CITY OF LONDON
Investment Management Company Limited

Emerging Markets Quarterly Outlook

July 2022*

Overview

A High-Risk World

Macro risks have multiplied and intensified on many fronts over the past quarter: the risk of recession, of higher and more persistent inflation and of sharper interest rate hikes. In addition, commodity prices could yet spike again if China rebounds or Russia 'weaponizes' its energy exports. For EM, this makes for a difficult environment. Its best hope is a recovery in Chinese growth.

In an environment of heightened uncertainty, investors are responding to changes in data with sharp swings in asset prices. In particular, having priced in successively higher terminal interest rates for the US throughout Q1 and most of Q2, investors now appear convinced that the imminent economic slowdown will be sufficiently pronounced to slow inflation and thus reduce the need for aggressive Fed tightening. As a result, the peak in the policy rate is now seen at 3.7% by February 2023, and is expected to decline to 3.0% by January 2024 as the Fed would try to avert too sharp a recession. A corollary of the changed market outlook has been a sharp drop in commodity prices (e.g. oil, copper and wheat) by ca. 30% from their recent peak. This has implications for emerging markets, which generally trade large amounts of raw materials (either as inputs, exports, or both). Yet, the recent decline in commodity prices does not reflect an improvement in fundamentals - such as an increase in supply - but instead a shift in speculative positions in anticipation of a recession. As such, they are apt to reverse if oil exports were to be 'weaponized' by Russia or a Chinese rebound increased demand for raw materials.

Despite the harsh global downdraft in the form of fading demand and tightening financial conditions, there are some positive factors supporting emerging markets. Because of higher inflation and lower central bank credibility, EMs have engaged in monetary tightening cycles much earlier than DMs, in some cases up to one year before. This may also allow some of them to exit their cycle sooner, supporting growth. Indeed, the IMF forecasts that the EM/DM growth differential, which had dwindled to below one percent during the pandemic, is set to revert to its long-term average of 3.6% points in favour of EM. In addition, while a stronger dollar (weaker EM currencies) raises the cost of debt servicing for EMs, it also makes their manufactured exports more competitive. Finally, despite the strong headwinds for EM, the asset class outperformed its developed market counterpart by 2.9% points during H1 2022.

Market Strategy: Since our last quarterly publication, inflation has surprised to the upside, markets have upped their expectations for rate hikes and have begun to price in an early Fed 'pivot' towards rate cuts from February 2023. A corollary is a heightened risk of recession that will help quell, if not quench, inflation. We expect a scenario of a prolonged slowdown, possibly morphing into a recession, and accompanied by decelerating inflation, albeit still at a multiple of target levels. However, we also believe that policy rates will need to rise higher than currently priced in by markets.

The main counterpart to this gloomy scenario is a potential economic rebound in China as authorities may shift their emphasis on regulation, de-leveraging and equal distribution towards a focus on growth, which is currently on track to sharply underperform the official target. This suggests a world economy that will become increasingly de-synchronized and - as de-globalization advances – also more fragmented. The flipside of this is that it opens the door for opportunities through judicious country selection.

If China's rebound materializes – as is our assumption, to a limited extent – it will provide additional support to commodity prices. We previously oriented our allocation along commodity lines in the wake of Russia's invasion of Ukraine. We now refine it further as the first knee-jerk effect has passed:

- We downgrade **Brazil** from *overweight* to *neutral* as the presidential election approaches and fiscal policy has embarked on a less sustainable path;
- We downgrade **Mexico** to *underweight* as its economy is likely to suffer the effects of the US slowdown/recession;
- We upgrade **China** to *overweight* as it is tempering its regulatory crackdown and appears increasingly willing to counteract the growth slowdown currently underway.

EM Country Allocation

	Chg	-2	-1	0	+1	+2
Asia						
China	↑				■	
South Korea	-		■			
Taiwan	-			■		
Malaysia	-					■
Indonesia	-				■	
Philippines	-	■				
Thailand	-		■			
Vietnam	-					■
India	-		■			
Latin America						
Brazil	↓			■		
Mexico	↓		■			
Europe, Middle East and Africa						
Turkey	-	■				
Saudi Arabia	-			■		
South Africa	-					■

Note: Up/down arrows indicate a positive/negative change in our asset allocation compared to the previous quarterly outlook. A dash indicates no change. *Source: CLIM*

**The publication reflects asset performance up to 30 June, 2022, and macro events and data releases up to 13 July, 2022, unless indicated otherwise.*

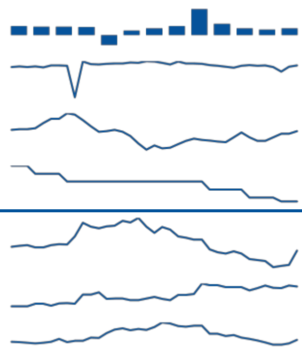
Asia

China

Overweight (↑)

A phasing out of mobility restrictions, rising chances of policy support and an incipient recovery support China.

