ALLIANCEBERNSTEIN

APRIL 2023

Q2 2023 Quarterly

Balancing the Strategic and the Tactical

- More fallout is likely from the rapid change in the interest-rate regime, so investors should expect continued volatility.
- Tactically, higher rates put downward pressure on near-term growth estimates, and tighter financial conditions can help the Fed achieve some of its policy aims.
- Over the long run, projected long-run bank returns on equity (ROE) are presumably lower, given that regulation is likely to tighten. More important, we think this situation will accelerate the shift to private credit creation.
- In terms of factor exposures, we see a case for a tactical defensive stance, but there's still a positive strategic case for value in a higher-inflation world that isn't changed by the recent turmoil.
- On balance, we're neutral on emerging markets (EM), seeing more alpha opportunities within the asset class: bright spots include India, Brazil and China—which may be a nirvana for active management.

Inigo Fraser Jenkins
Co-Head—Institutional Solutions

Alla Harmsworth
Co-Head—Institutional Solutions and Head of Alphalytics

Additional Contributors: Robertas Stancikas, Harjaspreet Mand and Maureen Hughes

Detail

Introduction

Balancing different time horizons always presents challenges. It may be intellectually ugly to hold different positions over short horizons and long horizons, but sometimes the macro setup suggests it's the right way to proceed.

Our strategic message for investors who need to protect their portfolios' long-run purchasing power is that overall risk levels likely have to climb in the face of higher inflation and lower nominal returns. Nevertheless, over shorter horizons we think it's right to stick with a more cautious tactical position. This view holds at the asset-class level for equities and high-yield. It also holds for factor allocations, where value's recent travails might persist in the short term, given its procyclical exposure. Longer term, we think investors who need a positive real return should be more constructive on these positions.

We make the case that, tactically, EM may fare better than developed markets (DM). This is another distinction between near-term and long-term views, with a longer-term EM opportunity in exposure to active return streams rather than a directional passive tilt to the region.

Balancing the Tactical and Strategic Outlooks

Leading up to the recent turmoil in the banking sector, we were struck how many clients expressed bewilderment in meetings about the apparently contradictory signals from stock and bond markets. What they mean is essentially that an inverted US yield curve implied a sharp slowdown in growth, yet outflows from risk assets have been muted. The banking turmoil went some way to reset expectations, but based on our assessment of the consensus tactical position of chief investment officers (CIOs), they remain cautious. Although it's horrible to peddle a consensus view, we find it hard to disagree tactically.

While the specific issues were very different, we see parallels between the recent banking turmoil and the UK LDI crisis of 2022: the change in the path and volatility of interest rates was an underlying common force at work. This change is so large compared with prevailing circumstances of recent years that there's likely to be more fallout to come. This should not make one fundamentally bearish, but it does point to a higher level of background volatility.

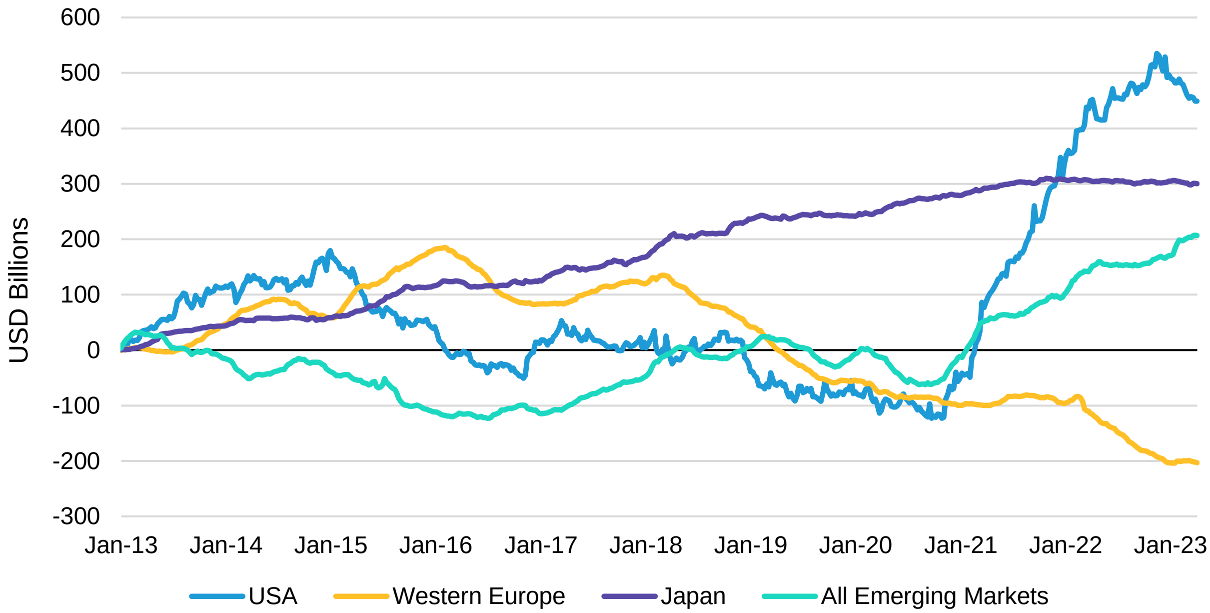
There are both tactical and more strategic consequences of the recent banking turmoil. Tactically, it puts downward pressure on near-term growth estimates by reducing credit creation, increasing risk-aversion and accelerating flows into short-term high-quality fixed income (and gold!). This tightening of financial conditions achieves some of the aims that the Fed was trying to achieve by raising rates. The ongoing flow from bank deposits into money-market funds could well put more downward pressure on the willingness of banks to extend credit.

There are longer-term implications, too. Whatever projection one had of the long-run ROE for banks, the forecast is presumably lower now with the view that regulation will tighten. More importantly, from an investor allocation perspective, we think this will accelerate the shift taking place in recent years with more credit creation occurring in private markets than from traditional sources (banks). In our forthcoming note on private assets, we make the point that one force driving higher allocations to private markets is the shrinking stock of public equities and a retrenchment in bank lending. This force looks set to remain.

To the extent that there has been equity selling in recent months, it has been focused on Europe (*Display 1*); there's been only tentative selling of US equities. Mitigating circumstances suggest that it's right not to assume a very negative view of near-term equity returns. Nevertheless, the lack of a significant equity outflow into a period of slowing growth is odd—and is mirrored in high-yield markets by a notable lack of risk aversion implied by credit spreads. Spreads have started to widen, given the bank turmoil in recent weeks, but it's been very muted compared with past periods of slower growth.

DISPLAY 1: A LACK OF CAPITULATION ON US EQUITIES

CUMULATIVE FLOW BY REGION



Historical analysis and current estimates do not guarantee future results.

As of April 5, 2023

Source: Emerging Portfolio Fund Research and AB

A key topic in recent client discussions has been the reason behind the market's relatively muted net response. How much of this is a result of authorities being viewed as having tempered concerns about deposit flight and the strength of the banking system, and how much stems from the hope that this episode will push the Fed to cut rates? If hopes of rate cuts are the driver, we worry that there's potential for disappointment; it still seems unlikely that the base case should be to presume that rates will be cut.[1]

A tactical defensive factor stance; strategically still a case for value

The value factor has seen a steep loss since the Silicon Valley Bank (SVB) episode, reflecting value's pro-cyclical exposure and the weight of financials in non-sector-neutral definitions of value. In *Display 2*, we show the performance of long-short factors from the close of March 8, 2023 to April 12, 2023. While our horizon for factor views is usually longer than this, intra-day and daily factor performance can often clearly show where the linkages are. In terms of individual value factors, the defensive dividend yield factor fared better than the more pro-cyclical price/book and price/equity (PE) factors. Quality, Growth and Low-Volatility factors all did well, as one would expect.

[1] For the latest note on this from Eric Winograd, Director of Developed Market Economic Research, AllianceBernstein see With Banks in Focus, the Fed Signals (Cautious) Optimism, March 23, 2023

DISPLAY 2: SELECT FACTOR PERFORMANCE (LONG/SHORT) SINCE MARCH 8, 2023

	Non-Sector Neutral						
	Composite Value (Cheap/Expensive)	Dividend Yield (High/Low)	Composite Quality (High/Low)	Composite Growth (High/Low)	Price Momentum (High/Low)	Volatility (Low/High)	Size (Large/Small)
US	-5.33	-0.05	1.62	6.84	4.40	7.35	7.78
World	-1.98	-0.96	3.65	4.04	-2.72	4.61	1.56

	Sector Neutral						
	Composite Value (Cheap/Expensive)	Dividend Yield (High/Low)	Composite Quality (High/Low)	Composite Growth (High/Low)	Price Momentum (High/Low)	Volatility (Low/High)	Size (Large/Small)
US	-2.60	2.12	2.99	3.49	3.93	5.47	6.38
World	-0.40	0.03	3.55	1.37	-1.07	3.66	2.71

Historical analysis and current estimates do not guarantee future results.

