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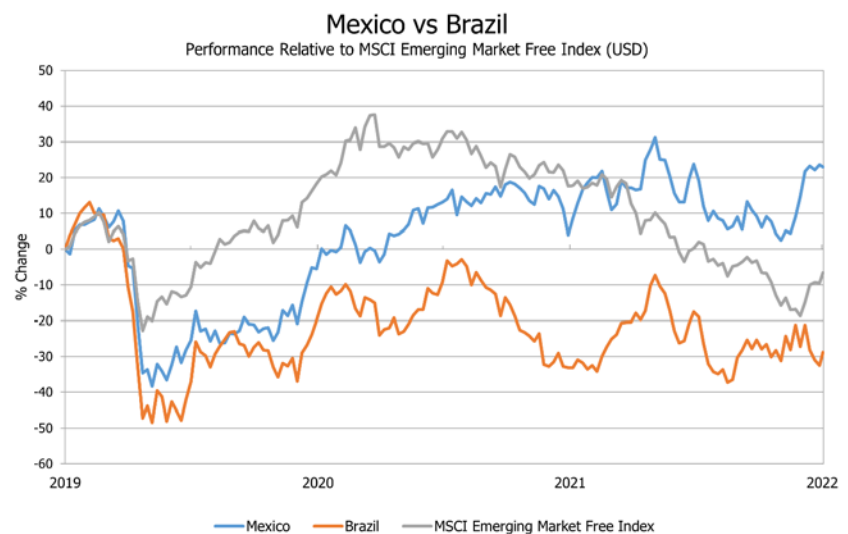
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Up Close and Friendly

Strained geopolitical relationships and over-extended supply lines are leading to a trend of relocating critical plants on nearer and friendlier shores

First, we must start with some numbers. One of the several paradoxes of the markets in the last couple of years is that, beneath the short-term volatility, we could sometimes find slightly more hidden, blurred, but more stable long-term trends. The performance of the emerging market of Brazil and Mexico have clearly demonstrated that they are on slightly different paths. This is a common occurrence in emerging markets, as often some 'pairs' of countries are played against each other, India and China, for example.



In 2022, Brazil was among the best performing markets. Despite a significant fall triggered by Lula da Silva's stunning re-election as president. In Mexico, we saw that the economy has grown considerably more than other markets, while equity valuations have improved relative to company earnings. Importantly, Mexico has significantly outperformed Brazil on a three- and five-year basis, and one may ask oneself, how come? There are several reasons, some related to Mexico and Brazil's peculiarities and some to the broader market.

A significant and new phenomenon is beginning to appear, so-called 'onshoring' or 'nearshoring' or even 'friendshoring'. It involves business operations transferring to a nearby country, or to a friendlier one, in preference to more distant or more hostile alternatives. Mexico seems to be among the largest beneficiaries, followed by markets in Eastern Europe.

But again, this is not a new concept. In the 1990s, the North American Free Trade Agreement (NAFTA) encouraged free trade and led to a significant bilateral commercial relationship between the US and Mexico. As globalization continued to flourish, Western nations took full advantage of China's low-cost manufacturing base. This lasted until the late 2010s, when President Donald Trump came with the first formal pushback to the globalization trend. This position has continued into Biden's administration, with more barriers on China, including import bans of certain materials and introducing restrictions on US citizens working for Chinese firms.

For many years the world enjoyed Russia supplying discounted commodities, Germany providing reliable machinery and China manufacturing cheap goods. As a result, western consumers enjoyed cheaper finished goods. Supply-side shocks have broken the chain, accelerated first in the pandemic and then due to the war in Ukraine.

Of course, Saudi Arabia and other oil-rich states will always supply the world with more oil, Brazil will benefit from higher exports of food and metals, Japan will compete with Germany to provide more machinery - the list goes on. But Mexico enjoys the great opportunity of offering both a near and a friendly shore for businesses wishing to relocate supply chains from Asia, in particular from China. Researchers at Bank of America Merrill Lynch estimate that the opportunity could lead to an increase in Mexican exports by 9% of GDP¹

I recently attended a Latin American conference, and the attendees were very excited, showing maps, investments in motion, and infrastructure projects directed towards warehouses and roads. A new and exciting twist to this emerging trend is Chinese and other Asian companies joining the migration and adding their own direct investment into Mexico.

Let's not forget Eastern Europe, a smaller manufacturing region working with the world's second wealthiest player, Europe. It is an inevitable move. Importantly, more Eastern European countries have a second chance, particularly the Czech Republic and Hungary, as the premium in production and labor cost compared with China is still high. I often meet Chinese companies exporting to Europe, and I'm stunned when I hear how low their costs are compared to Eastern Europe. While Mexico may accrue most of the benefits of serving the United States, in Eastern Europe it will be more structured and spread out among a number of countries, not least as the Czech Republic can hardly compete on labor costs anymore. Bulgaria, Romania, Eastern Poland and, once peace is restored, parts of Ukraine will enjoy substantial manufacturing inflows as more countries diversify their supply chains. Additionally, several initiatives are already working, such as the '3Seas', and several Ukrainian funds are being gathered to help finance the country's reconstruction. Curiously enough, such moves could also help with better company-level ESG* scores.

Even if the war in Ukraine ends soon, a return to the old patterns is unlikely, certainly not to the same degree. Whether you call it national security or political and economic diversification, some redundancy is already being built into the system, and, unfortunately, that has a terrible impact on costs and inflation. But that is how economies build reliability, too. And that is how you build new regional chains, and that newly built capacity and redundancy increases the whole pot. There is no doubt that Brazil would also benefit from Mexico's nearshoring, and that other Asian countries will be included in the newly formed regional chains moving out of China.

Hence, to finish with a view of our latest portfolio changes, we are fully employing our famous and robust dual philosophy, adding more to Mexico,

¹ Source: Bank of America as of October 25, 2022

while taking some profit in Brazil. Although China may be a long-term structural loser of the “nearshoring”, we have been tactically cutting our underweight position. The reason is that valuations have become very low after 3 years of zero COVID policy, regulatory pressure (particularly on the internet platforms) and real estate sector woes – and the recent swift reopening and signs of easing regulatory pressure and support to the real estate sector are positive catalysts. China is thus currently a great example of a recovery market. We have also trimmed from our positions in Indonesia and India, and now look to reopening plays in Thailand and Malaysia

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

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*ESG is defined as utilizing environmental, social, and governance (ESG) criteria as a set of standards for a company's operations that socially conscious investors use to screen potential investments.

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The Fund invests in international and emerging markets. International investments involve special risks, including currency fluctuation, lower liquidity, different accounting methods and economic and political systems, and higher transaction costs. These risks typically are greater in emerging markets. Such risks include new and rapidly changing political and economic structures, which may cause instability; underdeveloped securities markets; and higher likelihood of high levels of inflation, deflation or currency devaluations.

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