	3Y history	Latest	
GDP, % yoy		4.8	Q1
PMI, index		50.2	Jun
CPI, % yoy		2.5	Jun
Policy rate, %*		11.25	Jun
MSCI China**		14.9%	Q2
EPS, % yoy		10.7	Jun
12M Forward P/E		12.0	Jun



**Required Deposit Reserve Ratio for Major Banks.*
***US$ total return relative to MSCI EM.* *Source: Bloomberg*

China's policy priorities appear to be shifting again and with them, the way markets are perceiving the outlook. Given the sharp slowdown due to the mobility restrictions imposed earlier this year, private growth forecasts had dropped below 4% for 2022, significantly below the official 5.5% target. In tacit recognition of weak domestic activity, authorities appear to de-emphasize the 2021 focus on financial stability, regulation and de-leveraging, recalibrating policy towards growth. Indeed, the PBoC has gingerly begun to ease its monetary stance across a variety of instruments, while the government announced an Rmb800bn credit line for policy banks to promote infrastructure-related lending, initiated another Rmb300bn financial lending instrument for major infrastructure projects and front-loaded Rmb1.5trn of local government bond issuance originally scheduled for 2023.

As the government eased lockdown requirements for Shanghai and other cities, it also halved the quarantine period for inbound travellers as well as the mandatory self-isolation requirement for those who have come into close contact with infected individuals to one third of the previous requirement (although some regions have also tightened testing-and distancing measures).

The first signs of recovery were already apparent in the June data that reinforced the message from May: manufacturing PMIs rebounded strongly, with the output component of the Caixin index jumping a sharp 13.2 points to 56.4.

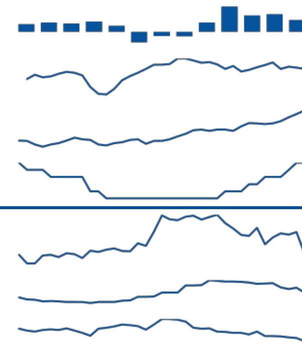
Market Strategy: The Biden administration is mulling a partial easing of tariffs on China in an attempt to thaw relations after the stand-off in the wake of Russia's Ukraine invasion. This adds another potential positive as China comes back into favour after last year's sharp sell-off, although valuations still appear unattractive, reflecting weak earnings expectations, with the forward P/E ratio for MSCI China significantly above its historical premium to EM. Overall, we believe there are upside risks and move our allocation to *overweight*.

South Korea

Underweight

The slowdown in the semiconductor sector and tight monetary policy will likely act as a drag on equities.

	3Y history	Latest	
GDP, % yoy		3.0	Q1
PMI, index		51.3	Jun
CPI, % yoy		6.0	Jun
Policy rate, %		2.25	Jul
MSCI South Korea*		-9.5%	Q2
EPS, % yoy		14.0	Jun
12M Forward P/E		8.3	Jun



**US$ total return relative to MSCI EM.* *Source: Bloomberg*

South Korea's economy started the year on a strong footing, with GDP expanding by 3% yoy in Q1. But the outlook for the economy has softened recently on the back of slower growth in China and the growing risk of a US recession, South Korea's two biggest trading partners. Additionally, the combination of a supply glut and waning demand for chips, as reflected in the 53% yoy increase in South Korea's domestic chip stockpiles in May, suggests a slowdown in revenue growth in the all-important semiconductor sector. Consensus expects GDP growth to slow from 4.3% yoy in 2021 to 2.7% yoy this year.

Headline inflation surged to 6.0% yoy in June, driven by a weaker won, higher energy prices and the reopening of the service sector. The central bank (BoK) continued its tightening cycle by raising rates by 25bps at both their April and May meeting, followed by a historic 50bps hike in July. The market is pricing in a further 100bps tightening during this cycle. But with household debt-to-income at 171%, the BoK is likely to be cautious of the burden on debtors. As a result, the market expects the BoK to start cutting rates by the end of next year.

Meanwhile, the new government under President Yoon Suk-yeol has announced plans to reduce the fiscal deficit from 5% of GDP this year to 3%, while reducing the debt-to-GDP ratio to 50% over five years, marking a shift away from the expansionary fiscal stance of the previous government.

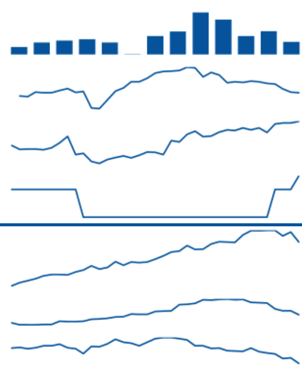
Market Strategy: South Korean equities were one of the worst performers in EM in Q2, losing 20.9% in USD terms. Aggressive monetary policy tightening and the global slowdown are a headwind to investor sentiment and thereby valuations. Earnings for the IT sector (which accounts for 44% of MSCI Korea) have fallen by nearly 10% since their peak in April. With the forward P/E ratio for South Korea in line with its historical discount to EM, we maintain our *underweight* allocation.

Taiwan

Neutral

A mounting semiconductor glut will weigh on earnings growth, reinforced by continued supply disruptions.

