JOHCM Emerging Markets Opportunities Strategy

EMERGING MARKETS OPPORTUNITIES

25 MARCH 2020

James Syme, Senior Fund Manager

Paul Wimborne, Senior Fund Manager

Matters of state: our very latest views on EM

Facing a market sell-off and a shift in macroeconomic expectations unparalleled even in the history of emerging markets, a few key drivers of returns in the asset class are very clear in terms of magnitude and direction, even if precise levels are not yet visible:

- OECD GDP faces a very sharp decline in, at least, the first half of 2020, and possibly longer. This immediate fall-off in global growth, and with it global trade volumes, is negative for emerging markets.
- Partly driven by global growth, and partly by a price war between major producers, the oil price has fallen to levels not seen since 2002-3. This has a markedly differential effect on emerging markets that are net importers or exporters of oil.
- There is a rolling global financial crisis, focused on leveraged assets and financial structures.
- Interest rates have fallen heavily around the world, both at the policy end and at longer maturities.
- The flight to safety has driven a huge rally in the US dollar against almost every other asset, even gold.
- At least at the time of writing, it does seem as though a number of Asian emerging markets have managed through a spectrum of policies to contain the spread of coronavirus.

Some things are uncertain. Of particular importance is the current seeming lack of a take-off of coronaviruses in more tropical countries – the continuation of this pattern is critical for the future of the emerging market asset class. Another key uncertainty is the efficacy of the aggressive monetary and/or fiscal stimulus being applied by leading OECD nations.

As a starting point, and drawing on Harvard Business Review's 'What Coronavirus Could Mean for the Global Economy', we are proceeding with the following assumptions:

- The global economic downturn will be v-shaped, but with a very, very deep V.
- The duration of the downturn will be quarters rather than years.
- The pattern of more tropical countries being less affected will continue.

If any of these assumptions change, we will adjust accordingly.

Not all of the usual rules apply

In looking for country opportunity in emerging markets, we are focusing at this time on which countries have the greatest ability to support growth through policy. We accept that backwards-looking economic data and current forecasts are both useless at this time.

Whilst monetary and liquidity drivers, currency outlook and valuation are all important components of our process, we think that there is only limited work that monetary policy can do at this time. Meanwhile, the extreme cheapness on historical measures of pretty much every emerging equity market and currency will be of no importance until economies begin to recover.

These matter more: fiscal deficits and oil price sensitivity

There are a number of key markers which we feel identify the markets with the strongest potential to support growth.

The first is fiscal deficit, a key point of analysis for us at all times. Fiscal deficits are interesting when analyzed in the context of both the level of local bond yields, and also the recent change in yields. **We have found in previous crises and recoveries that moves in bond yields and credit default swap (CDS) levels are salient data points for emerging equity markets during crises.**

Another, and one we have written on recently, is the impact on the country's oil import bill of a US$ 40/bbl decline in oil prices.[1] This size of decline is material, benefiting Taiwan by an estimated 4.4% of GDP per year, and hitting Saudi Arabia by 15.9% of GDP.[2] These are very large numbers and might be of dominant importance were it not for Covid-19.

A country tour of EM

The following areas are of particular interest to us:

- **China and Taiwan** – both have shown high levels of state capacity and social cohesion, combined with low levels of dollar sensitivity. Both are large oil importers. Whilst each will take a hit from a sharp fall in exports to Europe and North America, there should be the ability to offset this with government action. Correspondingly, Taiwan and China have been the best performing of the main emerging markets.

[1] https://www.bp.com/en/global/corporate/energy-economics/statistical-review-of-world-energy.html as at December 31, 2018.
[2] Bloomberg/ World Bank as at December 31, 2018.

- **South Korea** – similarly, South Korea has seen a strong state and social response to the Coronavirus, and is a low dollar-sensitivity, oil importer. Some features of the Korean equity market (short-volatility savings products), plus Korea's role as an easily-traded market with a deeply liquid futures contract, have seen significant selling in Korea, with the market underperforming Taiwan and China despite a broadly similar set of drivers. We feel that Korea is a substantial opportunity at this time. In particular, the excessive cash that many Korean companies hold is a strong defensive characteristic.
- **Central Europe** – Hungarian yields have sold off as the central bank has remained too loose for too long, driving a spike in inflation. But both Poland and the Czech Republic have seen low and falling bond yields yet equity market weakness. The large weight in banks in both markets must serve as some offset, but these are fundamentally well-run, high state-capacity countries that benefit from EU membership and may offer opportunity.
- Other markets that look to have been very weak given their fundamentals include **Chile, Peru, India and Indonesia**, all of which are oil importers and which have seen equity returns much worse than might otherwise be expected. Chile and Peru have performed worse than oil-exporter Mexico, while Indonesia has performed more in line with Russia and South Africa. The recently announced 21-day lock-down in India will have a significant impact on economic activity there, hitting an already weak economy. However, local bond yields suggest that the government will have substantial ability to support the economy, given the current account and inflation implications of the move in the oil price.
- Three countries look, to our analysis, to have very significant risk: **Brazil, Colombia and South Africa**. In each case, the combination of fiscal and current account deficits before the crisis started act as a significant constraint on the ability of the government to support economic activity. Serious fiscal stress can emerge here without any easy resolution. With the possible exception of Egypt, we assess these three markets as the most risky in EM right now and have aggressively moved to reduce our exposure.
- Another group of markets we are watching closely, and where we still hold positions, is **Russia, UAE and Mexico**. All are oil exporters, and have started from reasonably promising fiscal positions and state capacity. However, with the impact from the downturn in global trade and tourism (Mexico and UAE) and the collapse in the oil price (Russia and UAE), these markets face a long recovery from here. That said, there are stocks in these markets, particularly in the mid-cap space, at valuations (based on actual cashflows and dividends rather than earnings) that seemingly justify the risk of owning those stocks.

Opportunities and risks by sector and industry

Whilst we do not make global sector allocations, when looking for stocks in preferred countries, we are aware of sector and industry dynamics. In the current environment, we identify the following risks and opportunities:

- Banks generally carry a triple threat in this environment: from the cyclical impact of the downturn; from reduced net interest income as rates fall; and from taking part in loan repayment holidays. We remain significantly underweight financials.
- Defensive cashflow-generating assets are extremely valuable in this environment. This includes consumer staples, but can also include transport assets, telecoms, utilities, some real estate-related businesses and even precious metals miners.
- The disruption to the global economy is acting as a huge accelerant for the migration of activity online. In emerging markets there are both online companies who will benefit from this (which has largely been recognized by markets), and also a significant ecosystem of hardware manufacturers feeding into the infrastructure that supports online activity. We believe that the medium-term outlook for companies here is very strong and are actively seeking out new names in this space in our preferred countries.
- Strong balance sheets are absolutely essential, as the single most important aspect of any stock investment is that it survives the downturn without bankruptcy or dilution. The portfolio went into the crisis with a significant style skew towards stronger balance sheets and that has been maintained.
- Finally, just as the state is now the prime mover in economies, so it is at the company level. State support (from solvent governments) can be a huge opportunity in this environment, and there are stocks that we own in some markets like UAE, Russia and China where we see state ownership as a key feature.

Country calls still count most

Every emerging market crisis is different, and this one features some very challenging dynamics. We remain firm in our belief that country drivers (in this instance, state capacity and its deployment to support economies) will remain the key differentiator. We will maintain our approach of not taking a directional view, but rather focusing on preferred stocks in preferred countries.

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 Strategy 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 Strategy'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 Strategy'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.