the United States, Brazil, Guyana, and Canada will likely add to production. On the demand side, we anticipate lower demand growth from developed markets but increased demand from EMs, China in particular.

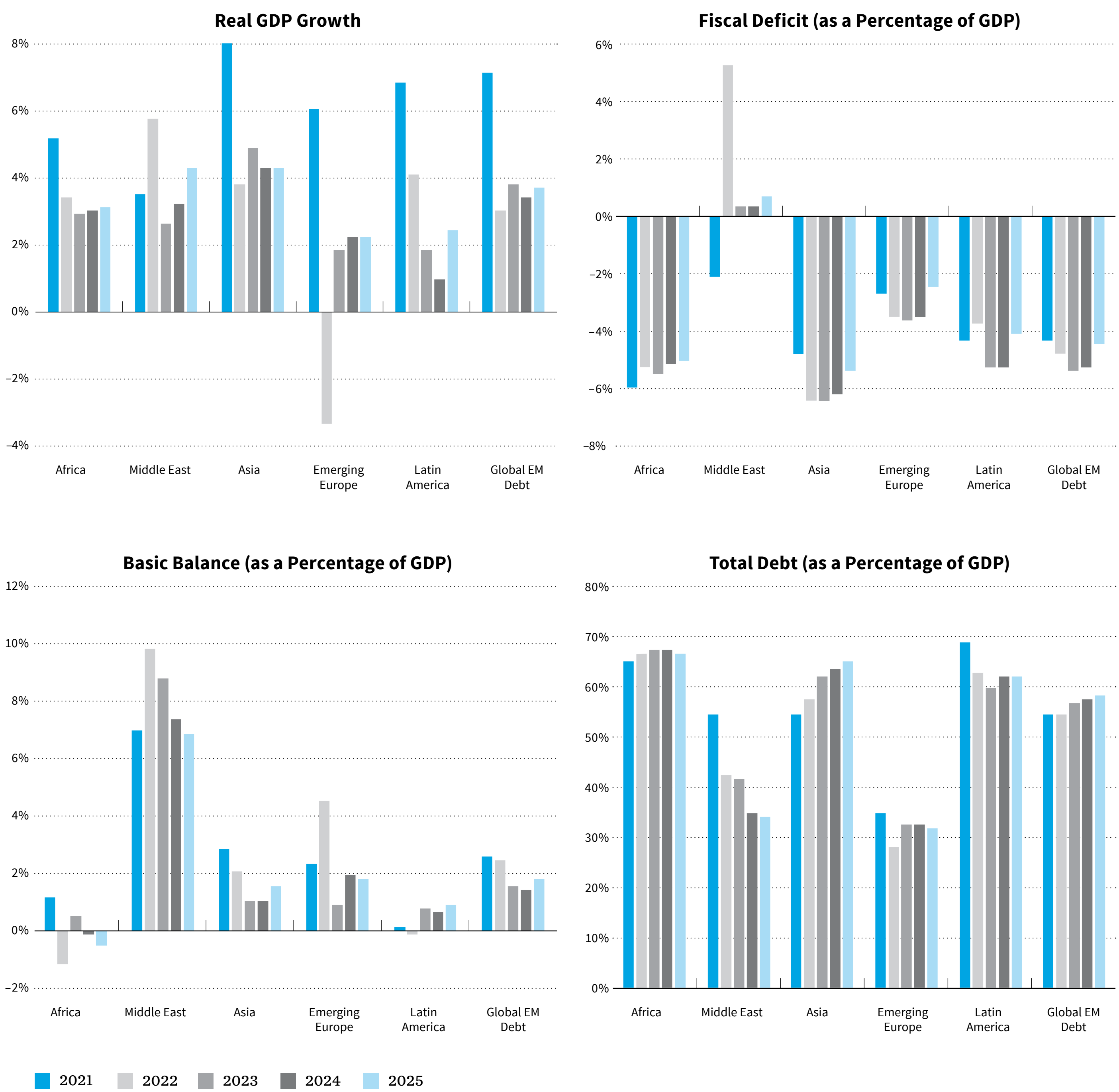
In industrial metals, we believe prices should remain supported by the green demand dynamic at play in China, Europe, and the United States, with these countries moving ahead with their energy transition plans. Supply increases should also moderate next year in most metals due to lack of new projects and low profitability.

1 OPEC+ refers to the Organization of the Petroleum Exporting Countries (OPEC) and its allies, including Russia.

EXHIBIT 9

Resilient Growth Stabilizes Credit Metrics

We believe the overall fiscal deficit in 2024 will be approximately –5.24% of EM GDP, marginally lower than last year's number.



Sources: Oxford Economics and William Blair, as of November 30, 2023. Methodology is GDP-weighted (based on the JP Morgan EMBIGD).

A Positive Influence in China

In China, an important driver of sentiment given the country's strong economic and financial links to the EM world, the proactive policy easing measures implemented in the second half of 2023 helped set a floor for growth expectations in the coming year. Please see our China section on page 19 for more details.

A Solid Financial Sector

In the EM financial sector, we believe earnings have peaked as top-line growth has leveled off. Monetary policy easing in most major EMs is likely to pressure banks' revenues as assets reprice at lower rates, although the impact could be mitigated by lower funding costs. Asset-quality metrics are expected to be broadly stable, but we see risks skewed to the downside in some jurisdictions due to myriad country-specific factors, including stress in certain sectors, macroeconomic imbalances, weather effects, and elevated household debt. Still, we expect capitalization to remain solid as we do not see loan growth significantly picking up into next year.