3Y history



	Latest	
GDP, % yoy	3.1	Q1
PMI, index	49.8	Jun
CPI, % yoy	3.6	Jun
Policy rate, %	1.50	Jun
MSCI Taiwan*	-8.4%	Q2
EPS, % yoy	18.1	Jun
12M Forward P/E	10.9	Jun

**US$ total return relative to MSCI EM.* *Source: Bloomberg*

Following a surge in demand for semiconductors during the height of the pandemic, demand is now falling off rapidly as the need for new equipment for work-from-home arrangements fades, needs for gaming equipment subsides and the crypto-industry implodes. On the other hand, anticipating a structural shift in demand, semiconductor producers are expanding capacity. Some 34 new facilities came online worldwide in 2020 and 2021 and another 58 are scheduled to begin production between 2022 and 2024, raising global capacity by roughly 40%. In addition, carmakers, data centers, white good producers and other users have built up inventory in anticipation of continued shortages, which now appears unnecessary. All this contributes to a glut of semiconductor supply which will likely depress prices further.

In addition, Taiwan suffered disruptions of its offshore production in China as lockdowns impacted supply chains. This is already translating into mounting weakness in Taiwanese activity. But while tech-related industrial production has softened, non-tech production has been even weaker. All told, the manufacturing PMI dropped below 50 in June as the new orders and export components in particular revealed a loss of momentum in external demand.

Inflation has risen successively, if modestly, to a 14-year high of 3.6% in June, triggering a second rare central bank hike to 1.50%. Continued tightening is likely to challenge an economy witnessing both a domestic demand slowdown and weakening external demand.

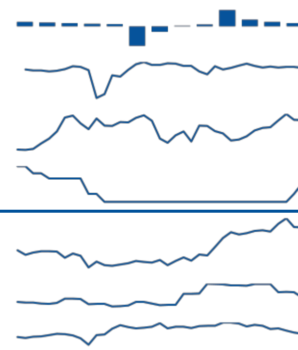
Market Strategy: As the supply-demand balance turns negative for semiconductor prices, global bond yields rise and supply disruptions continue to hold domestic activity back, the high earnings expectations currently priced in appear excessive. We thus maintain our *neutral* allocation for Taiwanese equities.

India

Underweight

A deteriorating balance of payments and rising inflation hamper the economic outlook.

3Y history



	Latest	
GDP, % yoy	4.1	Q1
PMI, index	53.9	Jun
CPI, % yoy	7.0	Jun
Policy rate, %	4.90	Jun
MSCI India*	-2.2%	Q2
EPS, % yoy	14.4	Jun
12M Forward P/E	18.6	Jun

**US$ total return relative to MSCI EM.* *Source: Bloomberg*

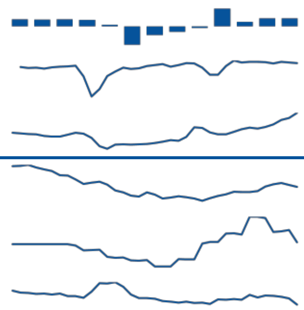
As expected, India's balance of payments is deteriorating in response to the commodity price shock that followed Russia's invasion of Ukraine. Indeed, the trade deficit widened to a record level in June on the back of increased imports. Importantly, imports increased not only across oil and gold categories, but also more broadly. At the same time, export performance softened. This has raised the current account deficit to approximately 4% of GDP (pending the release of GDP figures) by end-Q2, up from 1.5% of GDP in Q1. In response, the RBI announced new regulatory measures to attract capital flows in order to ease pressure on the balance of payments. It also intervened in the market in support of the rupee, keeping it stable in real terms. It remains to be seen whether the RBI will maintain this costly intervention policy or let the rupee depreciate to help counter the external shock.

CPI reached a preliminary peak of 7.8% yoy in April and has since receded to 7.0% yoy in June. However, the decline in the headline rate owes much to the government cutting excise duties on fuel and core price measures remain strong. Wholesale prices also remain elevated, recording a 15.2% yoy gain in June. The RBI tightened its monetary stance further following its belated start, raising its repo rate by 50bps in June, to 4.90%,

Market Strategy: The Indian market underperformed the MSCI EM Index by 2.2% points in Q2, yet remains expensive with a P/E of 18.6, some 50% above its historical premium over EM. Activity has so far not been impacted by weakening external or softer household demand as the economy remains in its post-pandemic recovery and mobility improves (even rising above pre-pandemic levels). A persistent feature of the recovery in India is that employment has remained below the pre-pandemic level. As China slowly regains popularity amid investors, attention is turning away from India and we thus maintain our *underweight* allocation.

ASEAN

High inflation has triggered a hawkish shift among the region's central banks, threatening to dampen the recovery from the economic re-opening.



	3Y history	Latest	
GDP, % yoy		4.7	Q1
PMI, index		52.0	Jun
CPI, % yoy		4.6	May
MSCI ASEAN*		-2.4%	Q2
EPS, % yoy		4.4	Jun
12M Forward P/E		13.2	Jun

**US$ total return relative to MSCI EM.* *Source: Bloomberg*

The emergence of the latest Omicron strains, BA.4 and BA.5, has led to an increase in cases across ASEAN. But the experience of other countries suggests that a combination of vaccine coverage and prior infections should keep hospitalisations and deaths low, reducing the risk of lockdowns and thereby of costs to the economy. After standing out among EM peers for their muted inflation, price pressures in ASEAN countries have started to mount. High inflation has so far prompted policy tightening in Malaysia and the Philippines, while expectations for the first rate hike in Thailand and Indonesia have been brought forward. With regional economic growth resting on the recovery in consumption, high inflation and tighter policy pose a downside risk to the outlook.