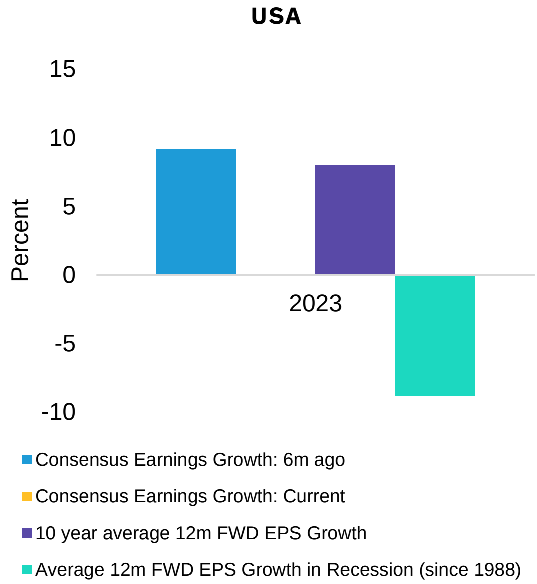
Note: The table shows the factor performance (Long/Short, Top vs Bottom Quintile), stocks within factor quintiles are equal weighted and factors are rebalanced quarterly. Sector Neutral factors are adjusted to have an equal representation of stocks from each sector.
As of April 12, 2023
Source: FactSet, I/B/E/S, MSCI and AB

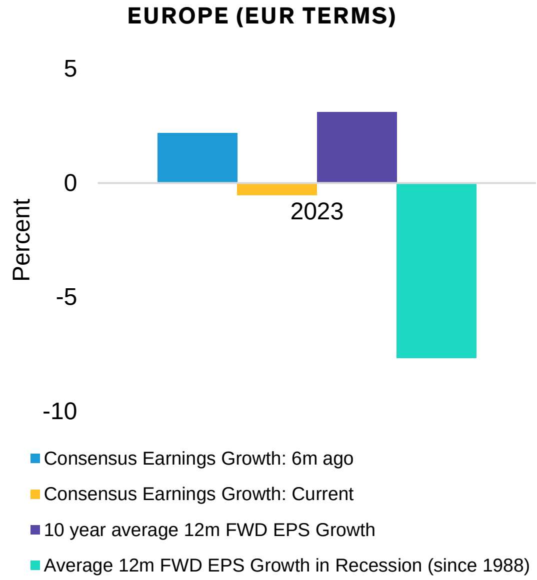
What about future positioning? We were already cautious tactically on value exposure going into this episode (we've been tactically positive on low volatility and free cash flow yield—and remain that way). However, there's still a positive strategic case for value in a higher-inflation world that isn't changed by the recent turmoil. That said, one specific issue about the composition of value has come up with clients in recent weeks: the appropriate financials weight. We've stated in the past, and would reiterate, that there's a case to reduce financial weightings in non-sector-neutral value, based on the view that real yields will remain subdued per unit of inflation, given long-run macro forces. This reduced weight on financials within a strategic value exposure would also be supported by the view that, in some way, banks have to pay for the government backstop, such as through regulation.

Earnings forecasts: required earnings cuts may be mostly done

One apparent puzzle earlier this year was the lack of a steep cut to consensus earnings, with the consensus growth rate for 2023 now essentially zero in the US and Europe (*Display 3*). We should stress that this is a nominal forecast; corporations are able to pass on at least some inflation. While this forecast is higher than the change in expected earnings during prior recessions, our base case is still for a period of slower growth rather than a hit to growth in line with that of average recessions. Indeed, our model for the level of S&P earnings growth consistent with current macro indicators has risen over the last month, so we may be most of the way though the required earnings cuts.

DISPLAY 3: HAVE EARNINGS FORECASTS BEEN SUFFICIENTLY CUT?





Historical analysis and current estimates do not guarantee future results.

As of March 27, 2023

Source: Datastream, IBES and AB

Money markets, gold and bitcoin

We've been struck by the fact that gold and Bitcoin have again been a legitimate source of debate in client meetings. We stand by our view that investors who need to protect the long-term purchasing power of portfolios might want to consider at least some role for gold, at least as a diversifier—its correlation with equities doesn't vary with inflation levels.

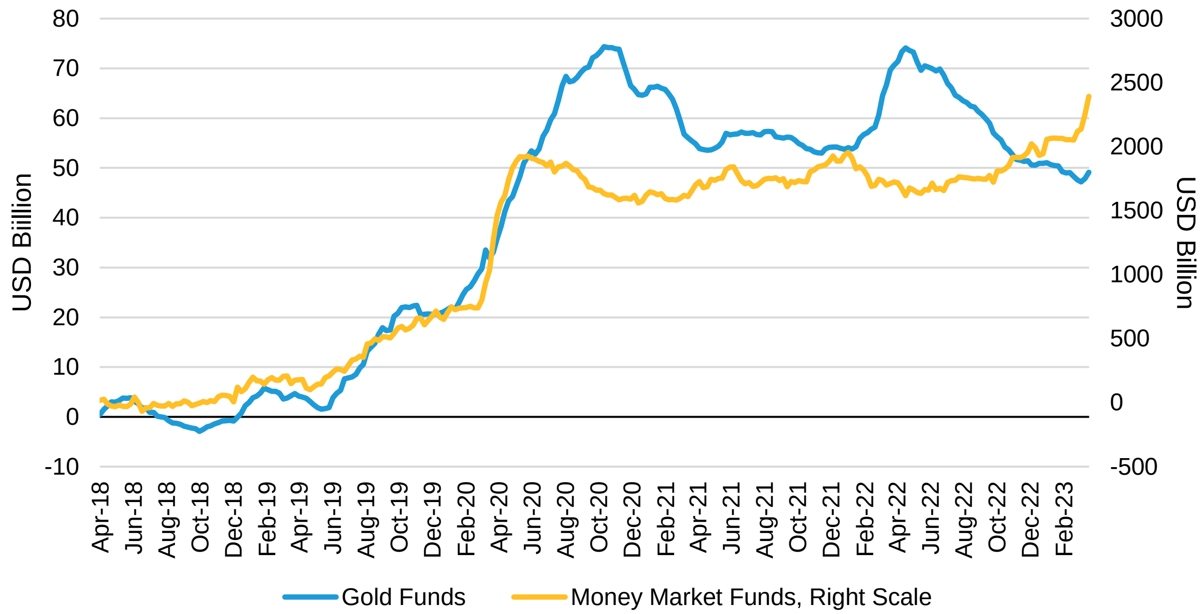
Crypto dynamics have changed significantly as a result of the recent banking turmoil, with Bitcoin behaving as a "safe haven" (inverted commas definitely required) asset as opposed to a risk asset. We won't propose that crypto should have a near-term allocation in institutional portfolios, given its degree of volatility, the extreme value destruction of the past year and the degree of regulatory uncertainty. Nevertheless, recent performance suggests that more investors are recognizing the potential broader role of short duration non-fiat assets in portfolios.[2] We continue to believe, however, that the more important role of digital assets in portfolios is the prospect of tokenization of real assets.

During the pandemic, flows into gold funds and money market funds diverged. Most recently, the rise in real yields since early 2022 suppressed the near-term attractiveness of gold. However, in recent weeks, as rate expectations and real yields have declined, flows have again demonstrated a positive correlation—a state of affairs we think is likely to persist.

[2] See Portfolio Strategy: Cryptocurrencies in asset allocation - I have changed my mind, Bernstein Research, November 20, 2020. We would also note that one fear about crypto and central bank digital currency (CBDC) was the extent to which it might undermine the concept of fractional reserve banking. In our view, however, that model has already taken a sudden hit this year, with the need for governments to significantly expand deposit insurance.

DISPLAY 4: MONEY MARKET AND GOLD FLOWS

GLOBAL FUNDS VS. MONEY MARKET FUNDS (CUMULATIVE FLOW – USD BN)



Historical analysis and current estimates do not guarantee future results.

