

THINKING ABOUT EMERGING MARKETS IN 2022

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Emerging markets (EM) investors experienced a roller-coaster ride in 2021.

Global economic recovery, [inflation](#), [commodity](#) prices and threats of Chinese corporate regulation were among the main drivers in a year where the broad [MSCI EM Index \(MSCI EM\)](#) lost 2.54%.

2021 also saw the largest return dispersion in 18 years in favor of the [MSCI EM Value Index](#) versus the [MSCI EM Growth Index](#), with the former outperforming the latter by 12.47%.

Our [WisdomTree Emerging Markets ex-State-Owned Enterprises Index \(EMXSOE\)](#) also saw increased [volatility](#) and [drawdowns](#) last year as our state-owned enterprise (SOE) screen slightly tilts the portfolio away from [value](#) sectors and into companies with higher profitability metrics and growth potential.

Time to Recover

EMXSOE's drawdown from February 2021 to December 2021 ranks the fourth largest since the Index's inception in 2014 and is comparable to the one from 2018 when EM [Growth](#) underperformed EM Value. On all previous occasions, drawdowns were close to or in excess of -20%, and the recovery time was slightly higher than the length of the drawdown.

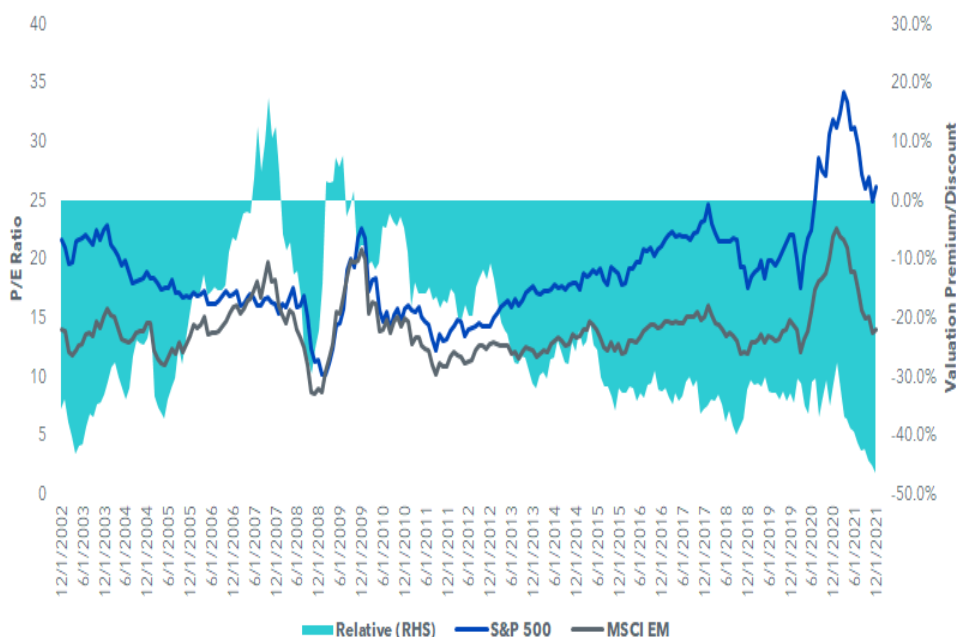
A common adage in EM investing is to "avoid being a tourist." Volatility can make investors skittish and sell at exactly the wrong time. We fear there could be a lot of EM "tourists" who unwind allocations after a disappointing 2021—we would advise against this impulse.

Period	Drawdown			EMXSOE		MSCI EM Index	
	Length	Recovery By	Recovery Time	Drawdown	Recovery	Drawdown	Recovery
May 2015–Jan. 2016	8 months	Apr. 2017	1 year 3 months	-23.26%	35.04%	-28.18%	35.41%
Feb.–December 2018	11 months	Aug. 2020	1 year 8 months	-23.99%	36.58%	-21.14%	18.95%
Feb.–March 2020	2 months	June 2020	3 months	-18.88%	22.95%	-19.86%	18.08%
Feb.–December 2021	11 months	-	-	-8.27%	-	-5.44%	-

Sources: WisdomTree, FactSet. Data from 12/31/14–12/31/21. Drawdown measured as peak to trough total return.

