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Capital Management Group

JOHCM Global Emerging Markets Opportunities Fund

EMERGING MARKETS SPOTLIGHT

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As we have previously noted, we believe that growth metrics, and policies designed to support growth, are by far the key data points to track for markets, with stimulative monetary policies and attractive valuations almost everywhere in the emerging world. Without changing that view, though, we note some interesting differences between inflation dynamics in major Latin American countries.

To put the headlines up: Brazilian consumer price inflation, having ended 2019 at a 4.3% year-on-year increase, fell to a 20-year low of 1.9% in May 2020, recovering slightly to 2.1% in June. Mexican consumer price inflation, having ended 2019 at 2.8%, rose to 3.3% by June. Clearly there are some very different dynamics at play here. Why, and what does it mean for investors?

Firstly, both countries have had difficult coronavirus crises. In the two weeks to 3rd August, European Centre for Disease Prevention and Control figures show Brazil third and Mexico sixth globally in terms of total new cases (USA and India, and South Africa and Colombia, hold the other places). In both countries there has been very significant disruption to economic activity. In Brazil, industrial production and retail sales to May were-21.9% and-7.2% respectively; in Mexico those figures were -30.7% and-23.7%.

Historically for both countries, the imported component of inflation has been volatile, driven at times by exchange rate volatility. The Brazilian real fell 28.1% against the US dollar in the first seven months of 2020. The Mexican peso, meanwhile, fell 16.4% against the US dollar in the period.

So, with a deeper slowdown in Mexico (which should have eased demand pressure on prices), and a smaller fall in the currency, why has Mexican inflation proved so sticky?

A deeper look into the Mexican data shows a very stable core CPI rate (year-to-date the range has been 3.6%-3.7%, with declines in housing, non-food merchandise and services being offset by significant price pressure in food merchandise). The food, beverages and tobacco price index rose by 6.6% in the year to June, which the central bank attributes to a reallocation of household spending and to disruptions in the supply of certain goods.

One feature of food prices in emerging markets is that spikes up and down are common but typically short-lived as supply and demand adjust quite quickly. Certainly, the expectation of the Mexican central bank and of many observers is that policy interest rates can be cut in the second half of 2020. The deputy governor of the central bank, reporting to Congress a few days ago, said 'in my personal opinion the cycle hasn't ended (and) that we'll look to take our monetary stance to an expansive level in accordance with the current economic situation'. The central bank has cut rates from 7.25% at the start of the year to 5.0% at the last meeting, with consensus expectations that the rate will fall to 4.2% by the end of the year.

By comparison, Brazilian interest rate cuts may have been front-loaded this year, with a decline from 4.5% to 2.25% so far. The central bank's monetary policy committee in the minutes of its last meeting said that any additional rate cuts would be 'small'. Notably, given Brazil's extremely weak fiscal position, the minutes described current monetary policy as 'close to the level from which further interest rate reductions could be accompanied by asset price instability.'

There are a number of reasons why we (cautiously) prefer Mexico to Brazil at this time, including Brazil's difficult coronavirus statistics and extended fiscal deficit, but the outlook for monetary policy in the second half is another.

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

Discrete 12 month performance (%):

	31.07.20	31.07.19	31.07.18	31.07.17	31.07.16
A USD Class	1.63	-1.75	4.00	25.02	0.24
Benchmark	6.65	-2.15	4.46	25.34	-0.61
Relative return	-4.71	0.41	-0.44	-0.25	0.86

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 July 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.