As of March 22, 2023

Source: EPFR and AB

Conclusion: Tactically, it seems right to remain cautious on risk assets (over a one-quarter horizon). There's scope for equity outflows and credit-spread widening in coming months, but more strategically we don't think the recent banking turmoil is a systemic event of the level that makes one bearish on risk assets. Thus, it doesn't impact a mildly positive view on equities over horizons longer than 12 months nor the role of equities in the long-run generation of real returns for investors who need to preserve long-run portfolio purchasing power. Our views on the value factor within equities mirrors this: short-term caution but a more positive view longer term. The recent upheaval plausibly creates an even larger role for non-traditional credit providers, further entrenching the potential role of private credit in portfolios.

EMERGING MARKETS

While we're tactically cautious on developed market (DM) equities with a broadly risk-off stance, we have a relative preference for EM stocks over this tactical horizon. The view is nuanced, and a highly selective, active-investing approach is essential—but we think this type of exposure to EM can outperform DM over the next six to 12 months. In a global portfolio context, this would amount to a neutral tactical view, with more opportunities within the asset class than at the broad index level.

Over a strategic horizon, geopolitical risks and trade tensions are ongoing concerns against the background of higher macro volatility globally. Populist politics may hinder fiscal consolidation, and the net-zero transition may pose challenges to some EM economies. The asset class is likely to remain volatile, even as some of the recent headwinds fall away. This, again, leads us to emphasize the need for a highly active approach to both manager and security selection, with skill needed in identifying companies with strong business fundamentals as well as growth and return potential in a lower-growth, lower-return world.

In the following sections, we focus on the tactical outlook, discussing where we see the more attractive opportunities within EM.

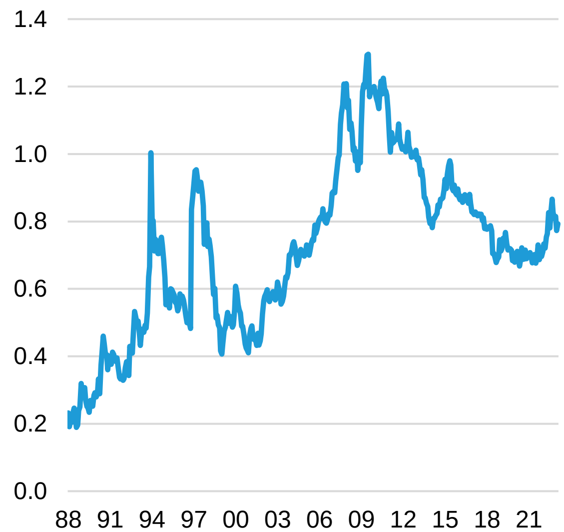
Valuations

Valuations are more relevant over a medium- or long-term horizon, but even tactically they're important in helping determine an entry or exit point and in setting the context for how the asset will behave in response to shorter-term catalysts. Looking at the EM equity valuation on several measures, we find aggregate numbers somewhat unexciting, valued broadly in line with history. On a Cyclically Adjusted PE (CAPE) basis relative to DM, EM is now trading at 0.79x versus the historical average of 0.71 (in absolute terms this is a CAPE of 17.3x compared with the historical average of 16.3x); valuations are similarly neutral versus history on a forward PE basis, again both in relative and absolute terms. While not a headwind, this valuation, on its face, does not seem compelling enough for us to be overweight on a strategic horizon, given the longer-term risks to the asset class. But multiples are also at levels where we think EM equities can outperform tactically in the presence of positive catalysts we'll discuss below, including:

- China reopening and the associated boost to growth
- The peak in the rate cycle in many EM economies, given more contained inflation
- A reduction in the pace and magnitude of hikes by the Fed and other DM central banks, given recent developments in the banking sector
- The possibility that the USD has peaked, at least over a tactical horizon

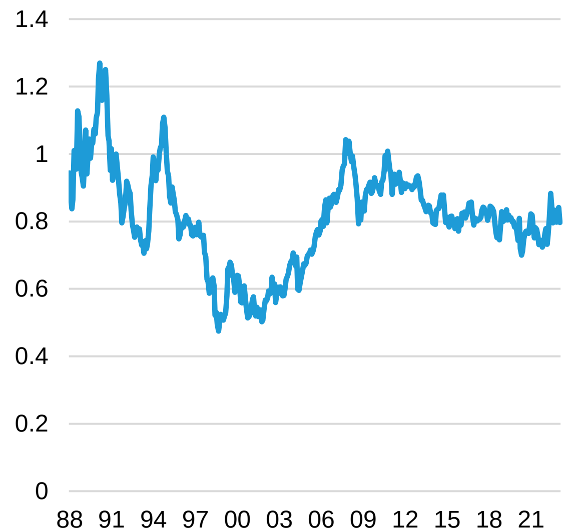
These aggregate numbers are also somewhat deceiving, masking big divergences between different parts of EM.

DISPLAY 5: EM CAPE RELATIVE TO DM



Historical analysis and current estimates do not guarantee future results.
As of February 28, 2023
Source: Global Financial Data, Datastream and AB

DISPLAY 6: EM 12 MONTH FORWARD PE RELATIVE TO DM



Historical analysis and current estimates do not guarantee future results.
As of February 28, 2023
Source: Factset, IBES and AB

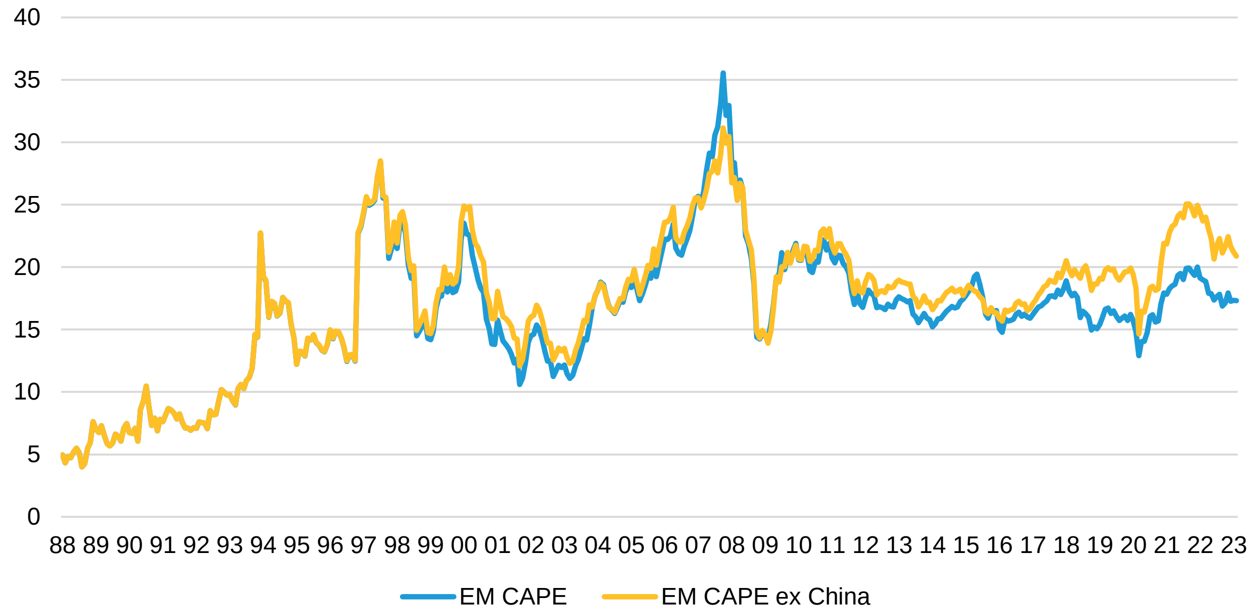
When we look under the hood of these multiples, one immediately apparent valuation spread is between China—which is cheap versus history on several metrics—and EM excluding China, which is expensive (*Display 7).* Based on absolute CAPE, EM is trading at 17.3x, marginally above the historical average of 16.27, while EM ex-China is trading at 21.2, a significant premium to the historical average of 17.2. On a forward PE basis, China is currently trading at 10x forward earnings (*Display 8*)—below the long-term historical average of 12.7x. EM ex-China is trading at 16.5x (*Display 9*), a significant 1.3 standard deviations above the historical average.

These multiples, of course, reflect China's multiple shocks in 2022 (including the COVID-19 lockdown and property crisis) and its sharp underperformance relative to the rest of EM; China lagged broader EM by about 3% and the MSCI All-Country World Index by 10.5% in USD terms; performance has not yet recovered meaningfully. China's more favorable valuations is one reason we see potential for China to outperform the rest of EM in the near term.

Speaking of valuation spreads within EM, we also note that within the EM ex-China basket, the dominant component driving up the multiple is India, currently trading at 19x. We'll come back to this point.

