JOHCM Emerging Markets Opportunities Fund

EMERGING MARKETS SPOTLIGHT

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Followers of our views will know that we have had a steadily evolving interest in the traditionally higher-beta emerging markets, seeing domestic recoveries that have a good distance to run based on current trade balances and on the reset to credit and demand cycles that 2020 created. Also supporting those trade balances are some powerful upward moves in terms of trade (the ratio of export prices to import prices) in some of these economies.

First among these has been India. After the weak economic environment seen in 2019 and then the effects of the Covid-19 lockdowns, India has seen a powerful demand recovery in recent months. PMIs have generally been printing at above 55 and vehicle sales remain strong. The recovery began into the autumn festive season, and companies were unsure if it would last, but it has. In particular, companies are reporting strong demand and a reduced need to fund promotion and associated expenses to generate sales. Driving the recovery has been urban demand (which slowed in 2019 and 2020, even for FMCG companies, but which has revived as Covid cases continue to fall), premium segments (as disposable incomes and consumer confidence improve), and real estate (helped by lower mortgage rates and improved affordability).

Recoveries in Brazil, Mexico and South Africa have been more mixed, but certainly some data points, such as Brazilian bank lending growth, or South African retailers' results, show firm recoveries. We would particularly note, though, the potential for these recoveries to continue for much longer than markets are pricing in, suggesting that continued positive surprise in corporate results can drive equities and currencies higher for longer in these countries. To be clear, we see these countries as the least understood and consequently most attractive part of EM.

Yet, with the exception of India, we have been relatively cautious about adding exposure, even as these economies recover and portfolio capital that fled in the first half of 2020 returns. Why? There are two main reasons for our short-term caution despite our longer-term optimism.

Firstly, there are some significant challenges from Covid second waves in some of our preferred markets. Brazil has a major second wave underway, centred on the city of Manaus, where a new variant is causing the majority of infections. South Africa has also had a second wave with a new variant at its heart, although case data there is now rapidly improving. Mexico's second wave has been much more severe than its first, although again, case data is now improving. These second waves, and others, may lead to a short-term setback in both economic recoveries and in investors' optimism.

Secondly, we are concerned about the potential for a short-term inflationary bulge as rising commodity prices meet the year-on-year effect of the March/April 2020 base. The Brent oil price per barrel was US$17.30 at the end of March 2020, US$40 at the end of January 2021 and nearly US$60 at the time of writing; soybeans (based on the Chicago bushel price) traded between US$6.50 and US$7 in the first few months of 2020, but are nearly US$14 at the time of writing. The same pattern exists for diverse commodities, from wood pulp to copper, from wheat to ethylene. In the higher beta emerging markets, stronger currencies have, and can continue to, offset the domestic inflationary effects, but we are concerned that there is a risk of more challenging inflation prints in coming months. We are particularly concerned about Brazil and Russia (where inflationary pressures were starting to emerge before Covid hit), although differing reaction functions are more likely to see rate hikes and slower growth in Russia, and currency and bond market weakness in Brazil, should this occur.

Neither of these issues reduces our long-term enthusiasm for these markets. India has been a powerful example of what a domestic demand recovery can mean for equity investors, while those same commodity prices are highly supportive of economic fundamentals and financial markets in more commodity-sensitive EMs like Brazil, Mexico, South Africa and Russia. We continue to look to increase our exposure to markets like these, but we will also look to be tactical with regard to timing our portfolio shifts.

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

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