Malaysia

(Overweight)

Malaysia is set for a strong rebound in economic activity this year, as the country's shift to an endemic strategy at the start of Q2 paves the way for a recovery in consumption and tourism. Indeed, retail sales rose by 19.9% yoy in May. The industrial sector was a touch softer, as industrial production growth slowed to 4.1% during the same month, while the manufacturing PMI pointed to only a modest improvement in June. Meanwhile, as the region's sole major net oil and gas exporter, Malaysia will continue to benefit from higher energy prices. All told, GDP growth is expected to pick up from 3.1% last year to 6.1% in 2022.

Inflationary pressures continue to mount in Malaysia, as headline inflation reached 2.8% in May, although government subsidies for food and fuel have alleviated some of the inflationary burden on consumers. But reports that the government is seeking to move towards a targeted fuel subsidy programme suggest that inflation is yet to peak. The central bank (BNM) unexpectedly initiated its policy tightening cycle at its May meeting, followed by another rate hike in July. Consensus is projecting a further 65 bps of rate hikes by the end of next year.

Market Strategy: Forward earnings of the MSCI Malaysia Index have been revised higher, driven by improvements in the financial and consumer staples sectors. The premium of Malaysian equities to EM is in line with its five-year average, but the dividend yield of 4.6% is attractive compared to EM's 3.0%. As such, we maintain our *overweight* to Malaysia.

Indonesia

(Overweight)

Indonesia's economic outlook is bright, as the domestic demand recovery continues apace and international tourists return. The previous surge in commodity prices has awarded the government with fiscal space to extend energy subsidies, shielding households. Indeed, despite the recent drop in most commodity prices, coal prices have remained elevated, while Indonesia has increased its coal exports to Germany and India.

Consensus is projecting GDP to accelerate to 5.2% yoy this year, after a 3.7% yoy expansion in 2021. As elsewhere, Indonesia has been experiencing above-target inflation and the central bank (BI) has tightened policy by raising the reserve requirement. But the decline in foreign reserves, despite the trade surplus, on the back of FX interventions suggests that the BI could start hiking rates in Q3.

Market Strategy: Forward earnings continue to trend higher, growing by 6.8% since the start of the year. Indonesia's stock market appears fairly attractive, with the forward P/E premium to EM just a touch above its five-year average. We remain *overweight*.

Philippines

(Underweight)

Pent-up demand and growth in overseas remittance flows is expected to support domestic demand, with consensus expecting GDP growth of 7% this year. The rebound in consumption, along with high energy prices, means that the current account deficit is set to widen. Indeed, the central bank (BSP) projects the current account deficit to widen from 0.5% to 3.3% of GDP, which will likely weigh on the peso. The large expenditure plans of newly-elected President Ferdinand Marcos Jr. point to a worsening twin deficit problem.

Meanwhile, at 6.1% yoy in June, inflation has now comfortably breached the BSP's upper-bound target of 4% as price pressures have become more broad-based. Being a large importer of energy and food, inflation is expected to remain above target for the rest of the year. As a result, following 125bps worth of rate hikes since May, the BSP is projected to continue tightening policy.

Market Strategy: Given the soft macro backdrop, the MSCI Philippines Index looks expensive. The forward P/E ratio is trading at a 47% premium to EM, slightly above its five-year average. As a result, we stay *underweight*.

Thailand

(Underweight)

In the face of the Omicron variant-driven rise in cases at the start of the year, Thailand has stuck with its strategy of living with the virus. This has supported a recovery in the tourism sector, which accounts for 12% of GDP. Indeed, foreign travel spending in Q1 rose by 86% over the same period in 2021. In turn, consensus expects GDP growth to pick up from 1.5% in 2021 to 3.4% this year.

Higher tourism receipts will help narrow the current account deficit from 2.3% last year to 1.1%. Combined with above-target inflation (7.7% yoy in June), the central bank (BoT) is now expected to bring forward its first rate hike to Q3.

Market Strategy: The Thai stock market continues to look expensive, with the 12M forward P/E at a 63% premium to EM, significantly above its five-year average. In addition, earnings momentum is soft and the dividend yield of 2.6% is below EM's 3.0%. Thus, we maintain our *underweight* allocation.

Vietnam

(Overweight)

Vietnam's economy has gone from strength to strength, as GDP grew at a faster-than expected pace of 7.7% yoy in Q2. The recovery in domestic demand could offset the softer manufacturing sector, where the rebound in industrial production has been softer. Indeed, as a large manufacturing hub, Vietnam is exposed to the slowdown in global growth. All told, consensus expects GDP growth of 6.8% this year, faster than the 2.6% recorded last year.

Meanwhile, in stark contrast to the rest of the region, inflationary pressures have remained fairly muted in Vietnam, with headline inflation at 3.4% yoy in June. With a surplus production of rice, Vietnam has been sheltered from the worst of the food price shocks. Consensus expects inflation to remain within the National Assembly's target of 4%, allowing the central bank to raise rates only gradually.