DISPLAY 7: CHINA IS CHEAPER THAN OTHER EM

EM CAPE & EM CAPE EX CHINA

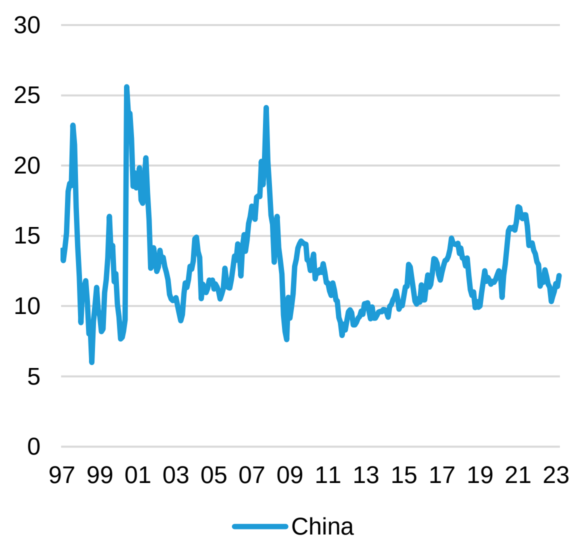


Historical analysis and current estimates do not guarantee future results.

As of February 28, 2023

Source: Global Financial data, Factset and AB

DISPLAY 8: CHINA FORWARD P/E



Historical analysis and current estimates do not guarantee future results.

As of March 14, 2023

Source: Factset, IBES and AB

DISPLAY 9: EMERGING MARKETS EX CHINA FORWARD P/E

Historical analysis and current estimates do not guarantee future results.

As of March 14, 2023

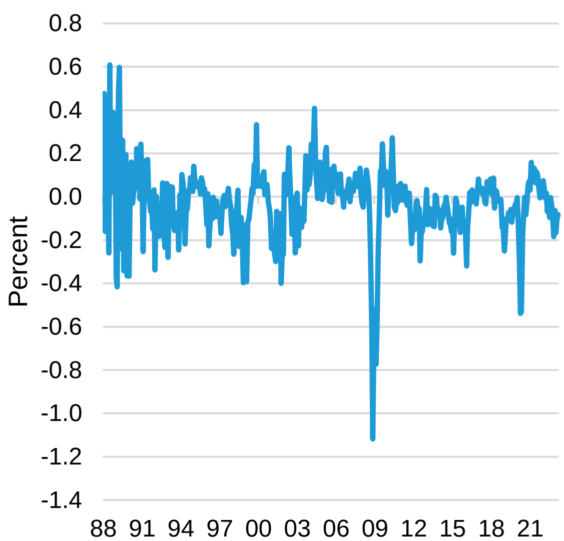
Source: Factset, IBES and AB

ANALYST AND INVESTOR SENTIMENT

For EM as a whole, analyst sentiment is still negative, reflecting the darkening global growth outlook after the post-pandemic bounce (*Display 10*). The pace of earnings downgrades is, if anything, somewhat *more* rapid than in DM, despite the stronger EM growth outlook, and, in our view, downgrades should be close to “done.” We think the tailing off of downgrades could provide a supportive background as China’s reopening provides a near-term boost to earnings growth in the region (more on this below). Further, added sentiment-based support may come from flows—our GEM Fund flow indicator, a contrarian indicator of EM versus DM relative 12-month forward returns—signals positive returns one-year forward.

It's also informative to look at changes in exposures to different regions among our large sample of globally benchmarked active portfolio managers. EM exposure has declined slightly over the past couple of years, which may mean that there’s room to add to allocations if things improve. So, overall, we see modestly supportive sentiment that can provide a favorable tactical background for the EM universe.

DISPLAY 10: EM EARNINGS REVISIONS BALANCE

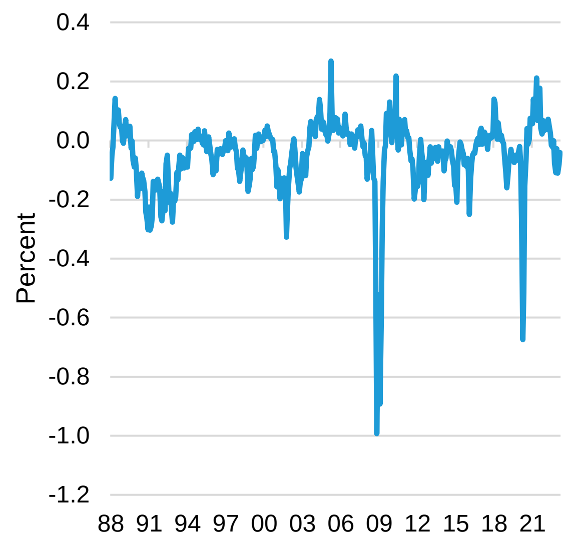


Historical analysis and current estimates do not guarantee future results.

As of March 31, 2023

Source: Factset, IBES and AB

DISPLAY 11: GLOBAL EARNINGS REVISIONS BALANCE

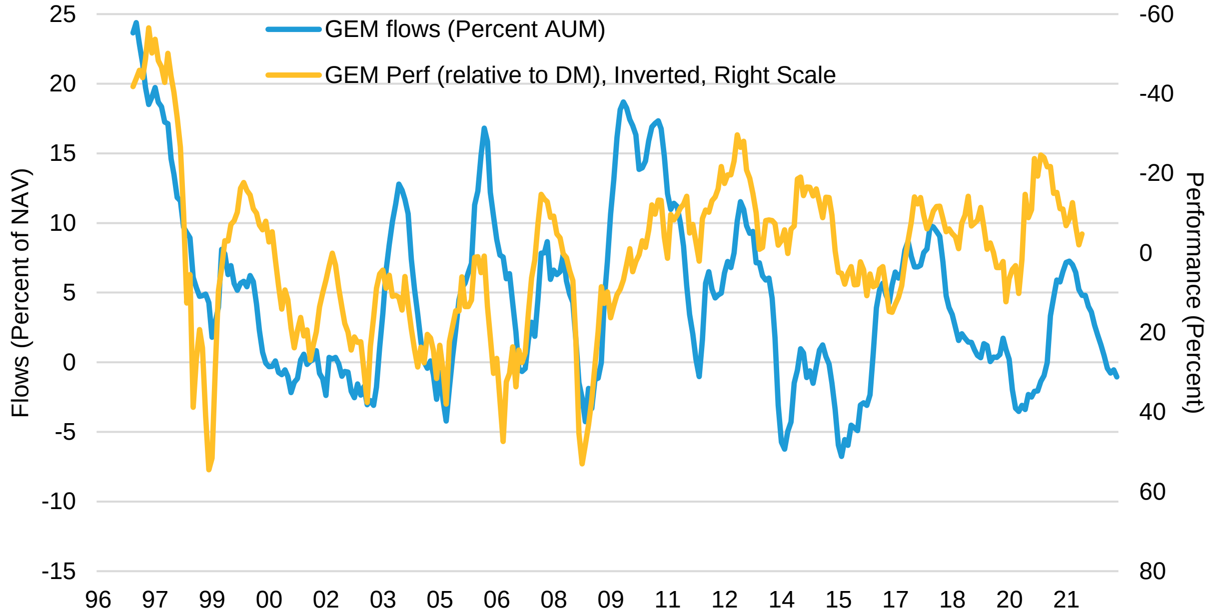


Historical analysis and current estimates do not guarantee future results.