Look at Valuations!

EM carries an important [valuation](#) discount relative to U.S. markets, as measured by the [S&P 500 Index](#), because these stocks tend to be riskier, and investors require a higher risk premium. As of the end of 2021, the relative valuation discount between MSCI EM and the S&P 500 reached a 20-year maximum (minimum) as MSCI EM's [P/E](#) fell north of 36% last year.



Sources: WisdomTree, FactSet. Data from 12/31/02–12/31/21

Lower P/Es are not always strong buy signals, as these can move because of two reasons: lower (higher) prices and higher (lower) earnings. In the case of EM in 2021, valuations became more attractive due to both lower prices and increasing earnings.

The table below shows EMXSOE’s 10 largest holdings along with their starting and ending P/E ratios.

Except for Infosys, whose P/E increased, and Meituan, which became unprofitable, the other eight companies saw a reduction in their P/E ratio.

As we can see in the breakdown columns, this P/E reduction was led by earnings growth outpacing price growth or, in some cases (Tencent and Alibaba), prices trending negatively while earnings grew or remained unchanged.

Name	P/E Dec. 2020	P/E Dec. 2021	P/E Change	Breakdown	
				Price Change	Earnings Change
Taiwan Semiconductor Manufacturing Co., Ltd.	27.98	27.82	-0.6%	18.1%	16.7%
Samsung Electronics Co., Ltd.	22.12	15.18	-31.4%	-1.6%	40.9%
Tencent Holdings Ltd.	42.79	23.85	-44.3%	-18.8%	46.4%
Alibaba Group Holding Ltd.	34.64	17.80	-48.6%	-48.9%	0.8%
Reliance Industries Limited	31.61	29.87	-5.5%	19.7%	29.3%
Infosys Limited	29.43	38.59	31.1%	53.4%	14.2%
Meituan	200.00	-56.64	-128.3%	-23.5%	-
Housing Development Finance Corp. Ltd.	28.35	22.57	-20.4%	2.0%	28.8%
MediaTek Inc	36.33	19.65	-45.9%	65.7%	195.5%
LUKOIL PJSC	17.98	7.66	-57.4%	41.0%	218.6%

Sources: WisdomTree, FactSet. Data from 12/31/20–12/31/21. Price change measured in local currency. Earnings change measured as change in trailing 12-month net income.

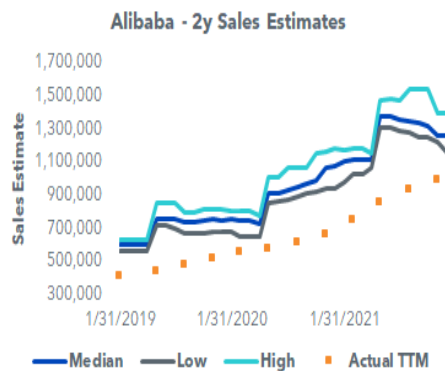
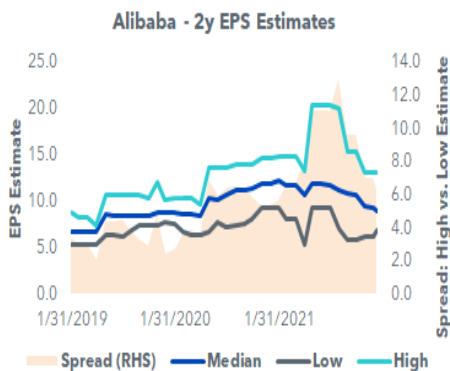
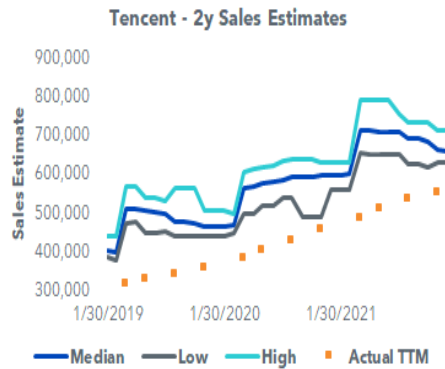
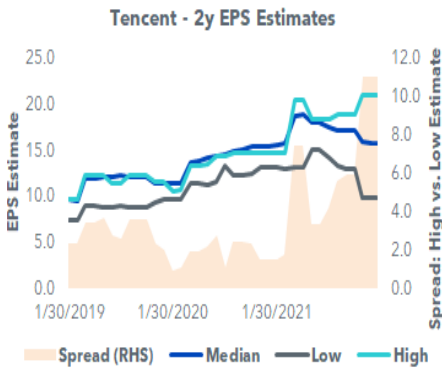
Chinese Regulation and Its Effects on Estimates

