JOHCM Funds

JOHCM Emerging Markets Opportunities Fund

EMERGING MARKETS SPOTLIGHT

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Much of the commentary around the impact of the coronavirus on economies around the world has emphasised the unprecedented nature of the crisis. The outcome, though, is in some senses not new to emerging markets. Sudden, brutal hard stops in domestic consumption and activity, accompanied by capital flight and spectacular correlated sell-offs in equities and currencies, have been a sporadic feature of the asset class since at least the Latin American debt crisis of the early 1980s.

That pattern allows us to look for signs as to which economies (and, potentially, markets) we view are in the best positions to recover. There are particular indicators that, in our experience, show an economy at least has the foundations of a recovery in place, although history suggests it is usually worth looking for positive momentum in economic indicators and corporate results/expectations as well. Looking at these indicators, two markets stand out as particularly interesting right now: India and South Africa.

The signs of a hard landing in the economy are obvious: GDP, PMIs, industrial production, retail sales, imports, investment and corporate profits all fall sharply, whether the shock is country-specific, regional or global. Clearly, this has happened in both India and South Africa. India's composite PMI bottomed out at 7.2 in April, while year-on-year GDP in the quarter to June was -23.9% and -7.5% in the quarter to September. In South Africa, the main PMI index had a lowest reading of 30.3 in April, while year-on-year GDP in the quarter to June was -17.1%. These numbers represent huge output gaps of economies operating below capacity.

For recovery to happen, though, there has to be a source of demand. One of these is the stimulative effect of weaker real effective exchange rates. Weaker currencies both stimulate exports (and import substitution), and can also attract capital inflows (a sufficient time after the sell-off – memories are short in the carry trade). As a result, one key metric for us is change in trade balances and current account balances: several important historical recoveries in economies and markets have followed big upward moves in external balances. Looking at the two markets in focus, we see India's trade deficit averaging US$172bn/month through 2018 and 2019, but sharply recovering through 2020, with the last two prints showing a monthly deficit of less than US$95bn. Similarly, India's current account balance was in surplus in the June quarter for the first time since 2004. Both balances have also moved strongly towards the positive in South Africa as well, with the trade balance the strongest it has been since the end of apartheid and liberalisation, and the current account balance the strongest it has been in nine years.

These moves are very positive, but are also seen in several other emerging markets. It is a different metric that makes India and South Africa stand out: bank deposits. Both countries have seen a huge build up of domestic bank deposits during the crisis, significantly increasing the potential for domestic demand recoveries when confidence returns.

In the year to September 2020, credit in India grew by only 5.8%, but aggregate deposits were 11.0% higher. The central bank noted that 'the increase was witnessed across all population groups'; meanwhile the credit/deposit ratio declined to 72.0%. The huge growth in incremental deposits was coincidental with an undershoot of both consumer spending and private sector investment. With the central bank's reverse repo rate sitting well below the banking system's average cost of funds, there is very real economic pressure on banks to grow credit as soon as demand returns.

South Africa has also seen a sharp move higher in bank deposits. Year to date, to September, public sector deposits were up ZAR95.3bn* (US$6.3bn), private sector corporate deposits up by ZAR109.0bn (US$7.2bn) and household deposits up by ZAR97.1bn (US$6.4bn). With interest rates having fallen sharply, there is also huge potential for a drawdown of South African bank deposits to drive investment and consumption.

*ZAR = South African rand

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

Excess saving has been a global problem since at least 2009, and there is only so much that conventional monetary policy can do in an absence of demand and Keynesian 'animal spirits'; it may partly fall to government spending to convert private sector savings into end demand. However, with improving coronavirus case data in both countries, with a vaccine potentially to be deployed soon, and with other parts of the global economy picking up, we are excited about the potential for the domestic demand cycle in both countries, and have been adding to domestically-focused stocks, notably banks, in both markets.

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