As of March 31, 2023

Source: Factset, IBES and AB

DISPLAY 12: EMERGING MARKET EQUITY FUND FLOW INDICATOR



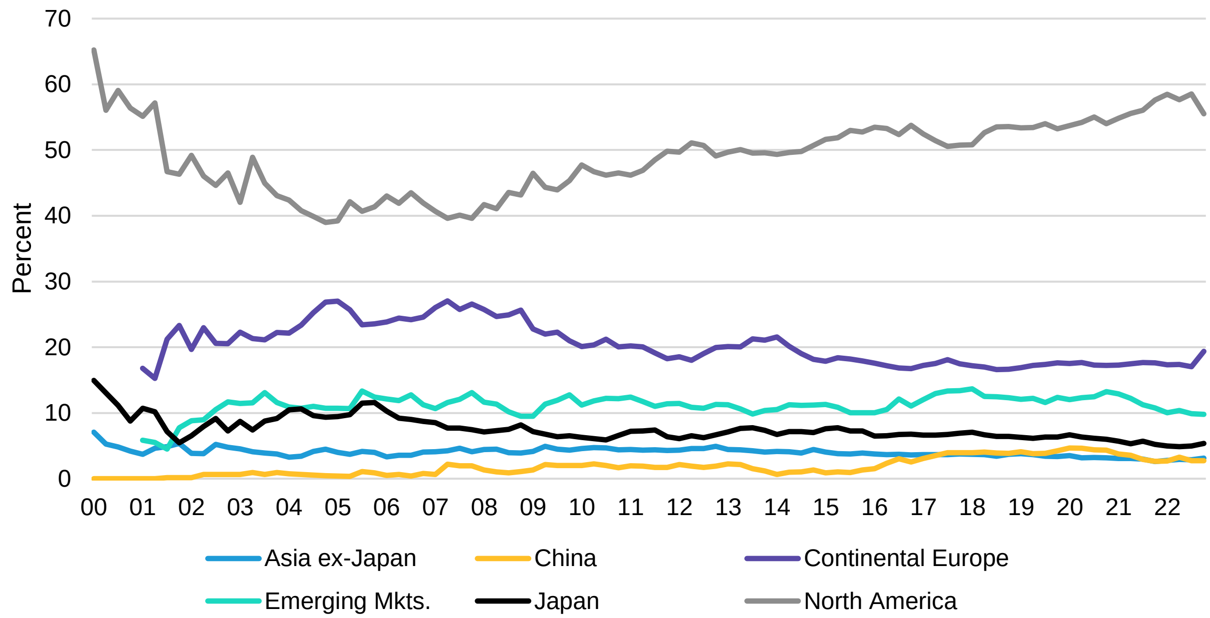
Historical analysis and current estimates do not guarantee future results.

The EM flow series is the cumulative value of net inflows into Global emerging market equity funds (GEM) as a percentage of aggregate NAV for GEM equity funds.

As of February 28, 2023

Source: EPFR global, Thomson Reuters Datastream and AB

DISPLAY 13: GLOBAL PM EXPOSURE BY REGION



Historical analysis and current estimates do not guarantee future results.

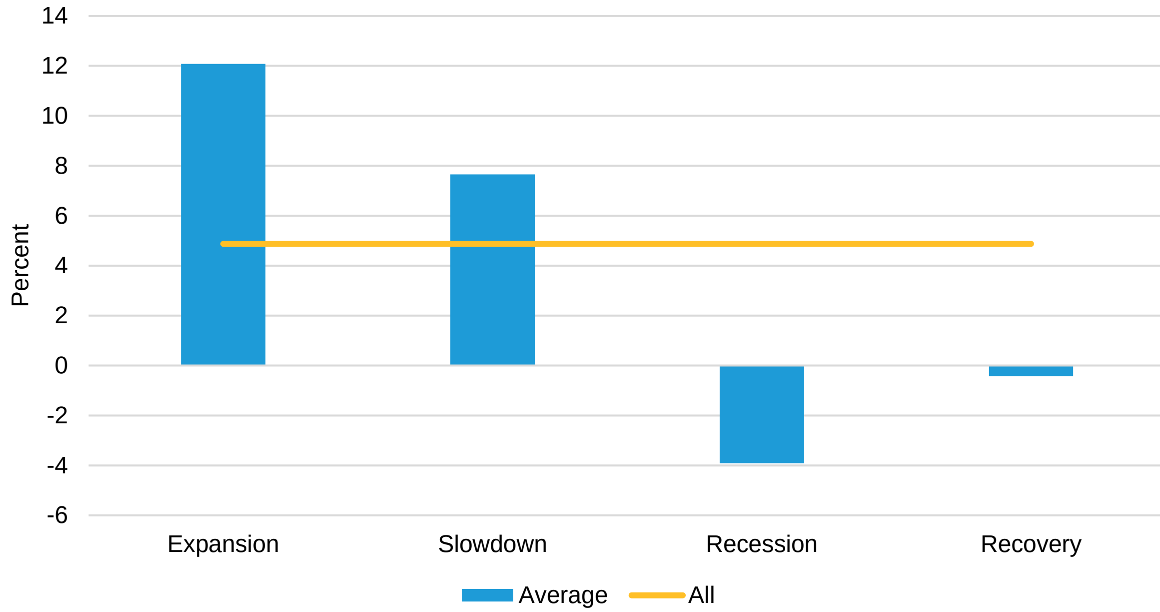
Note: For a sample of Global including EM funds we analyze the aggregate exposure to different regions.
As of February 28, 2023
Source: eVestment, FactSet, Morningstar, MSCI, S&P and AB

MACRO

Multiple drivers are at work when assessing the macro and cyclical outlook facing EM in the near term. It helps to refer to empirical analysis in an attempt to unstitch the impact of these different aspects of the environment, which are themselves interlinked. On balance, we think the macro picture can be tactically supportive of EM, although some countries within the group may be much better positioned than others.

Starting with the global business cycle, EM have historically tended to underperform DM in recessions, on average (Display 14) (note that the cycle phases here are based on the changes and levels of the OECD Composite Leading Indicator). However, in a “mere” slowdown rather than outright recession, EM have tended to outperform.

DISPLAY 14: EM RELATIVE PERFORMANCE AND THE GLOBAL BUSINESS CYCLE



Historical analysis and current estimates do not guarantee future results.

The chart shows MSCI EM relative performance vs MSCI World in USD terms during different phases of the business cycle proxied by the OECD CLI index.

Data from January 31, 1988, through January 31, 2022

Source: OECD, Thomson Reuters Datastream and AB

While recession in DM clearly remains a risk, the International Monetary Fund expects global real GDP to grow by 2.9% in 2023. This rate is down from 3.4% in 2022—indeed a slowdown—but a global recession isn't currently the base case in most economic forecasts. Further, most of the weakness is coming from the US and Europe—EM are expected to grow faster than last year, by 4% from a 3.9% rate in 2022, with *the growth gap between EM and DM widening significantly* from 1.2% to 2.8%.

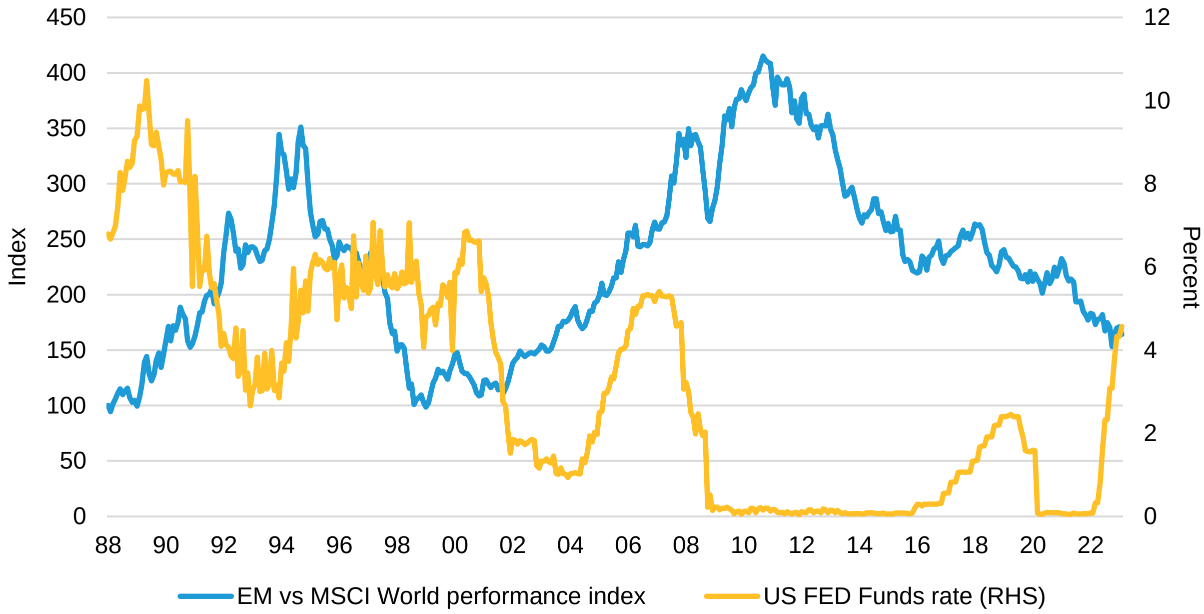
Within EM, Asian economies (notably China and India) are expected to drive most of global growth in 2023, as they benefit from ongoing dynamics from China's reopening and less-intense inflationary pressures than other parts of the world. Beyond 2023, global real GDP growth should pick up to 3.1% in 2024 (with tailwinds from fading shocks related to the pandemic, higher inflation, and monetary-policy tightening). However, growth will remain below pre-pandemic trends, given ongoing supply-side weakness. We expect the wider growth gap between EM and DM to be maintained.