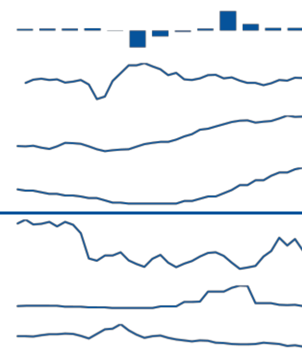
Market Strategy: The government's corruption crackdown at the start of April triggered a sell-off in Vietnamese equities, and the Communist Party seems intent on pressing on with its campaign. While this is a potential headwind for equities, we note Vietnam's economic fundamentals are strong. Moreover, Vietnam's stock market appears cheap, with the forward P/E premium to EM significantly below its five-year average. We therefore maintain our *overweight* allocation.

Latin America

Brazil

Neutral (↓)

Risks to fiscal sustainability are growing, while inflation has yet to be brought under control decisively.



	3Y history	Latest	
GDP, % yoy		1.7	Q1
PMI, index		54.1	Jun
CPI, % yoy		11.9	Jun
Policy rate, %		13.25	Jun
MSCI Brazil*		-13.0%	Q2
EPS, % yoy		8.1	Jun
12M Forward P/E		5.4	Jun

**US$ total return relative to MSCI EM.* *Source: Bloomberg*

The presidential elections scheduled for October increasingly dominate the outlook for Brazil. As feared, President Bolsonaro's poor approval ratings - amidst a botched response to the pandemic and unending culture wars - prompted him to resort to populist campaign promises: Congress is about to approve yet another constitutional amendment increasing social benefit spending by Brl41 bn. Changes and challenges to the fiscal spending cap continue to undermine fiscal sustainability. What is more, former president Lula – who served an abridged jail sentence for corruption, yet was released prematurely due to a judicial technicality and currently leads the polls by 10 percentage points – has vowed to abolish the spending cap altogether.

If we are correct that China's growth will pick up (albeit modestly), this will benefit Brazil's economy through a rise in demand for its commodities as China is by far its largest export destination. Yet, the largest commodity export group for Brazil are agricultural products, which are fairly price-and income inelastic. In addition, as a large importer of refined petroleum products, Brazil generates only a small oil trade surplus. As a result, the effect of recovering Chinese demand would mostly be felt through Brazil's ferrous metals exports and thus be somewhat limited.

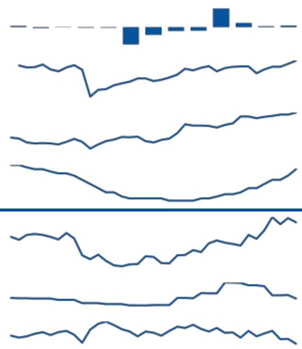
Meanwhile, the rise in inflation has yet to be decisively halted as the IPCA recorded an 11.9% yoy increase in June, while the Selic policy rate remains at 13.25% despite almost monthly increases throughout this cycle. Further tightening, and thus economic headwinds, remain on the cards.

Market Strategy: Brazil underperformed the MSCI EM by 13% points over Q2 and with a P/E ratio of 5.4 appears very attractive. However, we believe that this relies on earnings expectations which are unsustainably high and thus represent a significant downside risk. As a result, we shift our Brazil allocation from *overweight* to *neutral*.

Mexico

Underweight (↓)

Mexico's growth outlook is weakening due to the US slow-down, while inflation reaches new heights.



	3Y history	Latest	
GDP, % yoy		1.8	Q1
PMI, index		52.2	Jun
CPI, % yoy		8.0	Jun
Policy rate, %		7.75	Jun
MSCI Mexico*		-3.7%	Q2
EPS, % yoy		16.5	Jun
12M Forward P/E		11.8	Jun

**US$ total return relative to MSCI EM.* *Source: Bloomberg*

The Mexican economy faces a series of headwinds as the external environment, notably in its northern neighbour, deteriorates, causing: 1) lower demand for its manufactured goods and thus reduced exporting activity, 2) reduced domestic industrial production, 3) tightening financial conditions abroad and at home and 4) a likely decline in foreign remittances. To be sure, manufacturing has been strong since late 2021 and kept its momentum until May on the back of a strong rise in auto production (and exports). However, output and new order components of the June PMI already showed some weakness, pointing to a likely deterioration in manufacturing ahead.

The overall pace of growth will thus depend on the strength of domestic demand. Several markers do indeed point to the nascent strength of consumer demand: strong consumer goods imports and an acceleration in services consumption relative to goods, both on the back of a tight labor market and accelerating real wage growth.

Meanwhile, inflation continued its relentless rise, reaching 8.0% yoy in June, the highest recorded in over two decades. Although the increase owed much to high food prices, core CPI also rose to 7.5% yoy. With growing wage pressures and rising inflation expectations, the risk of elevated inflation becoming entrenched has become significant. As a result, Banxico shadowed the Fed's move at its June meeting with a 75bps hike, bringing the overnight rate to 7.75%. With real rates thus only just approaching zero, Banxico is likely to continue to deliver further tightening to rein in expectations as well as actual inflation readings.

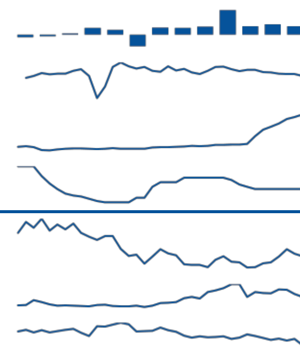
Market Strategy: Mexico underperformed the MSCI EM by 3.7% points during Q2, following strong outperformance during the previous quarter. As a result, valuations have moved mildly in its favour. Nevertheless, a deteriorating growth and inflation outlook paired with the potential for renewed commodity price shocks prompt us to shift our allocation to *underweight*.

