March 2020

JOHCM Funds

EM Spotlight – Coronavirus Special

JOHCM Emerging Markets Opportunities Fund

James Syme
Senior Fund Manager

Any commentary on emerging equity markets in February 2020 has to discuss the effects of coronavirus (hereafter Cov-19), but we would want to ground any such discussion in the bigger picture of what was happening in the global economy and markets before the first Cov-19 diagnoses in Wuhan in January, and how those trends have, if anything, accelerated.

To be clear, the disruption and tragic deaths from Cov-19 are the main story on every news channel everywhere for good reason, but the biggest story for investors is the evolving policy response in developed nations, with the US Federal Reserve's surprise 50bp cut on 3rd March the highlight. For reasons that we do not need to concern ourselves with, the political systems of the developed world are looking to their central banks to 'solve' the economic impact of Cov-19. This inability to find a government-driven solution is not new, but it is an evolving and accelerating situation.

Bond yields in the US have been declining since 2018, and that decline has continued even as trailing CPI inflation has pushed higher. The Fed became more accommodative in the fourth quarter of 2019, increasing its balance sheet in order to maintain order in repo markets, but 2020 has seen a dramatic decline in bond yields, with the US 10-year Treasury currently yielding less than 1%. Again, this has accelerated since Cov-19 concerns picked up, but this is merely the intensification of an existing trend. And so we come to the rate cut.

Monetary policy an ineffective tool

The uncertainty that Cov-19 imparts to the economic outlook certainly indicates that every institution should be looking to support businesses, consumers and markets. And a 50bp rate cut is what the Fed can do, but with the whole bond yield curve out to ten years sitting below the post-cut policy rate of 1.25%, it suggests that more will have to be done, and soon. Ultimately, monetary policy is a highly ineffective tool to respond to simultaneous demand- and supply-shocks, but in the absence of the political will to use fiscal policy, it is all the Fed can do. To be clear, this is not unique to the US. The upcoming UK budget is now expected to put off a transformational shift in fiscal spending because of concerns about a revenue shortfall, while Germany remains shackled to a balanced fiscal budget.

This much easier US monetary environment suggests a continuation of the broadly positive environment for emerging markets (and gold) that we have seen since September. Without doubt, the economic disruption from Cov-19, both in developed and emerging economies, will cause lower GDP and earnings growth, and stress where reduced cash flows meet indebtedness. A review of these is in order. But let us be clear that 'much lower for much longer' US rates, combined with gentle monetisation of the US federal deficit and a stable or weaker dollar is a great boost for both emerging economies and the prospects for emerging equity markets.

Let's take two examples of what that looks like in EM. Firstly, consider Greek government bonds. The Greek 10-year government bond is currently yielding 1.3%, having traded at yields below 1% at time in February. This has been an enormous decline from 13.6% in 2015 (and over 30% in 2012). While some of that represents improved creditworthiness, it has also been driven by a move in German yields from over 3% in 2011 to -0.6% at the time of writing. Secondly, policy rates in Brazil have fallen from 14.25% in 2016 to 4.25% today (and some forecasts are for a decline to below 4% in coming months).

These kinds of moves represent an enormous boost both to economic activity and also to valuation of cashflow streams. The Greek government 2034 bond finished 2018 at a price of €99.80 and currently trades at €140.26; the Brazilian Bovespa index is 71% higher than its level when policy rates first started falling in 2016. From a sentiment point of view, it is hard to overstate how incredible Greek yields at 1% and Brazilian policy rates at 4% are, given the histories of discount rates in emerging markets like these.

What does the virus mean for EM?

So, what has Cov-19 meant for emerging economies? The Chinese economy has clearly taken a significant hit to both production and consumption. We have been following various daily/weekly data signals (such as daily coal usage at major power plants), and these have vastly undershot previous recoveries from the Lunar New Year slowdown. The monthly data is now showing signs of the hardest landing in the economy: composite PMI at 27.5, car sales down 80% year-on-year, steel inventories up 55% in four weeks. There is some sign of a recovery in more industrial measures (such as coal consumption) but consumer metrics (car sales, cinema attendances) continue to look very weak. There will always be challenges around Chinese economic data but clearly H1 2020 will be significantly weak in economic terms.