The bottom line here is that while recession is clearly a risk for the EM outlook, a global recession isn't our base case, and a weakening economic outlook need not imply a negative outlook for EM relative to DM performance. Further, as China and other Asian countries help drive global growth through the rest of 2023 and 2024, the widening positive growth spread could provide support to EM equities relative to DM, given that relative growth has historically been an important driver of the EM/DM performance spread. Admittedly, growth rates do vary quite considerably within EM—again emphasizing the need for a selective, rather than blanket, approach to investing in these markets.

The other big performance driver is, of course, the direction of US and global interest rates and bond yields. Historically, the relationship between the performance of EM versus DM and the US fed funds rate tends to be negative (*Display 15*). This makes sense: rising US rates increase debt burdens on EM economies, trigger capital outflows to higher-yielding and safer US assets, and generally cause tighter financial conditions in EM that—in extreme cases—have led to financial crises in the past.

It's worth noting that the negative relationship isn't perfect or linear—it depends on individual EM country fundamentals and, importantly, on the drivers of rate increases. Our research has shown that when rates rise in response to cyclical growth news (increases also typically accompanied by corresponding equity markets moving in the same direction as bond yields) the EM response is much more muted than when the rate/bond yield increases are driven by monetary news. News such as information about future inflation and/or the Fed's reaction function tend to have a significant negative impact.

DISPLAY 15: EM VS MSCI WORLD PERFORMANCE INDEX & US FED FUNDS RATE



Historical analysis and current estimates do not guarantee future results.

As of March 31, 2023

Source: Datasteam and AB

Of course, the direction of bond yields is also related to changes in other variables, so it's difficult to analyze in isolation. In *Display 16*, we attempt to separate out the simultaneous impact of the US/global cycle, proxied again by the Composite Leading Indicators Index (CLI), changes in 10-year Treasury yields and the trade weighted US dollar. This is a simplistic analysis, but it provides insight into how each variable affects EM equity markets— stripped of the impact of the other variables. The relationship with the evolution of the CLI (the impact of the global cycle) is positive but not statistically significant. This ties with *Display 14* above, where we showed that the deteriorating outlook doesn't *necessarily* spell underperformance even if recessions might.

The negative relationship with US Treasury yields is more statistically significant, although, as we discussed above, the impact is nuanced, and at any given time would depend on the nature/causes of yield moves. The most important empirical relationship is with the trade-weighted dollar: dollar strength has a significant negative impact on EM and vice versa. Like rising bond yields, this effect works via several channels. A stronger US dollar raises the burden associated with a higher share of foreign-currency-denominated debt obligations in EM. It also increases the challenge of financing current-account deficits and may pressure EM policymakers to raise interest rates to prevent capital outflows while protecting their inflation targets, currencies and financial stability. All of this weighs on the growth outlook and equity markets.

DISPLAY 16: MSCI EM VS MSCI WORLD PERFORMANCE DRIVERS

Regression Statistics	
Multiple R	0.45
R Square	0.20
Adjusted R Square	0.18
Standard Error	2.55
Observations	116.00

ANOVA

	df	*SS*	*MS*	*F*
Regression	3.00	185.28	61.76	9.51
Residual	112.00	727.09	6.49	
Total	115.00	912.37		

	Coefficients	*Standard Error*	*t Stat*	*P-value*
Intercept	-0.35	0.24	-1.45	0.15
US 10 year	-3.52	1.22	-2.90	0.00
Composite Leading Indicator	6.68	4.21	1.59	0.12
Trade Weighted USD	-0.62	0.13	-4.77	0.00

Historical analysis and current estimates do not guarantee future results.

Regression covers the period from January 2020 to October 2019
As of February 28, 2023
Source: Datastream, OECD and AB

Where does this all leave us from a tactical standpoint? As discussed above, we think the near-term cyclical outlook is a source of downside risk but doesn't imply a bearish outlook for EM. In terms of interest rates, the Fed is still in tightening mode but the pace of tightening has slowed given the recent banking turmoil, with the central bank signaling just one more rate hike left in the queue. At the same time, the Fed indicated a cautious confidence in the resilience of the banking sector by deciding to go ahead with the March 22 hike. If, given this situation, recent US dollar weakness persists, it could be good tactical news for EM currencies and the outlook, given the background of inexpensive (if not outright cheap) valuations and benign sentiment we discussed above.

The risks to this view are plentiful and finely balanced. If worries about credit availability in the US remain, the most liquid currency—the US dollar—could be more likely to benefit. This has tended to happen in previous crises, even those originating in the US. While many EM central banks face lower inflationary pressures, giving them latitude to do less or face no further tightening, they're vulnerable to a sudden US dollar liquidity shortage, which could weigh on their currencies and, depending on how financial-stability risks evolve, still prompt more hikes from many of these central banks in the months to come.

These risks are one reason we remain neutral to EM as a whole, despite the potential positive catalysts. We think there are greater alpha opportunities *within* EM than at the overall asset-class level, which we'll discuss in the following sections.

WHAT TO BUY IN EMERGING MARKETS?

One can't overstate the importance of a selective approach to investing in EM, given the widely varying fundamentals and risks facing individual markets. Identifying the right approach for different risk appetites and long-term objectives is also essential.

While a more detailed set of investment recommendations is beyond the scope of this note, we can highlight several themes. Within EM, we want to focus on the markets that:

- Have robust enough *external finances* to withstand any US/global liquidity shocks (such as Mexico and Indonesia)
- Are 'ahead' of other economies in terms of the *policy tightening cycle* (Brazil, Mexico)
- Have their *inflation rates* contained or declining (China, Indonesia)
- Have seen *multiples and earnings expectations adjust* enough to be well positioned for a rebound (China, Indonesia, Brazil)
- Are *commodity exporters*, are well positioned for *the net-zero transition* and/or are benefitting from the *reconfiguration of global supply chains* (Brazil, Mexico, India, Indonesia)

Demographics is yet another theme, although it applies over strategic and tactical horizons, as do several of the above themes.

To elaborate on some of the points above, Brazil, Mexico and other Latin American countries began raising interest rates well before the US and Europe. Brazil moved the furthest; its policy rate is currently 13.75%, which explains why the Brazilian real was the top-performing currency against the US dollar in 2022. Inflation rates in Latin American countries remain relatively high but have started to trend down. Brazil and Mexico have already been among the top performers globally in 2022 but remain attractively valued—especially Brazil, which is trading at 6.6x forward earnings.

We think Brazil could be a market to watch. It may be one of the first countries to cut rates, which would provide a positive catalyst for outperformance. Brazil could also benefit from its high net commodity trade balance if commodity prices trend higher again—China's reopening could be one of the catalysts. Brazil also has a very favorable energy mix, with more than 80% of its energy produced by renewables, and it's an important player in the mining of industrial metals. Being a globally important food producer (Brazil is the source of about 10% of the global food supply) is also a strength.

Asia offers some of the most benign inflation rates and a superior near-term growth outlook. China's inflation, in particular, is well below the EM average (consensus expects a 2.2% CPI increase with 4.9% real GDP growth in 2023), giving Chinese policymakers room to provide more stimulus as needed. We'll discuss China in more detail in the following section. We also highlight India and Indonesia. India offers many positives: a strong economic growth outlook (consensus 6.1% real GDP growth this year), favorable demographics, a pro-business government, and a visible and transparent policy-making process.

India's emerging middle class is driving a rapid rise in the share of equities in household savings, but with plenty of room to grow further compared with DM. This situation supports the equity market and benefits the financials sector. The housing market is also buoyant, with affordability at historic highs. India is also well-positioned for the net-zero transition by rapidly boosting its solar and wind energy capacity, and it benefits from a neutral position in the Ukraine conflict—able to both purchase discounted energy from Russia and attract western companies' investment in onshore manufacturing and information technology.

One concern we have, set against all this, is valuations. India dominates the EM ex-China universe and is currently trading at a high multiple of 19x, a large premium versus other EM and more expensive than the US equity market. While this reflects the strong fundamentals and the market's attractive strategic outlook, it would argue for a selective approach to investing, looking for opportunities where valuations are less stretched than those at the index level—and where crowding is less of a concern.

Indonesia also offers interesting opportunities and ticks a lot of boxes across the themes we identified as important. It combines a strong economic growth outlook, moderate inflation, low levels of debt relative to GDP and a government committed to reform. Similar to India, it offers favorable demographics and a growing middle class. Indonesia is set to benefit from any commodity price increases, being among the largest commodity exporters. It's also benefitting from the diversifying of supply chains by global companies. For instance, it has seen increased interest from global auto and auto-parts manufacturers, drawn to its natural resources and ability to supply key inputs for electric vehicles, such as nickel and copper.