As mentioned earlier, one of the main drivers for price movement in 2021 was the Chinese government’s regulation threat on retail technology companies like Alibaba, Tencent and JD.com, among others. The extent and impact of this regulation is still unclear, but the

market’s reaction in most cases was to “sell and wait.” Meanwhile, analysts have attempted to incorporate these into their top- and bottom-line forecasts. It is interesting to see how, after the spread in analyst estimates widened with uncertainty last summer, expectations are for both companies to continue growing albeit at a slightly slower pace than in the past.

The question is: Did the market pull back too much?

Only time will tell, but we contend that these companies still have stellar growth trajectories and that valuation discounts between 40% and 50% from year-end 2020 levels present an attractive entry point.



Sources: WisdomTree, FactSet. Data from 12/31/18–12/31/21

Conclusion

After a volatile 2021 driven by headline risk, we expect EM prices to return to being driven by company fundamentals. As we’ve illustrated with our Alibaba and Tencent examples, sales estimates have clearly been re-rated lower on account of an uncertain regulatory backdrop. With that being said, the market seems to have fully priced in this regulatory risk—and then some.

For standardized performance and the most recent month-end performance click [here](#) NOTE, this material is intended for electronic use only. Individuals who intend to print and physically deliver to an investor must print the monthly performance report to accompany this blog.

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DEFINITIONS

Inflation: Characterized by rising price levels.

Commodity: A raw material or primary agricultural product that can be bought and sold.

MSCI Emerging Market Index: The MSCI Em (Emerging Markets) Index is a free-float weighted equity index that captures large and mid cap representation across Emerging Markets (EM) countries.

MSCI Emerging Markets Value Index: A market capitalization-weighted subset of stocks in the MSCI Emerging Markets Index that have lower share prices relative to their earnings per share, dividends per share, or lower prices relative to other financial metrics.

MSCI Emerging Markets Growth Index: A market capitalization-weighted subset of stocks in the MSCI Emerging Markets Index that have higher share prices relative to their earnings or dividends per share.

Volatility: A measure of the dispersion of actual returns around a particular average level.

Drawdowns: Periods of sustained negative trends of return.

Value: Characterized by lower price levels relative to fundamentals, such as earnings or dividends. Prices are lower because investors are less certain of the performance of these fundamentals in the future. This term is also related to the Value Factor, which associates these stock characteristics with excess returns vs the market over time.

Growth: Characterized by higher price levels relative to fundamentals, such as dividends or earnings. Price levels are higher because investors are willing to pay more due to their expectations of future improvements in these fundamentals.

Valuation: Refers to metrics that relate financial statistics for equities to their price levels to determine if certain attributes, such as earnings or dividends, are cheap or expensive.

S&P 500 Index: Market capitalization-weighted benchmark of 500 stocks selected by the Standard and Poor's Index Committee designed to represent the performance of the leading industries in the United States economy.

Price-to-earnings (P/E) ratio: Share price divided by earnings per share. Lower numbers indicate an ability to access greater amounts of earnings per dollar invested.