Technical Conditions and Valuations Support EM Debt

Overall, we anticipate a benign global macro backdrop and solid EM credit fundamentals underpinning a positive outlook for EM debt in 2024—a change from 2023.

In 2023, we saw substantial outflows from dedicated EM debt portfolios as investors shied away from asset classes sensitive to interest-rate duration risk. However, the market impact from sizable outflows was attenuated by muted activity in the primary market. Unfavorable financing conditions caused by rising interest rates led to another year of negative new net debt issuance, resulting in more balanced supply-and-demand dynamics in the marketplace.

We believe market technical conditions should gradually improve as developed market central banks approach the end of their monetary tightening cycles. We anticipate inflows to dedicated EM debt portfolios in 2024 as investors look for opportunities to increase interest-rate duration exposure to potentially benefit from attractive real and nominal yields. And, while we expect a pickup in activity in the primary bond market, we believe net debt issuance should remain in negative territory (in both the sovereign and corporate credit spaces) as issuers seek alternative sources of funding. High investor cash levels, defensive positioning, and multiyear-low foreign ownership of EM local bond markets should also add to a more constructive technical picture in 2024, in our opinion.

> "We believe EM debt valuations continue to overcompensate investors for credit risks, currency and local rate risks, and volatility."
>
> **Marcelo Assalin, CFA, Partner**

Additionally, we believe EM debt valuations continue to overcompensate investors for credit risks, currency and local rate risks, and volatility, and currently offer attractive value to investors with a medium- to long-term horizon and who have a willingness to tolerate a period of higher volatility.

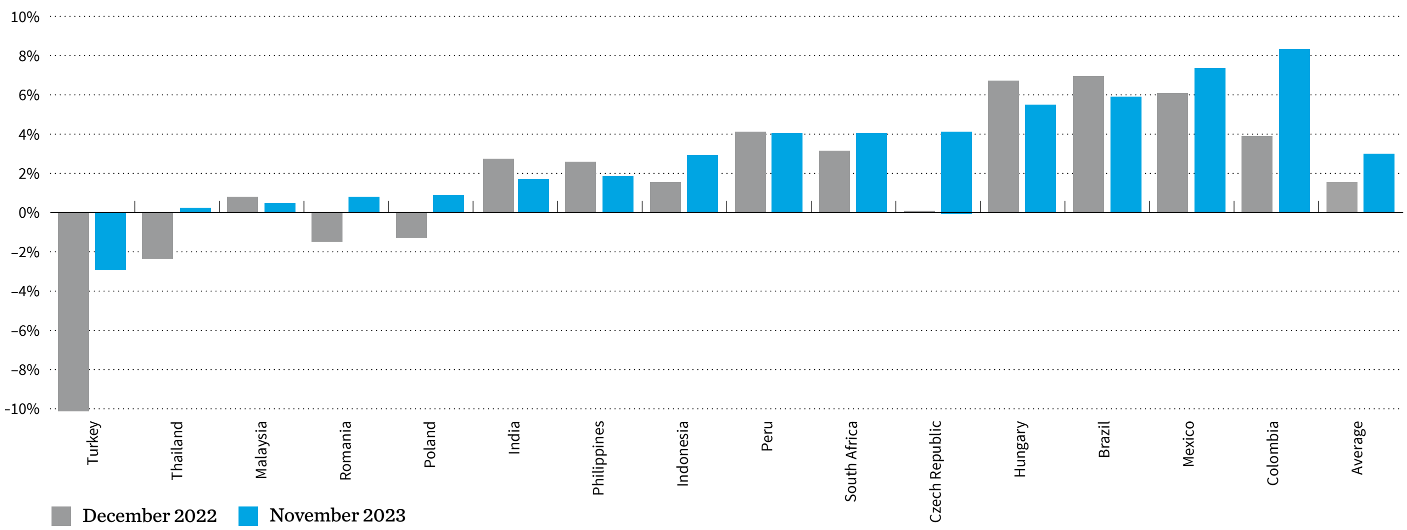
EM debt credit spreads appear compelling on both an absolute and relative basis, with current levels remaining wider than their historical levels. While EM sovereign high-grade credit spreads appear unattractive, high-yield credit spreads appear compelling, particularly relative to U.S. corporate high-yield levels. In the distressed credit space, we believe current prices continue to overestimate the probability of credit default and underestimate potential restructuring and recovery values.

For the local currency universe, headwinds of tighter Fed policy and a stronger dollar have eased while interest rates in EMs remain elevated. Indeed, while several EM central banks have begun to loosen monetary policy, inflation has fallen faster than rates, leading to a widening of real interest rates. With valuations in dollar terms little changed over the past year, the relative attractiveness of EM currencies against their developed market counterparts has risen substantially. We see further scope for modest currency appreciation over the coming year, led by high-beta countries.

EXHIBIT 10

Real Yields Have Risen as Inflation Has Fallen

While several EM central banks have begun to loosen monetary policy, inflation has fallen faster than rates, leading to a widening of real interest rates.



Sources: Bloomberg and William Blair estimates, as of November 21, 2023. Real yield calculated as implied 3-month FX forward yield less Q4 2024 forecast CPI.

For local rates, the backdrop is similar, albeit with the caveat that outperformance in recent quarters has eroded valuations somewhat when compared to foreign exchange (FX). We see further scope for curve flattening, however, and expect strong price momentum to bolster interest returns. With global growth slowing and inflation returning quickly to central bank targets in most countries in the benchmark index, we believe there is further scope for monetary easing and investor rotation from equities to bonds.