We next look at China, which deserves a separate section as an increasingly separate part of EM with very unique drivers.

CHINA -A NIRVANA FOR ACTIVE?

A strategic view on China is, to a very large extent, the view on President Xi's policy. Given the overriding influence of Xi's ideology on China's structural policy and outlook, getting the correct read of his policies is paramount.[3] Making a beta call on this market is challenging, even over a shorter horizon; investors may arguably see a growing need to consider the country in a class of its own, rather than part of EM.

This aside, we do think several positive factors at play may support this market in the near term. First, we discussed above the significant valuation differences between China and the rest of EM: China is trading at discounts on a number of measures, both versus China ex-EM and its own history. While the causes of the underperformance that led to the de-rating are clear, we see potential for performance to recover from here.

China is expected to outgrow most EM, with consensus expecting 5.2% real GDP growth this year; it also features a much lower inflation rate, with consensus at 2.3% CPI for 2023. Core CPI may trend higher as the reopening gains momentum but is unlikely to reach levels seen in DM. Similar to other markets, a build-up of household savings in China during the COVID-19 pandemic will support a pickup in consumption if and when confidence returns. The level of fiscal and monetary stimulus China provided during the pandemic wasn't nearly as large as that in key DM, so China's rebound may not be as aggressive and will need ongoing policy support. However, policymakers have shown a willingness to provide it, as evidenced by the recent cut to banks' reserve-requirement ratios. And this "slower" rebound—which may be the reason why earnings expectations have shown only a modest recovery so far—may, again, have its advantages if it means inflation stays contained.

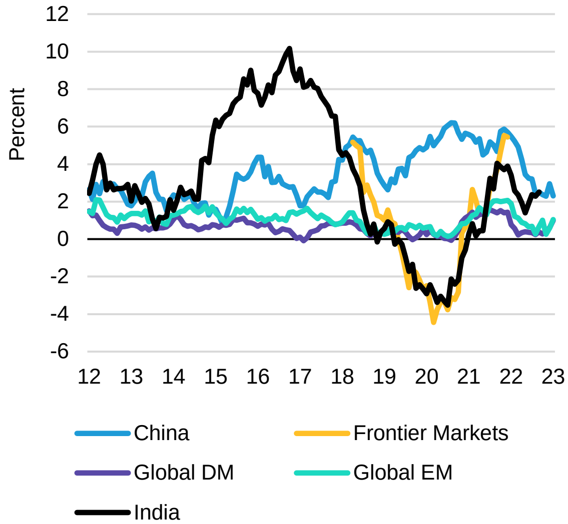
While China's government bonds and currency offer diversification and stability, we think the reopening is more of an "equities story" from a total-return perspective, with the domestically focused A-shares market the best place to look. Compared with the internationally favored H shares market, it's bigger, less exposed to geopolitical risks and offers more unexploited alpha opportunities. The A-shares market also features more firms poised to benefit from the domestic policy framework. For example, the focus on sustainable growth involves regulatory support for state owned enterprises (SOEs) and makes sectors dominated by SOEs—including financials, materials and traditional retail—more attractive versus "growth" sectors such as internet and biotech. Along with looking for policy-driven opportunities, another area would be companies that offer superior profitability potential at attractive valuations. This means value or QGARP-type approaches (quality growth at a reasonable price), given China's transitioning to a more mature, more policy-driven and slower-growth economy.

Finally, active management in China has long been a standout in alpha generation compared with other regions. The entire active industry has been under pressure and performance has suffered, but equity managers with China benchmarks continue to generate positive idiosyncratic alpha (IA)—alpha adjusted for common factor exposures—in excess of other key regions. (*Displays 17 and 18*). With value approaches starting to work better in Asia, we expect value managers to start generating more attractive idiosyncratic returns, while growth managers may see their alpha become more modest if the recent leadership shift toward value becomes more entrenched (*Displays 19 and 20*). Interestingly, after being underweight value for years, active managers with China benchmarks have been increasing their value exposure recently; we've seen the same, but more pronounced, repositioning among active managers with broader EM benchmarks (*Displays 21 and 22*). We'll follow up with more detail on the drivers and implications of these shifts in forthcoming research.

We think China remains a place of great opportunity for active managers, although as we said at the outset, a highly active and selective approach to both manager selection and security selection are key (this is also the case for EM more broadly). But, if investors approach it properly, China offers access to superior active alpha opportunities and can be an effective diversifier in many portfolios.

[3] You can find more detailed views on strategic opportunities in China from our equity team.

DISPLAY 17: THREE-YEAR IA BY REGION

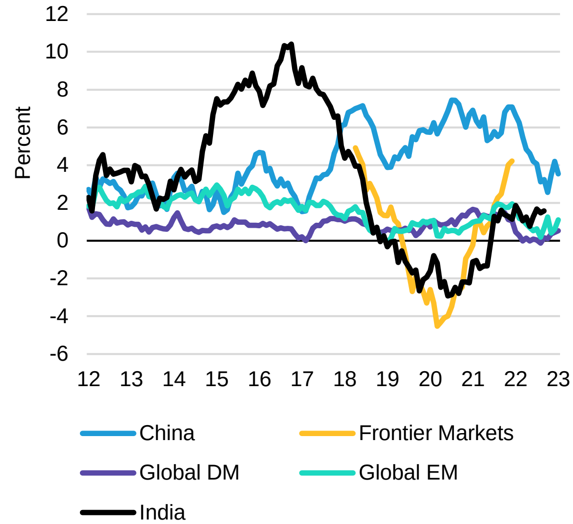


Historical analysis and current estimates do not guarantee future results.

As of January 31, 2023

Source: eVestment, FactSet, Morningstar, MSCI, S&P and AB

DISPLAY 18: THREE-YEAR EXCESS RETURN BY REGION

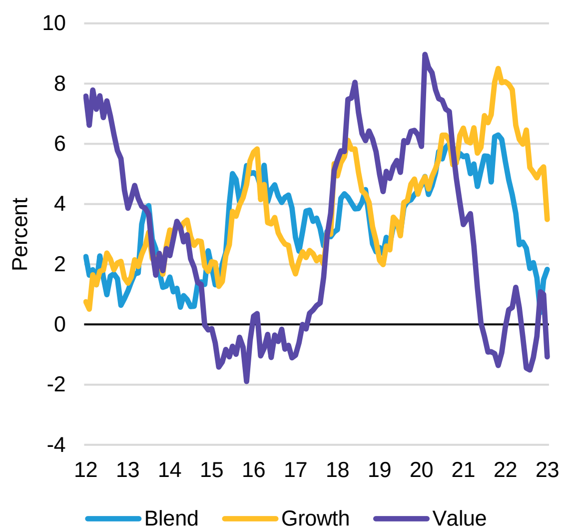


Historical analysis and current estimates do not guarantee future results.

As of January 31, 2023

Source: eVestment, FactSet, Morningstar, MSCI, S&P and AB

DISPLAY 19: CHINA THREE-YEAR IA BY STYLE

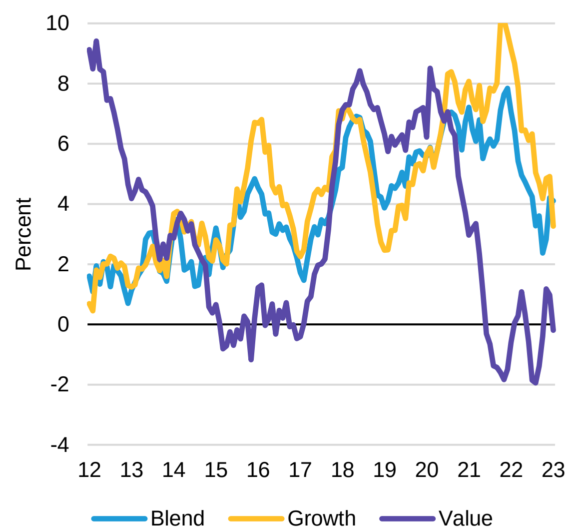


Historical analysis and current estimates do not guarantee future results.