It is hard to generalise around other emerging markets. South Korea has had the greatest number of Cov-19 cases in EM outside China and is seeing some impact on companies from closures at Chinese suppliers, as well as stress from very weak Chinese end-demand. Taiwan, by comparison, is still largely unaffected, but at some point Chinese factory closures and weak demand will bite into Taiwanese exports. Elsewhere, it is unclear what impact will be had on specific countries or companies, but it is clear that the broad tourism/travel/hospitality/leisure sector is being hit hard globally. This will hurt both emerging market companies in these industries as well as economies with high dependence on tourism.

Turning to markets, we have seen a substantially higher level of volatility in many areas and periods of very aggressive risk-off. The collapse in US Treasury yields, short-term US dollar strength and recent weakness in gold and gold miners is symptomatic of extreme risk-aversion. For now, the traditionally higher-beta markets, such as Turkey, Brazil, Russia and India, have been more volatile in US dollar terms; similarly the pattern of growth outperforming value is to be expected.

How are we navigating these markets?

We would highlight the following:

- We will remain focused on our process. We prefer markets where growth is strong, accelerating and/or supported by policy, as well as markets with lower political risk and markets with more attractive valuations of currencies and/or equity markets.

- Within preferred markets, though, we are very focused on the enormous opportunity that companies with more stable and reliable cashflow and dividend streams present. We expect that, as rates and yields decline in the developed world, so will rates and yields in the emerging world. As in the Greek and Brazilian examples above, this could lead to substantial gains for investors. As a result, we maintain our focus on companies and groups of companies where there is a material pick-up in shareholder returns, for example Korean and Brazilian corporate governance reform beneficiaries.

- We also see the new easier monetary environment as highly positive for domestic demand in current account deficit markets, as these markets are substantially constrained by a lack of financing. Any such opportunities must of course be assessed in the light of Cov-19 effects, and also with recognition of the negative impact of lower rates and yields on many financial sector stocks.

- Another group of stocks that should benefit from lower discount rates are long-dated growth stories (and the riskier and longer-dated the growth, the greater the effect). These companies, typically in the technology and internet industries, generally look expensive within our investment horizon and are less likely to be a substantial part of our portfolio.
- Finally, collapsing rates and increasing monetisation are highly supportive of the gold and platinum-group metals prices, and we expect to continue to hold positions in producers of these metals.

China – we remain underweight with generally defensive exposure

We remain underweight China, as we expect the already weak growth rate to undershoot in the near term. We also note the substantial ability of the government to provide cyclical stimulus, as in 2015, even if it ultimately cannot shift the trend growth rate higher. With the level of indebtedness in the Chinese economy, and the opportunity offered by falling US rates, we think it is likely that rates and yields in China decline substantially through 2020, creating support for Chinese equities.

We hold a generally defensive, strong cashflow, high-quality portfolio in sectors such as gas utilities, toll roads, property services and telecoms. We also hold exposure to oil & gas companies (where cashflow and dividend yields are typically high but investor sentiment very negative), and the internet sector (but highly selectively given the degree of valuation re-rating in recent quarters).

South Korea – we still like the improving corporate governance story

South Korea is another market with significant Cov-19 exposure but also where high domestic leverage is likely to see declining rates and yields. In addition, we maintain our exposure to companies where we expect corporate governance reform to lift dividend payments (although we recognise that some readjustment may be needed away from cyclical sectors and towards defensive ones).
One cyclical area where we remain positive is semiconductors, where we continue to see strong demand. Adjusted for business days, Korean DRAM exports in February were +5.4% YoY (both from increasing demand for server/data centre memory, plus price hikes). Where we hold semiconductor exposure, it is all consistent with our corporate governance theme.