Opportunities in Hard Currency EM Debt

We have a constructive outlook for hard currency EM debt.

To start, multilateral support to EMs remains strong, and we believe it will make a meaningful contribution to external funding.

The International Monetary Fund (IMF) appears set to continue expanding its support to EMs in a number of ways: continuation of increased access limits (as agreed in March 2023); a 50% increase in member quotas in December 2023 (under the 16th General Review); the replenishment of the Poverty Reduction and Growth Trust (from which 0% loans are financed); and further engagements with sovereigns under additional programs and instruments. The combination of these factors has the potential to substantially boost the financing beyond the $192 billion committed by the IMF under existing programs for EMs within our universe, of which $137 billion is yet to be disbursed.

Meanwhile, the World Bank continues to engage across our universe, providing critical financing to development expenditures through inter alia project financing for infrastructure development and direct budget support (under its development policy financing tool).

Bilateral development partners are also becoming more diverse, increasing support from the Middle East to countries in our universe.

> “We continue to see scope for fundamental differentiation, and prefer countries with easier access to multilateral and bilateral funding, particularly in the EM frontier and distressed space.”

Marcelo Assalin, CFA, Partner

In our opinion, hard currency EM debt returns should be driven predominantly by lower underlying U.S. Treasury yields (duration) and carry, while credit spreads should remain relatively stable.

We believe the global market environment will be conducive to the outperformance of high-beta, high-yield credit, and we continue to position our portfolios for high-yield/investment-grade spread compression.

We also continue to see scope for fundamental differentiation and prefer countries with easier access to multilateral and bilateral funding, particularly in the EM frontier and distressed space.

Opportunities in EM Corporate Credit

We believe EM corporate credit could enter 2024 with normalizing default expectations and diverse yet resilient fundamentals.

The impact of higher-for-longer interest rates should become more apparent in the fundamental credit quality of EM corporate issuers in the next year. However, despite some deterioration in leverage metrics in 2023, these metrics remain better than those of developed market credit and are likely to level off into next year. While coverage metrics should, in theory, deteriorate, it will likely depend on the composition of debt. Most issuers in the universe locked in longer fixed-term rates, and some could even experience a competitive advantage due to relatively lower interest costs in the near term.

All things considered, EM corporate credit has continued to exhibit a combination of differentiated fundamental drivers, favorable supply technical conditions, and attractive relative valuations to select sovereign curves.

Even as rates have risen and refinancing concerns have moved front and center, many issuers have medium-term, low-rate fixed maturities, allowing them to ride out the current rate volatility without major deterioration to credit quality.

We see select opportunities in the EM corporate credit space and are seeking investment opportunities where credit fundamentals and attractive spreads coincide. Short-maturity bonds have outperformed, but opportunities in longer bonds are beginning to appear. We continue to focus on issuers with low refinancing needs, robust balance sheets, and positive credit trajectories.

Opportunities in Local Currency EM Debt

In local markets, one of the highlights of the past year has been the resilience of currencies to rising U.S. interest rates and higher U.S. Treasury volatility. This is indicative of light positioning among investors, lower external funding requirements among benchmark index countries, and a much-improved outlook for EM growth and macro balance sheets compared to developed market counterparts.

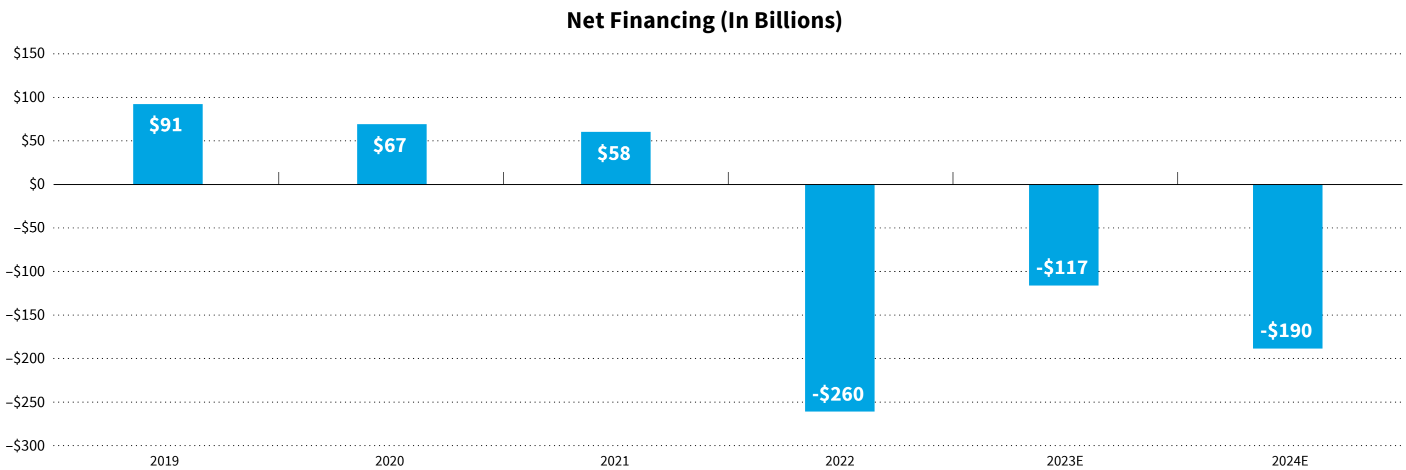
We expect this macro backdrop to remain largely in place, with EM growth slowing below potential levels but not slipping into recession, inflation returning to target, and investor flows providing a tailwind to asset prices.

