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FOR PROFESSIONAL INVESTORS ONLY

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Capital Management Group

Emerging Markets Spotlight

James Syme, JOHCM Global Emerging Markets Opportunities Fund

"The [IMF] also notes that current-account imbalances are increasingly becoming concentrated among rich nations, as surpluses shrink in China and among crude exporters."
Bloomberg, 24 July 2018

Followers of our process and portfolio will be aware of the respect we have for the IMF's annual External Sector Report, which focuses on IMF staff assessments of valuations of major exchange rates. This month saw the release of the 2018 report, which is generally positive about EMDEs (Emerging Markets and Developing Economies), identifying the major and riskiest imbalances as being the various large external surpluses (Germany, Japan, the Netherlands) and deficits (UK, US) in the developed world.

However, the report does also identify undervalued emerging market currencies. The report is focused on the end of 2017, but it is possible to adjust those valuations by year-to-date moves to arrive at current estimates of currency valuation. More interestingly, these can be combined with equity market valuations to identify areas of the emerging market universe that are cheap overall. Obviously our full country process considers many other top-down factors, including business and credit cycles, monetary policy, politics and governance, but this may point to areas of opportunity.

First up is Brazil, where the IMF assessed the real as 2% undervalued at the end of 2017, and subsequent weakness suggests a current undervaluation of 3.5%, while the equity market is cheap at 10.5x forward earnings. The IMF's view is that, in Brazil, 'lower-than-desirable credit, amid weak investment, pushed up current account balances, masking underlying competitiveness problems that pushed the current account in the opposite direction.' This fits with our view, and must be taken in the context of a fiscal problem that may, or may not, be addressed at the forthcoming October 2018 election (which we see as an absolutely key driver of Brazilian markets). Indeed, the IMF report notes that 'fiscal consolidation [in Brazil] should be met with reforms to boost investment.' We remain cautious on Brazil but are monitoring developments around the election.

Next up is Korea. With its large external surplus, Korea has a very different profile to most emerging markets. There are a number of drivers of Korea's undervalued currency (4.5% as at end 2017; 4.7% at present) and persistent current account surplus identified in the report. Overall, the IMF report sees Korea as having a higher-than-desired current account surplus, with the remedies involving a stronger currency and looser fiscal policy. We believe that the policies of the more left-wing Moon administration will achieve both of these aims, resulting in stronger domestic demand growth and an upward lift to returns from a stronger currency. Meanwhile, Korean equities are priced at just 7.7x forward earnings. Korea is one of our favourite markets.

Finally, we have the complicated case of Turkey. After several years of being assessed as overvalued, the IMF 2018 External Sector report sees the lira as about fairly valued as at end-2017, which means it is substantially undervalued after the fall in the exchange rate year-to-date. We estimate the lira to be 9.0% undervalued as at end-June 2018 and 14.2% undervalued as at 6 August 2018. Meanwhile, Turkish equities are priced at 5.8x forward earnings. The IMF sees Turkey as needing to 'adopt a credible policy package involving growth-friendly fiscal consolidation' as well as reining in easy credit, and there is no doubt that the implementation of orthodox policies in Turkey would produce a very powerful rally in Turkish assets. However, we can see no sign that policymakers are considering such steps, and remain negative on Turkey.

We believe that both currencies and equity valuations are critical components of assessing the investment opportunity in emerging markets but, as can be seen in these three cases, one can ignore neither the political and policy environment, nor the credit and demand cycles, in emerging markets.

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

Discrete 12 month performance to

	31.07.2018	31.07.2017	31.07.2016	31.07.2015	31.07.2014
A GBP Class	3.66	25.79	18.46	-0.94	8.16
Benchmark	4.16	25.84	17.47	-7.11	4.35
Relative Return	-0.48	-0.04	0.84	6.64	3.66

Past performance is no guarantee of future performance.

Source: JOHCM/MSCI Barra/Bloomberg, NAV of Share Class A in GBP, net income reinvested, net of fees, as at 31 July 2018. Inception date: 16 June 2008. Note: All fund performance is shown against the MSCI Emerging Markets (12pm adjusted). Performance of other share classes may vary and is available upon request.

Past performance is no guarantee of future performance.

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