J O Hambro
Capital Management Group

JOHCM Global Emerging Markets Opportunities Fund

EMERGING MARKETS SPOTLIGHT

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James Syme, Senior Fund Manager

Paul Wimborne, Senior Fund Manager

Whilst the country-level remains our focus when thinking about risks and opportunities in EM equity, we have to also be aware of developments at the sector and industry level. One that seems particularly important to us, at this time, is the rapidly worsening outlook for banks, both in emerging markets and globally.

We wrote two weeks ago that ‘banks generally carry a triple threat in this environment’. We now update that to four threats, and will discuss them in turn.

Firstly, banks are inherently cyclical businesses. Loan growth is a reflection of animal spirits in the economy, whether corporate or household, while the fee component of income is also driven by activity levels. Further down the income statement, provisions (cost of risk) is hugely counter-cyclical, peaking around the economy’s weakest point. It is unclear at this time exactly how bad the hit to both top line and provisions will be from the coronavirus-related economic slowdown, but moves in high yield and credit default swaps suggest that it will be severe. Banks that carry investment portfolios and/or financial inventory on their balance sheets will be further hit from the ongoing hit to asset prices. Although regulatory forbearance can shield capital adequacy from these effects, it cannot shield reported earnings.

Secondly, for most banks, fee income is the minor part of revenue for most banks. The major part is interest income. As interest rates decline, and particularly as deposit and funding rates approach the zero lower bound, net interest margins are compressed. This can have a severe impact on bank profitability, and is often then reflected in price-to-book ratios of banks in low rate environments, as seen in recent years in Japan, Korea, Taiwan and the eurozone.

Thirdly, and a new feature of the landscape, central banks and regulators in many countries are putting pressure on banks to grant repayment holidays on various types of credit. Many emerging markets, including Thailand, South Africa, Turkey, Hungary, Mexico, Colombia, India and UAE have seen banks offer delayed payment terms for interest and/or principal. Whilst this may reflect delay rather than negation of cashflows, it is clearly unhelpful, and also raises the possibility of further forbearance such as underpricing of loans and/or debt jubilees, all of which are risks to banks and their shareholders.

Finally, and possibly the most serious development is the move in some countries to ban dividends and buybacks for banks (and, potentially, for insurers). Whilst this is more of a developed market phenomenon so far (with the eurozone, the UK and New Zealand the first countries to do this), it clearly has the potential to be adopted by other countries. Doubts about pay-outs to shareholders are very likely to depress the valuation given to bank equity shares, in turn increasing the risk that any capital raise will be dilutive.

It is abundantly clear that pretty much every sector, indeed pretty much every form of human activity, is being severely affected by coronavirus and the social and economic impacts of efforts to control the virus. However, within that, we see a particularly negative outlook for banks, and potentially other highly-regulated financials such as insurers. We are about maximum underweight financials relative to benchmark at the time of writing.

JOHCM Global Emerging Markets Opportunities Fund
5 year discrete performance (%)

Discrete 12 month performance (%):

	31.03.19	31.03.18	31.03.17	31.03.16	31.03.15
A USD Class	-21.17	-2.55	20.18	18.95	-13.11
Benchmark	-17.72	-7.36	24.13	17.59	-11.92
Relative return	-4.19	5.19	-3.18	1.16	-1.35

Past performance is no guarantee of future performance.

Source: JOHCM/MSCI Barra/Bloomberg, NAV of Share Class A in USD, net income reinvested, net of fees as at 31 March 2020. The A USD Class was launched on 30 June 2011. Benchmark: MSCI Emerging Markets NR (12pm adjusted). Performance of other share classes may vary and is available on request.