Europe, Middle East and Africa

Turkey

Underweight

The central bank's reluctance to return to orthodox policymaking raises the risk of an economic crisis.



	3Y history	Latest	
GDP, % yoy		7.3	Q1
PMI, index		48.1	Jun
CPI, % yoy		78.6	Jun
Policy rate, %		14.00	Jun
MSCI Turkey*		0.5%	Q2
EPS, % yoy		10.3	Jun
12M Forward P/E		3.6	Jun

**US$ total return relative to MSCI EM.* *Source: Bloomberg*

Following a solid start to the year, with GDP expanding by 7.3% yoy in Q1, economic activity is set to slow as double-digit inflation and the weaker lira start to bite. Indeed, some of the strength in consumer spending can be attributed to consumers bringing forward their purchases amid elevated inflation. While the 23% year-to-date plunge of the lira could lift exports, the high import content in production and a potential recession in the EU, Turkey's largest trading partner, are likely to offset these benefits. As a result, the current account deficit is projected to widen from 2.2% to 5.1% of GDP this year, putting further downward pressure on the lira.

Despite inflation at a 24-year high, reaching 78.6% yoy in June, the central bank (CBRT) has continued to stand pat, further eroding its credibility. With the policy rate at 14%, real rates are deeply negative and will thus weigh on the lira. Policymakers have turned to other measures such as the FX-protected lira deposit scheme and lending restrictions to firms with large FX deposits in an effort to shore up the lira. But without a return to orthodox monetary policymaking, such measures will ultimately be unsuccessful.

Bringing this together, consensus expects GDP growth to ease from 10.3% in 2021 to 3.3% this year. The deteriorating economic outlook is likely to make the upcoming general election highly contentious, as the popularity of the ruling AKP has fallen sharply in recent months.

Market Strategy: The MSCI Turkey Index slightly outperformed EM in Q2, as Turkish investors sought stocks as an inflation hedge. Turkish equities appear cheap, with the forward P/E discount to EM significantly above its five-year average. Moreover, MSCI Turkey Index offers a dividend yield of 4.4%. However, we do not believe that the risks to the economic outlook and further lira weakness are fully priced in, and therefore remain *underweight*.

Saudi Arabia

Neutral

The Saudi stock market is expensive, suggesting that the robust economic outlook has been priced in.

	3Y history	Latest	
GDP, % yoy		9.9	Q1
PMI, index		57.0	Jun
CPI, % yoy		2.3	Jun
Policy rate, %		2.25	Jun
MSCI Saudi Arabia*		-1.0%	Q2
EPS, % yoy**		37.1	Jun
12M Forward P/E		15.9	Jun

**US$ total return relative to MSCI EM.*
***Tadawul All Share Index.* *Source: Bloomberg*

Saudi Arabia's economy continues to benefit from the surge in oil prices to multi-year highs. As one of the few members of OPEC with spare capacity, Saudi Arabia has been able to gradually increase production, boosting oil revenues. The resilience of its PMI readings suggests that improving mobility continues to support the non-oil sector. Moreover, high oil prices provide the government with fiscal space to further support the recovery in domestic demand, although the authorities are likely to be more disciplined in using their oil windfall than in the past. Indeed, the Kingdom's low debt-to-GDP ratio suggests that it is well placed to weather a drop in oil prices. Consensus expects GDP growth to pick up from 3.2% last year to 7.6% in 2022.

Meanwhile, despite the strength of economic activity, price pressures in Saudi Arabia have so far been contained, with inflation at just 2.3% yoy in June. This in part reflects the Kingdom's small component of food in its CPI basket and the riyal's peg to the US dollar. Consensus projects inflation to average just 2.5% yoy this year, the lowest among its Gulf peers. Nonetheless, the central bank (SAMA) will continue to hike rates in line with the US Fed.

Market Strategy: After significantly outperforming EM in Q1, Saudi Arabian equities delivered weaker returns in Q2 as oil price gains moderated. While the economic backdrop for Saudi Arabia is strong, its stock market appears expensive. The forward P/E ratio of the MSCI Saudi Arabia Index is at a 50% premium to EM, higher than its five-year average of 36%. And while forward earnings are still up by 5% since the start of the year, they have fallen by 8.0% from their peak in early-May. As a result, we stay *neutral*.

South Africa

Overweight

High commodity prices remain a key support to economic activity and thereby equities.

	3Y history	Latest	
GDP, % yoy		3.0	Q1
PMI, index		52.5	Jun
CPI, % yoy		6.5	May
Policy rate, %		4.75	Jun
MSCI South Africa*		-11.5%	Q2
EPS, % yoy		-7.3	Jun
12M Forward P/E		8.3	Jun

**US$ total return relative to MSCI EM.* *Source: Bloomberg*

The new sub-lineages of Omicron, BA.4 and BA.5, drove a renewed surge in virus cases in May. But despite South Africa's relatively low vaccination rate, antibodies from prior infections have prevented deaths from ticking up during its fifth wave. As a result, the government further relaxed restrictions, notably border entry requirements, in June. Consensus expects GDP growth of 2.2% this year, supported by a rebound in the services sector, a recovery in fixed investment on the back of positive terms of trade and the unwinding of the drag from last year's social unrest. This is softer than last year's 5.5%, but faster than its five-year average pace of 1%. Nonetheless, ongoing electricity shortages pose a downside risk to growth.

