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FOR PROFESSIONAL INVESTORS ONLY

Emerging Markets Spotlight

James Syme, JOHCM Global Emerging Markets Opportunities Fund

The outlook for emerging markets in the second half of 2019 and beyond has two main macro drivers: US rates and yields, and Chinese growth. This is obviously always the case, but these variables significantly surprised in the first half of the year and will remain of great interest ahead, unlike, say, the oil price (weakening demand but producer discipline), Asian and Middle Eastern geopolitics (both noisy but seemingly not yet at the point where any major player abandons the current system), or developments in Europe (messy politics should not distract from super-low bond yields).

The shift in the US yield curve, and the associated expectations for interest rates, has been dramatic. At the end of June 2018, the effective Fed Funds rate was 1.82% and the US 10-year Treasury yield was 2.86%; a year later, those rates were 2.40% and 2.01%, respectively. Even the 30-year Treasury, at 2.53%, is almost trading below the policy rate. This inversion of the longer end of the US yield curve has generally occurred before difficult times in markets, including the early 1980s twin recessions, the savings and loans crisis, the Asian crisis and end of the tech boom, and the global financial crisis. US data remains reasonably strong, but clearly US fixed income markets see the long economic boom that began in 2009 coming to an end.

Chinese slowdown

While the expectations are for a slowdown in the future in the US, economic growth in China is unambiguously soft. Recent disappointing data include a 49.4 reading for June's manufacturing PMI survey and May's industrial production number slipping to 5.0%, a 17-year low, while other, related data such as Taiwan exports (-5.8% to May), Korea exports (-13.5% to June) and the copper price (down 7.9% in the second quarter of 2019) all show the endemic weakness in Chinese demand. Whilst China notionally has a wider set of policy options than almost any other emerging market, internally imposed constraints mean that there is no easy way to stimulate growth whilst also managing the Renminbi exchange rate.

In addition, trade tensions and related uncertainty may be partly to blame for this developing sense of slowdown. From an EM point of view it doesn't matter if export demand is sliding because of the natural evolution of the economic cycle or because of a political overlay. It is clear that economic data, positioning in bond markets and revisions to forecasts point to an environment that is negative for the cyclical, export-driven part of EM. For countries, that means Taiwan, South Korea, China, Mexico, Malaysia and Thailand; for sectors, it means information technology and parts of the industrial, materials and consumer discretionary sectors.

At the same time, though, lower interest rates in developed markets mean the opportunity for lower rates in emerging markets. Year-to-date, various EMs, including Russia, Malaysia, India and Chile, have been able to cut policy rates, both in response to declining inflation and to reduced concerns about US monetary policy tightening.

EM winners in 2019

So, in this seemingly slower-growing world, what were the winning trades in the first half? From an EM country perspective, the best performing markets were Greece (MSCI USD price index +29.3%) Russia (+28.0%), Argentina (+27.2%) and Egypt (+24.9%). What these markets have in common is that they are generally

very cheap (in each case because of some fairly obvious political and economic dysfunction), and their strong performance reflects investors increased appetite for risk as risk-free rates decline. If global rates and yields are to remain depressed, this rotation into risk is likely to endure, even if the headlines remain troubling.

This isn't to make an argument for investing in the (long-underperforming) value style tilt in EM. Value may also capture many industries that are, at this point in time, strategically challenged by industrial and technological changes (such as retail, autos and telecoms). In addition, falling costs of capital should be proportionally more beneficial to companies with longer duration cashflows, i.e. growth companies. Rather, this is about the increased attractiveness of cheaper, riskier markets, both through value (to equity investors) and through carry (to bond investors).

Individual country opportunities despite a slowing cycle

We feel that this points to some markets that have lagged the rally in risk, year-to-date. Turkey remains very difficult from a political and policy standpoint, while the economy continues to work through the legacy of the strong credit boom that ended in mid-2018. Nevertheless, it is the emerging market that seems to be cheapest across the equity-rates-currency spread, with single-digit P/Es in the equity market, policy rates 830bp above trailing consumer price inflation and a currency far from its real effective exchange rate trend.

South Korea is a highly cyclical economy and equity market, with substantial exports to China, but extremely low valuations there (price/book value for the market of 1.0x) also reflect investors' sense that governance risk in Korea is elevated. Followers of our strategy will be aware of our expectation that increasing payout ratios will add a carry opportunity to the existing value opportunity there. Korea is also attractive because it should provide a hedge in the event that there is a recovery in the global economy, with a resultant back-up in yields.

Some other EM assets should also benefit from the current environment. Although Pakistan continues to face multiple economic challenges, the market is cheap and the recent IMF loan deal underpins the policy environment. In addition, gold has performed well in this period of low cost of capital, driving strong gains from EM gold miners.

EM equities remain in aggregate a highly cyclical asset class, but the first half of 2019 has shown that a slowing cycle still creates great opportunities within the asset class.

JOHCM Global Emerging Markets Opportunities Fund

5 year discrete performance (%)

Discrete 12 month performance (%):

	30.06.19	30.06.18	30.06.17	30.06.16	30.06.15
A GBP Class	5.83	6.23	31.13	2.08	9.33
Benchmark	5.22	6.56	29.01	2.46	2.54
Relative return	0.58	-0.31	1.64	-0.38	6.63

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 30 June 2019. The A GBP 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.

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