As of January 31, 2023

Source: eVestment, FactSet, Morningstar, MSCI, S&P and AB

DISPLAY 20: CHINA THREE-YEAR EXCESS RETURN BY STYLE

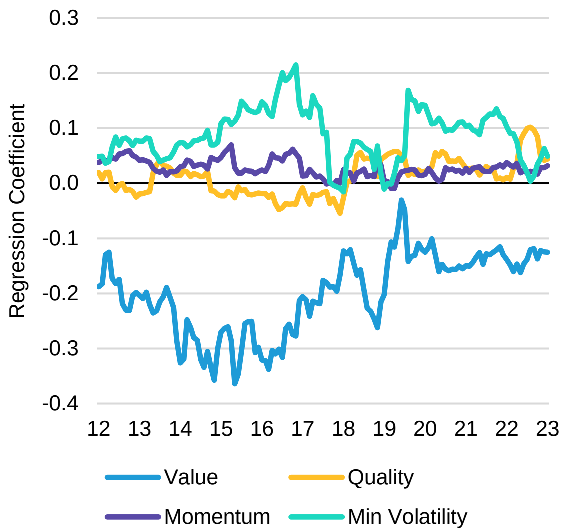


Historical analysis and current estimates do not guarantee future results.

As of January 31, 2023

Source: eVestment, FactSet, Morningstar, MSCI, S&P and AB

DISPLAY 21: CHINA THREE-YEAR FACTOR EXPOSURES

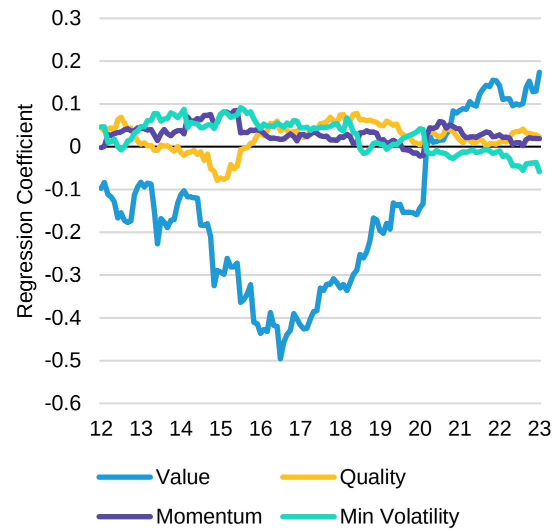


Historical analysis and current estimates do not guarantee future results.

As of January 31, 2023

Source: eVestment, FactSet, Morningstar, MSCI, S&P and AB

DISPLAY 22: EM THREE-YEAR FACTOR EXPOSURES



Historical analysis and current estimates do not guarantee future results.

As of January 31, 2023

Source: eVestment, FactSet, Morningstar, MSCI, S&P and AB

INVESTMENT RISKS TO CONSIDER

The value of an investment can go down as well as up and investors may not get back the full amount they invested. Capital is at risk. Past performance does not guarantee future results.

Important Information

The views expressed here may change at any time after the date of this publication. This document is for informational purposes only and does not constitute investment advice. AllianceBernstein L.P. does not provide tax, legal or accounting advice. It does not take an investor's personal investment objectives or financial situation into account; investors should discuss their individual circumstances with appropriate professionals before making any decisions.

This information should not be construed as sales or marketing material, or an offer or solicitation for the purchase or sale of any financial instrument, product or service sponsored by AllianceBernstein or its affiliates. References to specific securities are presented to illustrate the application of our investment philosophy only and are not to be considered recommendations by AB. AllianceBernstein and its affiliates may have positions in, and may effect transactions in, the markets, industry sectors and companies described herein.

Note to All Readers: The information contained here reflects the views of AllianceBernstein L.P. or its affiliates and sources it believes are reliable as of the date of this publication. AllianceBernstein L.P. makes no representations or warranties concerning the accuracy of any data. There is no guarantee that any projection, forecast or opinion in this material will be realized. **Note to Readers in Canada:** AllianceBernstein provides its investment-management services in Canada through its affiliates Sanford C. Bernstein & Co., LLC and AllianceBernstein Canada, Inc. It should not be construed as advice as to the investing in or the buying or selling of securities, or as an activity in furtherance of a trade in securities**. Note to Readers in the United Kingdom and Europe: For Investment Professional use only. Not for inspection by, distribution or quotation to, the general public. Note to Readers in the United Kingdom:** This information is issued by AllianceBernstein Limited, 60 London Wall, London, EC2M 5SJ. Registered in England, No. 2551144. AllianceBernstein Limited is authorised and regulated in the UK by the Financial Conduct Authority. **Note to Readers in Europe:** This information is issued by AllianceBernstein (Luxembourg) S.à r.l. Société à responsabilité limitée, R.C.S. Luxembourg B 34 305, 2-4, rue Eugène Ruppert, L-2453 Luxembourg. Authorised in Luxembourg and regulated by the Commission de Surveillance du Secteur Financier (CSSF). **Note to Readers in Switzerland:** This information is directed at Qualified Investors only. Issued by AllianceBernstein Schweiz AG, Zürich, a company registered in Switzerland under company number CHE-306.220.501. AllianceBernstein Schweiz AG is a financial service provider within the meaning of the Financial Services Act (FinSA) and is not subject to any prudential supervision in Switzerland. Further information on the company, its services and products, in accordance with Art. 8 FinSA can be found on the Important Disclosures page at www.alliancebernstein.com **Note to Readers in Japan:** This document has been provided by AllianceBernstein Japan Ltd. AllianceBernstein Japan Ltd. is a registered investment-management company (registration number: Kanto Local Financial Bureau no. 303). It is also a member of the Japan Investment Advisers Association; the Investment Trusts Association, Japan; the Japan Securities Dealers Association; and the Type II Financial Instruments Firms Association. The product/service may not be offered or sold in Japan; this document is not made to solicit investment. **Note to Readers in Australia and New Zealand:** This document has been issued by AllianceBernstein Australia Limited (ABN 53 095 022 718 and AFSL 230698). Information in this document is intended only for persons who qualify as "wholesale clients," as defined in the Corporations Act 2001 (Cth of Australia) or the Financial Advisers Act 2008 (New Zealand), and is general in nature and does not take into account any person's objectives, financial situation or needs. **Note to Readers in Hong Kong:** For Institutional Investor and Financial Advisor use only. Not for inspection by, distribution or quotation to, the general public. This document is issued in Hong Kong by AllianceBernstein Hong Kong Limited (聯博香港有限公司). This document has not been reviewed by the Hong Kong Securities and Futures Commission. **Note to Readers in China:** This information contained here reflects AllianceBernstein Hong Kong Limited ("AB") or its affiliates and sources it believes are reliable as of the date of this publication. This presentation has been provided to you for the sole use in a private and confidential meeting. AB makes no representations or warranties concerning the accuracy of any data. There is no guarantee that any projection, forecast or opinion in this material will be realized. Past performance does not guarantee future results. The views expressed here may change at any time after the date of this publication. This presentation is for informational purposes only and does not constitute investment advice. AB does not provide tax, legal or accounting advice. In considering this material, you should discuss your individual circumstances with professionals in those areas before making any decisions. This presentation or any information contained or incorporated by reference herein does not constitute an offer to sell or the solicitation of an offer to purchase any financial instrument, product or service sponsored by AB or its affiliates within the People's Republic of China ("PRC", for such purposes, excluding Hong Kong, Macao and Taiwan). **Note to Readers in Vietnam, the Philippines, Brunei, Thailand, Indonesia and India:** This document is provided solely for the informational purposes of institutional investors and is not investment advice, nor is it intended to be an offer or solicitation, and does not pertain to the specific investment objectives, financial situation or particular needs of any person to whom it is sent. This document is not an advertisement and is not intended for public use or additional distribution. AllianceBernstein is not licensed to, and does not purport to, conduct any business or offer any services in any of the above countries. **Note to Readers in Malaysia:** Nothing in this document should be construed as an invitation or offer to subscribe to or purchase any securities, nor is it an offering of fund management services, advice, analysis or a report concerning securities. AB is not licensed to, and does not purport to, conduct any business or offer any services in Malaysia. Without prejudice to the generality of the foregoing, AB does not hold a capital-markets services license under the Capital Markets & Services Act 2007 of Malaysia, and does not, nor does it purport to, deal in securities, trade in futures contracts, manage funds, offer corporate finance or investment advice, or provide financial-planning services in Malaysia. **Note to Readers in Singapore:** This document has been issued by AllianceBernstein (Singapore) Ltd. ("ABSL", Company Registration No. 199703364C). AllianceBernstein (Luxembourg) S.à r.l. is the management company of the Portfolio and has appointed ABSL as its agent for service of process and as its Singapore representative. AllianceBernstein (Singapore) Ltd. is regulated by the Monetary Authority of Singapore. This advertisement has not been reviewed by the Monetary Authority of Singapore.

ICN2023651