EM countries running current account deficits – medium-term beneficiaries of lower global yields

Emerging markets that run current account deficits are generally less trade dependent and more financing dependent. They are collectively a potentially huge beneficiary of the fall in global yields (in the medium term). Notably, February’s PMI surveys have held in much better in these markets than in the exporters.

Indian growth was very weak through H2 2019 and Indian trailing data remains weak, but February’s manufacturing PMI was 54, down from an eight-year high of 55.3 in January. Indian revisions remain weak but the market has been steadily outperforming EM over the year to date.

Turkey has also been surprising on the upside, as GDP growth beat expectations in Q2 2019, with accelerating growth and domestic demand becoming more prominent. The Turkish economy should continue to recover as financial conditions normalise and lending accelerates.

In Brazil, relatively strong PMIs continue (manufacturing PMI 52.3 for February), and Brazilian economic momentum remains reasonably strong in an EM context. However, the currency is sliding on lower Brazilian bond yields - currency valuation still matters, even in these times.

Mexico has been weaker, with disappointing GDP growth in Q4 2019 and manufacturing PMIs just reaching 50 (which constitutes a neutral outlook).

Our enthusiasm for current account deficit markets remains selective – South Africa is in real trouble with broken growth, yawning budget deficits and no obvious solutions.

South-east Asia – the middle ground

In the middle ground, south-east Asia has been a significant beneficiary of capital flows in other times of flows to EM, but also has significant dependency on both tourism and Chinese manufacturing supply. As a result, there has been significant weakness in GDP revisions in some markets, including Malaysia and Thailand.

Russia – a riddle

Russia remains a conundrum, a current account surplus market that behaves like a current account deficit market. It ultimately remains a commodity exporter and better options exist.

Commodities – we're happy to hold gold

Gold and platinum group metals prices performed well in Q4 2019 and recent price falls should not be a concern. 2008-9 saw periods of weakness in both the gold price and index gold miners' share prices in what was overall a period of strong returns. With super-low rates coming, and likely further expansion of developed market central bank balance sheets, we are happy to hold gold exposure until we see firm signs of full-blown economic recovery across the emerging world.

Style – we're significantly overweight strong balance sheets

Finally, from a style point of view we remain significantly overweight stronger balance sheets, which we feel is appropriate in this environment. Where cashflows are materially interrupted, debt can become an existential threat.

Summary: the collapse in yields is great news for EM

Risks are high, volatility has soared and newsflow is difficult, but we strongly believe that the decline in developed market rates and yields (led by the US) is immensely positive for many emerging economies and for the valuation of many of the companies in those markets. As always, we think the bottom 5% of a DCF model is more important than the upper 95%.

All the economic data is as of March 5th, 2020 unless otherwise noted.

An investor should consider the Fund's investment objectives, risks, and charges and expenses carefully before investing or sending any money. This and other important information about the Fund can be found in the Fund's prospectus or summary prospectus, which can be obtained at www.johcm.com or by calling 866-260-9549 or 312-557-5913. Please read the prospectus or summary prospectus carefully before investing. The JOHCM Funds are advised by J O Hambro Capital Management Limited and distributed through FINRA member Foreside Financial Services, LLC. The JOHCM Funds are not FDIC-insured, may lose value, and have no bank guarantee.

Past performance is no guarantee of future results.

RISK CONSIDERATIONS:

Investors should note that investments in foreign securities involve additional risks due to currency fluctuations, economic and political conditions, and differences in financial reporting standards. Smaller company stocks are more volatile and less liquid than larger, more established company securities. The small and mid-cap companies the Fund may invest in may be more vulnerable to adverse business or economic events than larger companies and may be more volatile; the price movements of the Fund's shares may reflect that volatility. Fixed income securities will increase or decrease in value based on changes in interest rates. If rates increase, the value of the Fund's fixed income securities generally declines. Other risks may include and not limited to hedging strategies, derivatives and commodities.

The views expressed are those of the portfolio manager as of March 2020, are subject to change, and may differ from the views of other portfolio managers or the firm as a whole. These opinions are not intended to be a forecast of future events, a guarantee of future results, or investment advice.