JOHCM Funds

James Syme
Senior Fund Manager

Paul Wimborne
Senior Fund Manager

December 2021

Emerging Markets Spotlight

The opportunity *within* emerging markets is more compelling than the opportunity of emerging markets.

The second half of 2021 has seen challenging macro news for emerging market assets: a new and troubling Covid variant, higher developed market inflation and the prospect of tighter US monetary conditions, and evidence that the Chinese economic slowdown is broad and likely to endure. These challenges are likely to continue into 2022, and concerns are rising that, longer term, emerging markets face some serious structural challenges to growth: Chinese demand capped by the need to work through the effects of the 2008-17 credit boom, worsening global demographics, and a reversal of globalization. That reversal is partly because Covid has shown the risks inherent in long supply chains, and partly because of rising economic nationalism; both have the potential to reduce the flow of FDI to Emerging Markets.

And yet, as ever, there are the opportunities inherent in an asset class as large and diverse as emerging market equities. There will always be some countries and some industries enjoying a boom. We retain our view that the opportunity within emerging markets is more compelling than the opportunity of emerging markets.

India’s recovery

Firstly, the recovery in India, not just from the Covid shock, but from the broad downturn since 2010, continues to deliver powerfully. Growth is likely to run in the next few quarters at around pre-pandemic levels, with urban consumption and investment (both private sector and public sector) both buoyant. With vaccination rates rising, Covid cases currently low, and credit growth holding up, the Indian consumer has rebounded strongly, but the length of the downturn and India’s promising demographics mean that this should continue into 2022. In addition, the long-awaited recovery in capital expenditure and investment seems to be underway. Construction and engineering companies are reporting very strong new orders, particularly from the hydrocarbon, infrastructure and industrial machinery industries, while the cement industry is also seeing strong demand growth. With the current account deficit still unconcerning, and moderate inflation allowing the central bank to remain on hold (probably until the middle of 2022), India continues to offer strong domestic demand opportunities.

What we are seeing in India has similarities to other, related, opportunities in other emerging markets. These are the re-opening opportunity, and the boost from commodity exports to some emerging economies.

With rising vaccination rates and rising confidence, the leisure, travel and tourism industries have seen some strong recoveries (for example, foreign tourism into Mexico). Several other regions have not yet recovered, but we believe that they will, and that the valuation of some market-leading companies in these regions does not reflect the potential for recoveries. The portfolio has exposure to leisure, travel and tourism in Brazil, China and Korea. All three groups of companies have seen strong operational momentum in recent quarters, even though the re-opening recovery is still at an early stage.

Talking to management of our Brazilian leisure, travel and tourism companies reveals one of the other opportunities: demand growth from national regions with high commodity exposure. Domestic air travel in Brazil has been recovering well, but the demand driver has not so much been the traditional 'triangle' of Brasilia, Rio de Janeiro and Sao Paulo, but rather the farming and mining regions of central and eastern Brazil. One executive described some of the drivers of growth as 'small cities and others you've never heard of, with non-stop flights to the largest leisure destinations all over Brazil. We are flying routes on weekends that we don't even serve during the week.'

It has been a similar story in South Africa where, despite unrest in July and continuing electricity supply problems, both the mining and agriculture sectors continue to enjoy elevated prices and robust volumes. That supports both demand in the economy, and the fiscal balance, allowing the government to provide additional much-needed fiscal support to the economy. Retail sales have continued to grow, but we have not yet seen the kind of credit cycle that has been so supportive in India.

There are other opportunities in emerging markets, including Korean and Taiwanese semiconductors and high-tech components that go into so many of the products that are in such strong demand. We also believe that the slowdown in China should lead to lower domestic bond yields there, potentially making assets with strong cashflows more valuable. But it is the recovery in India and the combination of re-opening plays and the boost to demand from commodities, which we believe are most overlooked by those investors who have focused too much on the global challenges for emerging markets.

Source for all data JOHCM/Bloomberg (unless otherwise stated)