

## EMERGING MARKETS SPOTLIGHT

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## JOHCM Global Emerging Markets Opportunities Fund

As we have mentioned in a few previous reports, one of the most significant parts of markets pricing in a global economic recovery post-Covid has been the move in commodity prices. Commodities are a major driver, both of returns for emerging market (EM) equities as a whole, but also as a major differentiator of returns between different parts of the asset class.

We feel that there are three broad drivers of the commodity boom: a natural demand bounce-back after 2020, US economic stimulus, and Chinese economic stimulus. In this report we aim to review the prospects for each of these, and then discuss our positioning around the commodity rally.

Pent-up demand during lockdown has created a huge demand shock as lockdowns and trade interruptions eased. This has particularly been seen in the housing and construction industries, with long lead-times and large price increases on products such as construction lumber, windows and bricks. One trackable index for this is the US CME lumber future, which has risen from US\$400/lot at the start of 2020 to over US\$1600/lot this month. There has also been a surge in demand for smart, programmable and/or connected devices, leading to real pressure on the availability of some semiconductor components. One benchmark DRAM memory chip has risen in price from US\$2.60 to US\$4.60 since August 2020.

Next we turn to US and Chinese economic stimulus, the other drivers of the commodity boom. Investors face a complicated world - the largest economy has broken with forty years of generally deflationary fiscal and monetary restraint, just as the second-largest economy has significantly tightened policy. The Biden administration moved quickly to pass a US\$1.9trn stimulus package, and is currently preparing a US\$6trn budget that will very substantially increase the rate of investment by the government sector in the US economy. However, as we noted in our December 2020 report, China has moved to end the acceleration in money supply growth and credit growth that began in mid-2020. Fiscal policy was tightened, which naturally reduces credit growth, and we have also seen a disappointing Q1 GDP growth rate of 0.6% quarter-on-quarter, and a decline in shorter-term bond yields as markets price in the slowdown.

In this environment, it is hard to see where commodity prices might go from their current elevated levels. Historically, a slower China is bad for commodity prices, but this has always been in an environment of tight US fiscal policy. In terms of where commodities might go, and how to be exposed to them in emerging markets, we would make the following observations.

Firstly, the dominant role of China in terms of global commodity demand and the historical importance of China to commodity prices should not be dismissed. When taken alongside the ability of market systems to increase supply in the face of high prices, we would not be surprised to see a meaningful pull-back in commodity prices at some point this year.

Secondly, it is important to note that not all commodities are the same. Agricultural products in particular can display a very strong supply response to high prices as farmers' planting decisions are affected. In addition some commodities are more exposed to Chinese end demand (steel, coal), and some more to US end demand (particularly oil).



The oil price has risen strongly in the last year, and with oil companies struggling to add production capacity in light of ESG restraints, there is, we feel, probably more upside to the oil price than to industrial metals from this point.

Thirdly, although the share prices of most commodity-producing companies in emerging markets have risen strongly, the correlation between moves in those share prices and the moves in the prices of the respective underlying commodity products remains high. These shares offer exposure to commodity prices, but nothing more. We do have exposure to commodity-producing companies, in sectors such as oil/gas, wood pulp, cement and gold, but in every case we have a clearly identified additional catalyst that we expect to come through as well as the supportive environment for commodity prices. For example, for a petroleum corporation we believe that the market has mispriced when (and even if) domestic product prices deviate from import parity prices; meanwhile in the first quarter of 2021 the company had free cash flow equal to 10% of its market cap. At a pulp and paper company, we feel that the company's substantial progress in ESG has not been recognised by ESG analysts yet. At a building materials company, we feel that the rapidly-improving European operating environment is not yet in consensus estimates or priced into the share price. And so on.

Fourthly, the macro-economic impact of commodity prices creates opportunities in other sectors in certain countries. Followers of our strategy will be aware of our increased allocation to Brazil and South Africa, and recent economic data and corporate results show robust demand growth there, particularly from South African financials and retailers. We would also note that strong economic recoveries are underway in the UAE (where we have maintained our position) and potentially also in Russia (which we are currently underweight). One of the great attractions of emerging market equities is the global macro exposures the asset class offers, and one of the great strengths of a top-down approach is being able to find preferred opportunities within this.

The overall environment for cyclical assets remains robust, both for commodities and for emerging market equities, but, as always, we feel it pays to be selective.

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