Elevated commodity prices have led to a strengthening in South Africa's balance sheet. Indeed, despite its higher oil import bill, South Africa's exports of minerals and metals mean that the current account is expected to remain in surplus this year. On the fiscal side, the deficit is also expected to narrow this year on the back of higher commodity prices.

Meanwhile, inflation reached 6.5% yoy in May on account of higher oil and food prices, breaching the 3-6% target range of the central bank (SARB). As such, following 125bps tightening so far this cycle, the SARB is expected to continue to raise rates. Consensus projects the terminal rate to reach 6.25%, from 4.75% currently.

Market Strategy: While South Africa's macroeconomic backdrop is not as strong as some of its EM peers, our cautiously optimistic view on commodities should continue to benefit equities. Moreover, South Africa's stock market appears attractively priced, with the forward P/E at a 21% discount to EM, nearly one standard deviation below its five-year average. Therefore, we retain our *overweight* allocation.

KEY ECONOMIC AND FINANCIAL INDICATORS

		Macroeconomic Data											Market Data							
		% change on year ago			Latest 12 months								Performance				Forecast (Bloomberg)†			
	Emerging Market	Annual GDP Growth*	Industrial Production*	Consumer Price Index*	Trade Balance*	Current Account Balance*	Foreign Reserves 2022 Latest*	Foreign Reserves 2021 Year ago	Currency vs $ 2022 Latest*	Currency vs $ 2021 Year ago	Short-Term Interest Rates*	Sovereign Rating S&P*	% S&P/EM Frontier Super Composite BMI	Stock Market Index S&P/EM Front. Super Comp. BMI US$	Change since 12/31/21 US$	Change since 12/31/21 Local Currency	2022 P/E Forecast*	EBIT Margin 2022 Forecast*	6 month Stock Market Index Estimate (Front. Super Comp. BMI) US$*	3 month Currency vs $ +/-*
		%	%	%	$ Bn	$ Bn	$ Bn	$ Bn			%		Jun. 30, 2022	Jun. 30, 2022	%	%		%		
Overweight	CHINA	4.8	0.7	2.5	818.3	335.3	3127.8	3221.8	6.7	6.5	1.1	A+	31.9	853.7	-11.7	-10.3	12.8	11.7	914	+
Overweight	SOUTH AFRICA	3.0	-2.3	6.5	23.6	52.9	44.9	44.3	17.0	14.6	5.8	BB-	3.4	715.6	-7.2	-4.8	9.2	20.6	723	+
Overweight	VIETNAM	7.7	11.5	3.4	-0.6	-6.0	106.3	97.9	23372.0	23016.0	3.4	BB+	0.5	249.7	-29.5	-28.0	13.7	21.1	264.2	-
Overweight	INDONESIA	5.0	5.7	4.4	44.6	4.7	122.3	128.8	15000.0	14494.0	3.2	BBB	1.9	1411.0	-1.3	3.2	14.2	24.8	1472	+
Overweight	MALAYSIA	5.0	4.1	2.8	63.2	10.6	99.7	106.3	4.4	4.2	1.8	A-	1.8	342.1	-12.1	-7.0	14.1	21.5	373	+
Neutral	BAHRAIN	5.5	n.a.	3.5	n.a.	n.a.	3.3	3.5	0.4	0.4	3.7	B+	0.1	247.6	2.7	2.7	n.a.	n.a.	265	uc
Neutral	BRAZIL	1.7	0.5	11.9	58.3	-26.1	325.9	343.5	5.4	5.2	6.8	BB-	4.8	582.3	-3.1	-8.7	5.2	26.8	623	+
Neutral	CHILE	7.2	1.8	12.5	5.7	-23.2	44.5	38.9	1019.7	749.0	6.6	A	0.5	342.4	7.6	18.3	7.0	20.0	343	+
Neutral	COLOMBIA	8.2	9.1	9.7	-16.7	-20.2	52.7	56.7	4642.4	3821.3	8.7	BB+	0.2	4819.1	-0.6	1.5	5.1	41.1	5103	+
Neutral	CZECH REP.	4.9	6.3	17.2	21.8	-7.7	152.3	165.1	24.3	21.7	7.2	AA-	0.1	1357.1	-0.9	7.3	10.9	n.a.	1390	+
Neutral	EGYPT	5.6	-10.1	13.2	-29.8	-18.6	27.2	34.1	18.9	15.7	11.3	B	0.1	1049.8	-34.4	-23.0	4.8	n.a.	1140	-