In our opinion, high-beta countries should see rapid monetary easing, which could support these trends in the coming quarters. At the same time, an easing of global liquidity conditions should benefit frontier markets seeking external funding, in our opinion.

EXHIBIT 11

EM Corporates Are Reducing Overall Debt

Net financing—the amount of new borrowing by corporates minus the principal repayments on existing debt—is negative, meaning the corporate sector is reducing its overall debt.

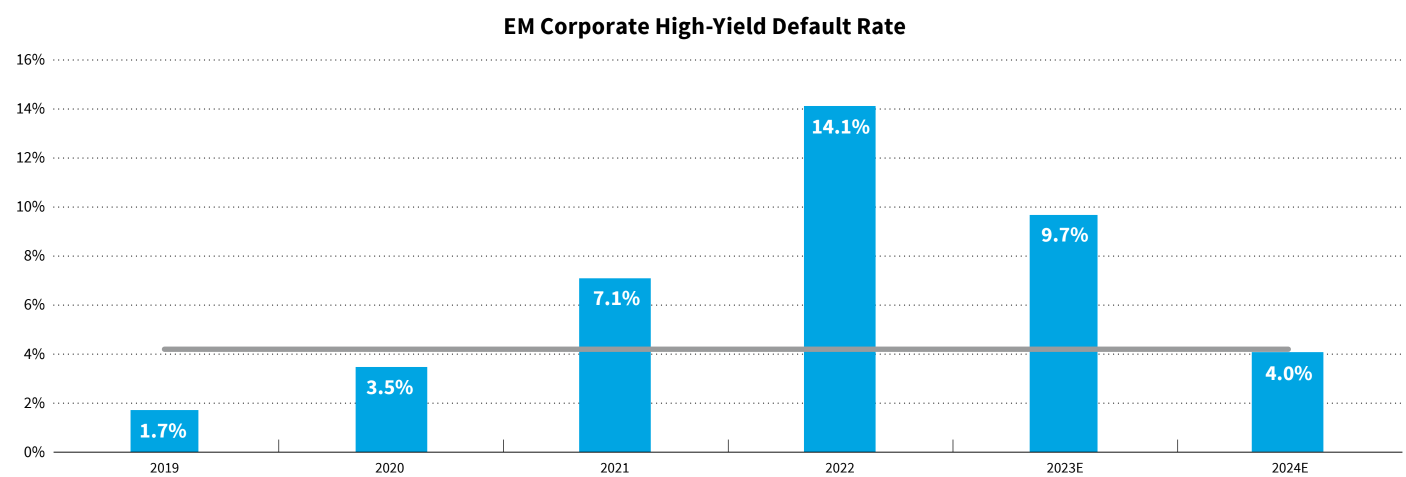


Sources: JP Morgan and William Blair, as of 2022. Data refers to the EM corporate hard-currency asset class, which is a broader universe than the index-eligible securities.

EXHIBIT 12

Corporate Default Rates Expected to Decline in 2024

Despite refinancing concerns moving front and center, many issuers have medium-term, low-rate fixed maturities, which may allow them to ride out the current rate volatility without major deterioration to credit quality.



Sources: JP Morgan and William Blair, as of 2022. Data refers to the EM corporate hard-currency asset class, which is a broader universe than the index-eligible securities. Horizontal line refers to the long-term average default rate (between 2000 and 2022).

Risks

While we have a high level of conviction in our constructive 2024 outlook, there are a few downside risks to our optimistic outlook.

We believe the Fed has reached the end of its hiking cycle and will start cutting policy rates at some point in the second half of 2024. However, keeping monetary policy conditions too tight for too long could result in a policy mistake that could lead to a U.S. recession.

Geopolitical tensions are also likely to continue to weigh on investor sentiment. The unresolved Russia/Ukraine conflict, instability in the Middle East, and tensions between China and Taiwan all have risks of escalation.

However, it is important to remember that there have always been potential incidents that could act as disruptors, and the current set of risks are already well known and perhaps fully priced by the markets already. We will nevertheless monitor all these risks very closely.

"There have always been potential incidents that could act as disruptors, and the current set of risks are already well known and perhaps fully priced by the markets already."

Marcelo Assalin, CFA, Partner

China | Restarting Economic Growth

Vivian Lin Thurston, CFA, Partner
PORTFOLIO MANAGER,
EM AND CHINESE EQUITIES

Clifford Chi-wai Lau, CFA
PORTFOLIO MANAGER, EM DEBT

China's government is finally moving to stimulate the economy after its sluggish post-COVID reopening. The country faces a slew of problems including low consumer confidence, plummeting property sales, and high youth unemployment. Even if the government succeeds in reviving the economy, investors may have to come to terms with structurally lower growth, a backdrop that calls for a much more selective approach to China's equity markets.

Why did the Chinese economy not rebound as expected after the post-COVID reopening in December 2022? What is your outlook for China's economic performance in 2024?

Vivian: The main reason China hasn't followed the post-COVID path of other countries is that consumer and business confidence is at an all-time low. This is understandable. The country was in lockdown for four years, longer than the rest of the world, and then saw a series of stop-start openings.

In addition, many Chinese tie their wealth to their property holdings, and property markets have experienced a severe downturn, with new home floor-space sales down 20% to 30% in 2023 following a 30% to 40% decline in 2022. This has created a negative wealth effect.

Weak employment and income recovery post-reopening has further exacerbated low confidence levels. The propensity to consume has been severely curtailed, and people have kept saving instead of spending.

The lack of a government stimulus has also not helped. In a confidence-led downward spiral, you need money to come in and jumpstart the real economy. It was not until recently that the government came out with a meaningful stimulus—a 1 trillion renminbi package announced in October 2023.

The absence of effective countercyclical measures over the past year is partly explained by the fiscal weakness of local governments. Their finances were damaged by the huge cost of managing COVID and the decline in land sales, which tend to be the biggest source of local government revenue. Another factor is a marginal shift of leadership's focus away from economic growth toward structural reforms. And, of course, the Chinese economy is just bigger now, which makes it harder to stimulate.

Our view is that we are now at a cyclical bottom and will see a gradual economic recovery as stimulus flows through and as the base effect, or year-ago comparison, gets more favorable.

Clifford: I agree with this. At the time of this writing, it looks as if we are still on track to achieve 5% GDP growth in 2023. At the same time, we see many pockets of weakness.

Manufacturing has been disappointing. The service sector is expanding, but at a slow pace. Exports have dragged, partly due to a soft global economy. Fixed asset investment has been weak. Private investors, domestic and global, appear to be concerned about regulatory risk. We think this is behind us, but it takes time to rebuild confidence. Credit demand has also been weak, especially demand for longer-term credit, reflecting a lack of confidence. But the numbers are slowly improving after government efforts to boost the demand side of the property market, which include cutting mortgage rates and reducing banks' reserve requirement ratios.

The 1 trillion renminbi stimulus package could be a game-changer, but there are a lot of holes to fill. One of those holes is a looming crisis in local government financing vehicles (LGFVs), which are private companies that borrow money from investors to fund local government initiatives. LGFVs' indebtedness could become a systemic risk if it is not carefully handled. It has grown too big for the central government to address with just a "debt-to-equity-swap" solution. It could weigh on economic growth for some time.

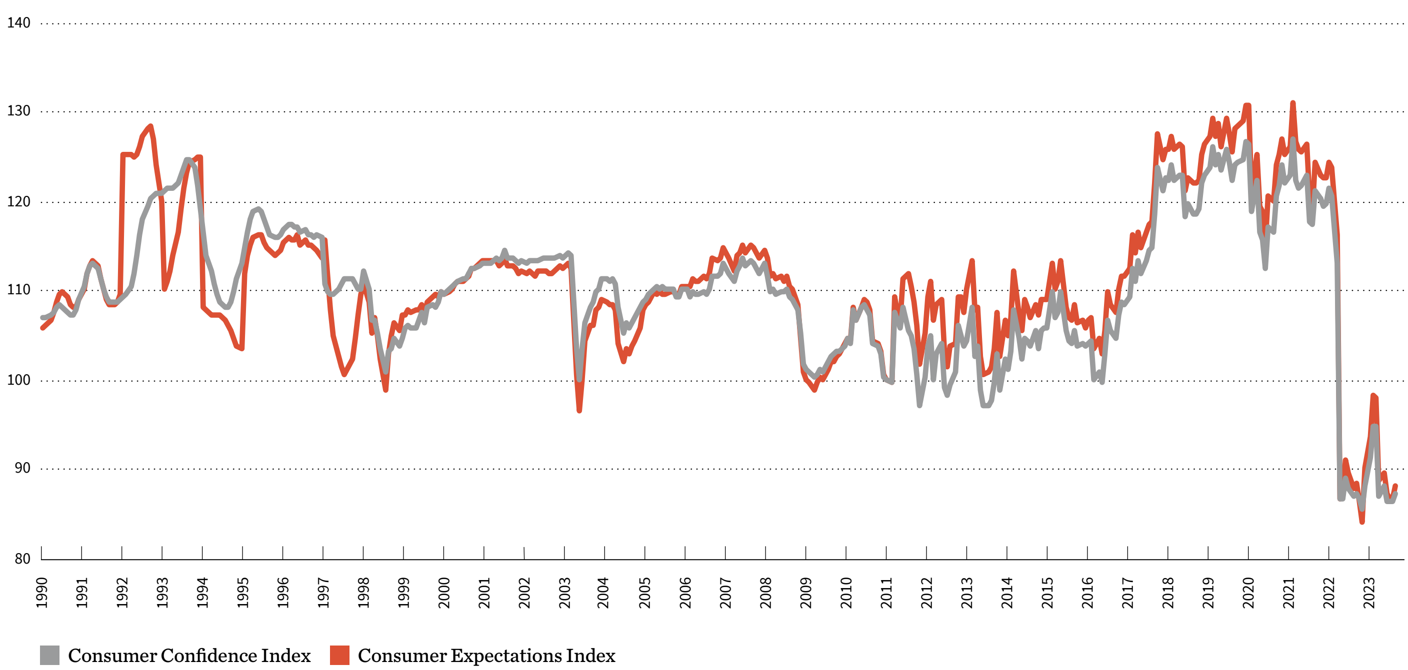
Despite all this, we expect the economy to perform better in 2024 because it will be coming off such a weak base.

> "The 1 trillion renminbi stimulus package could be a game-changer, but there are a lot of holes to fill."
>
> **Clifford Chi-wai Lau, CFA**

EXHIBIT 13

China's Consumers Lose the Will to Spend

Consumer confidence is at a record low in China after four years of COVID lockdowns, collapsing property sales, falling income, high unemployment, and other adverse events. We believe the consumer sector will be key to the recovery of the Chinese economy.



Sources: NBS, UBS, and William Blair, as of September 2023. The Consumer Confidence Index (CCI) and the Consumer Expectations Index (CEI) in China provide insights into consumer attitudes and expectations about the economy. The CCI reflects the overall confidence of consumers in the economic situation. The CEI focuses on consumers' expectations for the future.