Neutral	GREECE	7.0	3.2	12.1	-34.7	-15.9	2.9	3.4	1.0	1.2	0.0	BB+	0.3	32.0	-10.5	-3.7	15.0	23.2	32	+
Neutral	HUNGARY	8.2	3.4	11.7	-2.9	-8.7	30.7	30.8	408.2	302.8	11.9	BBB	0.1	394.4	-37.7	-27.0	6.0	n.a.	409	+
Neutral	KENYA	6.8	n.a.	7.9	-13.2	-66.9	8.1	7.8	118.2	108.0	6.6	B	0.1	609.7	-24.1	-21.0	10.5	23.9	623	+
Neutral	KUWAIT	1.3	n.a.	4.5	57.2	2.9	41.6	42.2	0.3	0.3	2.7	A+	0.8	144.5	8.7	10.4	20.9	n.a.	172	+
Neutral	MOROCCO	0.3	13.1	5.9	-16.8	-2.8	29.5	32.0	10.3	9.0	2.5	BB+	0.2	612.0	-18.0	-10.6	18.1	26.2	616	-
Neutral	NIGERIA	3.1	n.a.	17.7	3.3	-3.3	36.2	33.9	424.6	411.7	5.0	B-	0.1	194.2	3.0	3.3	7.7	26.1	209	-
Neutral	PAKISTAN	-1.3	15.4	21.3	-48.3	-15.2	8.9	17.1	210.1	159.5	9.8	B-	0.1	394.7	-19.3	-6.6	3.8	n.a.	430	-
Neutral	PERU	3.8	3.8	8.8	3.4	-6.2	68.7	71.9	4.0	4.0	0.1	BBB	0.2	1510.5	-7.9	-8.3	8.2	n.a.	1563	+
Neutral	POLAND	8.5	15.0	15.6	-14.7	-18.2	133.9	144.4	4.8	3.9	7.9	A-	0.6	242.4	-32.2	-24.4	6.3	14.5	247	+
Neutral	QATAR	2.5	n.a.	5.4	59.6	26.0	37.4	36.9	3.7	3.7	n.a.	AA-	1.0	345.6	5.2	5.2	12.2	n.a.	390	uc
Neutral	ROMANIA	6.4	1.1	15.1	-31.2	-120.9	40.2	42.4	4.9	4.2	6.7	BBB-	0.1	173.8	-10.3	-2.5	5.6	25.8	175	+
Neutral	SAUDI ARABIA	9.9	n.a.	2.2	35.8	37.4	425.8	436.8	3.8	3.8	2.9	A-	3.6	165.6	0.7	0.6	16.3	n.a.	186	uc
Neutral	SRI LANKA	-1.6	-7.2	54.6	-8.0	n.a.	4.4	6.5	360.7	199.4	11.1	SD	0.0	102.0	-65.4	-38.9	10.5	8.0	102	-
Neutral	TAIWAN	3.1	4.5	3.6	60.8	119.5	549.0	543.3	29.8	28.0	0.9	AA+	13.8	445.9	-24.0	-18.3	10.9	13.6	460	+
Neutral	UAE	3.4	n.a.	2.3	79.0	48.0	117.1	106.2	3.7	3.7	2.4	NR	1.2	173.8	-1.7	-1.7	13.9	n.a.	193.2	uc
Underweight	INDIA	4.1	19.6	7.0	-222.3	-39.1	538.7	554.1	79.7	74.6	5.0	BBB-	14.1	1449.9	-16.0	-10.8	19.5	15.2	1509	+
Underweight	SOUTH KOREA	3.0	7.3	6.0	1.7	74.6	423.4	443.5	1305.3	1147.4	2.6	AA	11.7	504.4	-28.8	-22.3	8.6	11.6	505	+
Underweight	THAILAND	2.2	-2.1	7.7	36.4	-16.6	208.8	234.1	36.2	32.6	0.3	BBB+	2.0	1199.3	-8.7	-3.4	18.2	9.7	1210	+
Underweight	TURKEY	7.3	10.8	78.6	-71.1	-29.4	53.6	43.8	17.4	8.6	33.1	B+	0.5	232.0	5.3	32.3	3.5	12.4	216	-
Underweight	PHILIPPINES	8.3	1.9	6.1	-53.5	-11.7	90.1	95.3	56.3	50.0	2.5	BBB+	0.7	681.0	-18.7	-12.3	16.1	19.0	697	+
Underweight	MEXICO	1.8	3.3	8.0	-20.6	-26.5	177.3	185.1	20.9	20.0	8.3	BBB	1.9	462.6	-7.7	-9.0	12.3	17.4	468	+
Underweight	ARGENTINA	6.0	-13.3	60.7	12.3	5.1	32.3	37.0	127.6	96.1	50.2	CCC+	0.4	585.2	-48.4	-37.1	5.1	14.1	631	-

The 33 countries shown in the table accounted for 98.5% of the S&P/EM Frontier Super Composite BMI on 30 June 2022. An additional 18 countries accounted for the remaining 1.5% of the index on the same date. These countries, which can be accessed via City of London's Frontier Markets strategy, are: Bangladesh, Botswana, Bulgaria, Cote d'Ivoire, Croatia, Cyprus, Estonia, Ghana, Jamaica, Kazakhstan, Lithuania, Mauritius, Namibia, Panama, Slovakia, Trinidad & Tobago, Tunisia and Zambia.
†Any forecasts are based on Bloomberg consensus forecasts, where available, and assumptions. Actual results may vary from any such statements or forecasts. Past performance is no guarantee of future results.
**Key Criteria*
Source: Bloomberg, CLIM

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