How will the 1 trillion renminbi stimulus package be deployed?

Vivian: In late October, China announced it will issue 1 trillion renminbi in special central government bonds and transfer the funding directly to local governments to support infrastructure investments and post-disaster recovery amid recent floods in certain areas. The first tranche, 500 billion renminbi, will be disbursed and deployed by the end of 2023 and the rest in 2024.

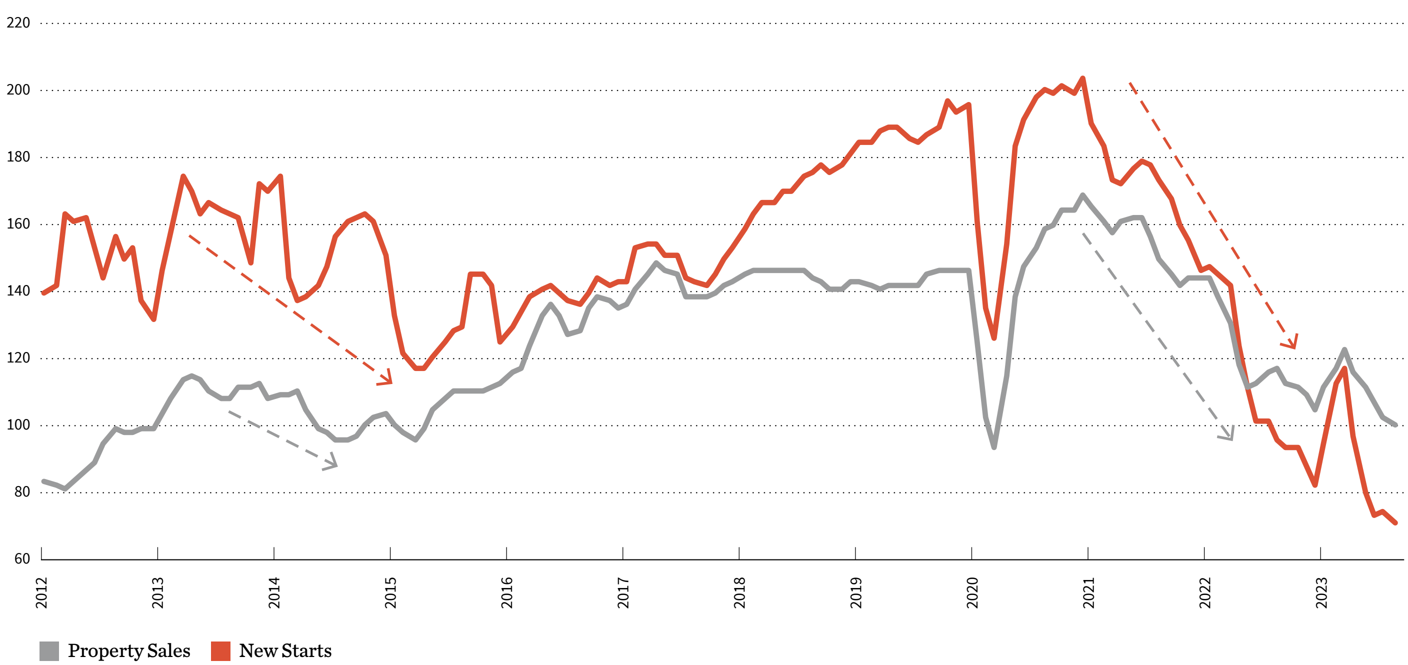
The magnitude of this stimulus package and its fast deployment indicate the government's determination to stabilize the economy. This stimulus should help strengthen local governments' fiscal stability, stimulate the real economy, and repair consumer and business confidence, although the impact could be more gradual.

Clifford: To be clear, the government is not aiming to use stimulus money to directly support the property market. It is trying to address the fallout from local governments being so dependent on land sale revenues in the past. Property market support will likely be second order and include lowering mortgage rates, redefining mortgage terms, and granting preferential credit. It is not the government's priority to protect struggling property developers from their creditors.

EXHIBIT 14

China's Property Bubble—Deflation Continues

Property sales in China have been in steep decline since 2021. The contagion has spread to include both new and existing home sales.



Sources: CEIC, UBS estimates, and William Blair, as of August 2023. China property sales refer to million square meters of floor space, seasonally adjusted, three-month moving average.

How has the semiconductor industry in China been affected by U.S. government efforts to restrict its access to advanced technology? How should investors assess this risk?

Vivian: The recent U.S. executive order was aimed at preventing China from advancing in three key fields with national security implications: semiconductors, artificial intelligence, and quantum computing. One major move has been to block China's access to high-performance semiconductor chips and related semiconductor equipment. The U.S. has been sanctioning and restricting China's technology advancement for some time and has steadily tightened restrictions to capture not just cutting-edge technology but a much wider range of technologies.

However, many Chinese companies have continued to push forward and even accelerated their pursuit of technology advancement by already producing advanced chips. While sentiment on this issue is negative, the real impact on Chinese companies is probably less than people expect. It will likely be felt more by global technology companies who supply China.

How should investors assess geopolitical risk in Chinese asset markets considering recent developments, like the heightened U.S.-China tensions and China's "no-limits" relationship with Russia?

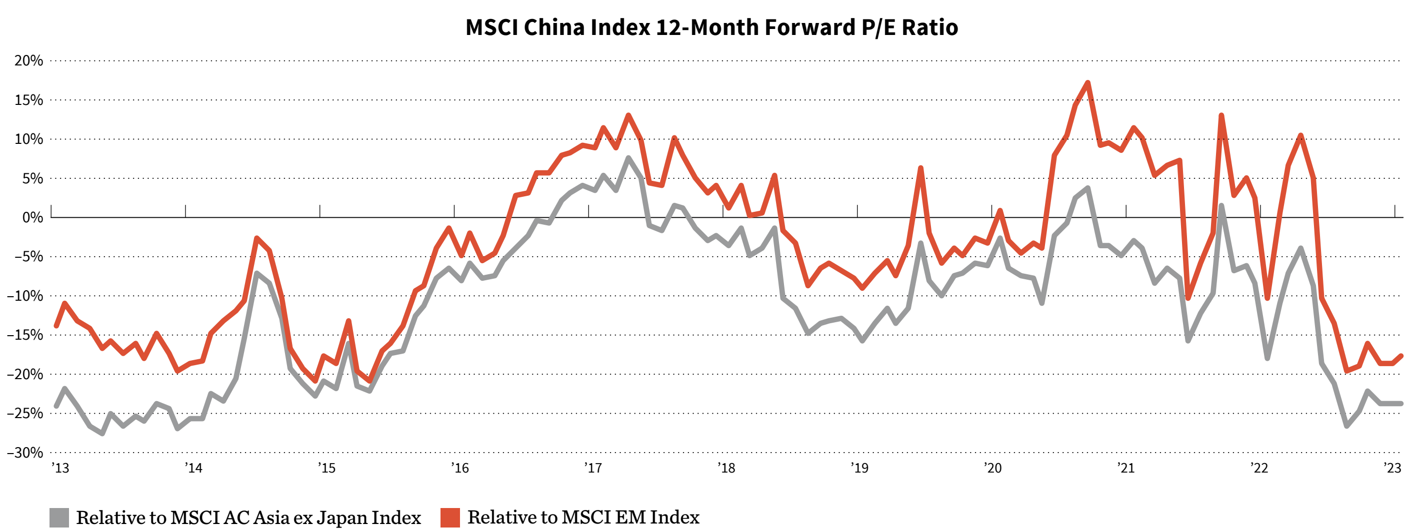
Vivian: Global investor sentiment towards China deteriorated in 2023. The United States and China are strategic competitors and that is unlikely to change. With every passing year, it plays out in different ways, but from an investor perspective, sentiment seems to be getting worse.

This shows up in a rising Chinese equity risk premium. Chinese equities derated tremendously in 2023. It was partly due to the cyclical downturn and partly due to lingering structural issues, but it was also due to increased geopolitical concerns. As a result, the discount rate, or risk premium, for Chinese equities is higher. That could be hard to reverse without the improvement of any of the three factors mentioned above.

EXHIBIT 15

China's Rising Equity Risk Premium

Chinese equities have derated significantly and the country's equity risk premium has risen. Given lingering structural issues and heightened geopolitical concerns with no end in sight, this could be hard to reverse.



Sources: Bloomberg and William Blair, as of October 2023.

What should equity investors be looking for in 2024? Which parts of the Chinese economy seem the most attractive for quality growth investors?

Vivian: We have seen value strongly outperform growth for the past two years, given the weak and uncertain growth outlook of the Chinese economy, rising interest rates globally, and a risk-off mentality amid geopolitical risks and conflicts. This is a challenging backdrop for quality growth investors. Although it is difficult to predict how this environment will shift, we continue to find and look for attractive companies and stocks with idiosyncratic drivers. As China's economic growth structurally decelerates, we believe Chinese equity investment is becoming more of a bottom-up, stock-picking play than a top-down beta play.

The consumer segment will be critical as we look to 2024. If consumption revives and retail sales recover, this could be a bright spot, especially for companies with pricing power, strong brand positioning, and an unchanged structural growth story.

In industrials, high-end manufacturing continues to look attractive. Some sub-industries experienced near-term slowdowns linked to weaker end-markets in electric vehicles, green energy, and semiconductors, but they are structurally strong. On the other hand, industrial machinery is more of a cyclical recovery story. It has a natural replacement cycle that was interrupted during COVID, so there is pent-up demand.

In tech hardware, the Chinese semiconductor industry is seeing improved fundamentals after a down cycle in the last couple of years. This was primarily due to weakness in end-demand for consumer electronics and smartphones driven by a poor product cycle (similar to global smartphone markets), sanction-led supply constraints, and reduced consumer confidence and purchasing power as a result of prolonged COVID lockdowns.

However, as third-quarter results come in, we are seeing early signs of a sequential order recovery and cycle bottoming. Over the long term, we believe the Chinese domestic semiconductor industry remains attractive, driven by structural share gains of domestic players considering their technology advancements.

> "The consumer segment will be critical as we look to 2024."
>
> **Vivian Lin Thurston, CFA, Partner**

Equity market performance in 2024 will depend on economic recovery, in our opinion. Many factors will need to align—confidence must improve, income to lower urban population groups must recover, and property markets must stabilize. In addition, employment needs to rise, especially youth employment, which has been depressed by both weakness in the service sector due to an anemic economic reopening and in the internet industry due to regulatory measures.

What is the outlook for China's bond market in 2024? Where do you see the best opportunities for fixed income investors?

Clifford: Our bond-market view is driven by our outlook for China's economic growth. We expect it to be better going forward, but not dramatically so. As a result, interest rates are unlikely to rise significantly. If anything, the government has reason to maintain low interest rates to keep financing costs affordable. Similarly, inflation does not seem to be a risk based on the latest numbers.

When it comes to investing in the Chinese bond market, we believe you must look at it in relative terms. At the time of this writing, the benchmark 10-year Chinese government bond is trading below 2.7%, whereas the U.S. Treasury 10-year bond has moved up to the mid- to high-4% range. That is more than 200 basis points of negative carry for a dollar-based investor.

We see little opportunity for capital gain other than miniscule carry gain, given China's low interest rates. That leaves the currency element as a source of potential profit for global investors. But we don't see major upside in the renminbi—the 12-month forward implied yield of CNH (the offshore renminbi) is less than 3%.

Perhaps one of the best opportunities could be for funds that deal in distressed debt. Most of the Chinese distressed property bonds are trading at single cents on the dollar. If there is some major turnaround in the Chinese property market, it is possible to imagine appreciation from these low levels leading to outsized benefits for investors.

But we aren't anticipating that the government will try to revive the property sector. In our opinion, it is more likely that it will continue to let the sector consolidate and de-lever in a market-driven way.

> "Perhaps one of the best opportunities could be for funds that deal in distressed debt."
>
> **Clifford Chi-wai Lau, CFA**

Final Takes

Olga Bitel, Partner

GLOBAL STRATEGIST

If the Fed adjusts its “neutral” monetary policy stance to be in line with meaningfully lower inflation and does so in a timely manner, and if the ECB follows suit in Europe, the world’s principal demand centers can maintain modest but sustainable economic growth in 2024. In that case, risk assets could continue to perform well, in our opinion, although perhaps less well in aggregate than in 2023. In other words, 2024 may be the first year of “normal” economic expansion post-COVID.

Todd McClone, CFA, Partner

PORTFOLIO MANAGER, EM EQUITIES

In addition to providing an attractive valuation environment, we believe EMs are the most efficient way to access some of the world’s most powerful secular themes: India’s emerging middle class, surging demand for artificial intelligence, and the near-shoring of supply chains.

Marcelo Assalin, CFA, Partner

HEAD OF EM DEBT

Over the past couple of years, the sharp adjustment of policy rates around the world has weighed on fixed income, and proved particularly challenging for EM debt. But after a few years of lackluster investment performance, we anticipate a strong 2024 for the asset class.

Vivian Lin Thurston, CFA, Partner

PORTFOLIO MANAGER, EM AND CHINESE EQUITIES

It’s clear that Chinese equity investing is no longer a beta story as China’s economy is decelerating and geopolitical risks are rising. We believe this backdrop calls for a highly selective approach to finding quality growth companies in sectors that can overcome the structural and cyclical headwinds.

Clifford Chi-wai Lau, CFA

PORTFOLIO MANAGER, EM DEBT

Investing in the Chinese property bond market is challenging, but we see light at the end of the tunnel. Although the opportunity set has narrowed significantly, we expect surviving developers to be less levered and more cautious about their future development, resulting in a healthier investment environment.

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William Blair is committed to building enduring relationships with our clients. We work closely with private and public pension funds, insurance companies, endowments, foundations, and sovereign wealth funds, as well as financial advisors. We are 100% active-employee-owned with broad-based ownership. Our investment teams are solely focused on active management and employ disciplined, analytical research processes across a wide range of strategies, including U.S. equity, non-U.S. equity, and emerging markets debt. William Blair is based in Chicago with global resources providing expertise and solutions to meet our clients' evolving needs.

The **DAX** is a stock market index consisting of the 40 major German blue chip companies trading on the Frankfurt Stock Exchange. The **FTSE MIB Index** is the primary benchmark index for the Italian equity market and represents the large cap component of the FTSE Italia All-Share Index. The **IBEX 35** is the benchmark stock market index of the Bolsa de Madrid, Spain's principal stock exchange. The **J.P. Morgan EMBIGD** tracks the total return of U.S.-dollar-denominated debt instruments issued by sovereign and quasi-sovereign entities. (Index information has been obtained from sources believed to be reliable but J.P. Morgan does not warrant its completeness or accuracy. The indices are used with permission. The indices may not be copied, used, or distributed without J.P. Morgan's prior written approval. Copyright 2020, JPMorgan Chase & Co. All rights reserved.) The **MSCI All Country (AC) Asia ex Japan Index** captures large- and mid-cap representation across two of three developed markets (excluding Japan) and eight emerging markets in Asia. The **MSCI China Index** captures large- and mid-cap representation across China A shares, H shares, B shares, Red chips, P chips and foreign listings (such as ADRs). The **MSCI Emerging Markets (EM) Index** captures large- and mid-cap representation across 27 EMs. The **MSCI Emerging Markets (EM) Investable Market Index (IMI)** captures large-, mid- and small-cap representation across 27 EMs. The **MSCI India Index** captures the large- and mid-cap segments of the Indian market. The **MSCI World Index** captures large- and mid-cap representation across 23 developed markets. The **MSCI World Banks Index** is composed of large- and mid-cap stocks across 23 developed markets countries. All securities in the index are classified in the banks industry group (within the financials sector) according to the Global Industry Classification Standard (GICS). The **Standard & Poor's (S&P) 500 Index** tracks the performance of 500 large companies listed on stock exchanges in the United States. The **Tokyo Price Index (TOPIX)** is a metric for stock prices on the Tokyo Stock Exchange (TSE). Index performance is provided for illustrative purposes only. Indices are unmanaged and do not incur fees or expenses. A direct investment in an unmanaged index is not possible.

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