JOHCM Funds

Emerging Markets Spotlight

James Syme, JOHCM Emerging Markets Opportunities Fund

"Politicians think of their own survival and that means taking action that the population likes. Nobody talks about the need for pension reform anymore, and that's worrying."
Robson Andrade, head of the Brazilian National Industry Confederation, quoted in Bloomberg article, 29 August 2018

Regular followers of our process will know that we consider a country's current account balance to be a key indicator to watch. That doesn't mean that it's the only place where deficits matter, though. There are times when the fiscal balance is the more important metric. That has been the case in the ongoing crisis in Argentina (where we have had a zero weight), but also forms the backdrop for October's presidential election in Brazil.

Argentina is in an economic crisis. To the end of August, the MSCI Argentina price index was down 54.5% in US dollar terms, as the currency sold off despite policy interest rates being hiked to 60%. At the heart of Argentina's problems is a huge fiscal deficit (forecast to reach 5.0% of GDP this year). The monetary system's financing of that deficit has driven credit growth at an annualised rate of over 30%, which was great for assets until foreign investors lost confidence, at which point it wasn't. Argentina now has to brutally tighten both monetary and fiscal policy at the same time.

This is unfortunate timing for Brazil, as it grapples with its own economic pressures, very much including the fiscal deficit. Like Argentina, Brazil has a large sovereign debt outstanding (75% of GDP, compared to Argentina's 65% pre-crisis and an estimated 85% now), which comes with very substantial interest payments. That makes it imperative that the primary fiscal balance (i.e. before interest payments) is positive, but that is neither the case in Brazil (primary deficit 1.4% of GDP) nor Argentina (primary deficit 2.5% of GDP).

Brazil's two significant additional weaknesses are intertwined. The first is its utterly unsustainable pension system. The various generous pension systems, implemented during the transition to democracy, use as a pay-as-you-go model in which the current workforce is taxed to pay pension payments. This system faces collapse with an ageing population; the combined annual shortfall of the pension schemes is close to 4.5% of GDP and set to rise.

In Brazil, only a constitutional amendment can modify pension laws, because the right to retirement benefits is engraved in the 1988 Constitution. Reform is incredibly politically difficult, needing the support of three-fifths of Congress to amend the constitution, and has proved impossible for both previous governments and the current Temer administration.

The second weakness is the chaotic state of Brazilian politics: there is a presidential election in October; the incumbent seized power through a controversial impeachment of his predecessor and has a popularity rating of 5%; at the time of writing, the two most popular candidates are campaigning from a prison cell (Lula, currently banned from standing), and a hospital bed (Bolsonaro, who has just survived an assassination attempt); all the candidates have negative net preference from the voters. And yet from this chaos, in the next eight weeks, must come the man or woman who will rescue the Brazilian national finances from future crisis. It is completely unclear as to who this will be or how this will happen, but it has to happen to avert disaster.

From a market viewpoint, the election of a president who can manage reforms could ignite a powerful rally in Brazilian assets. Year-to-date, the MSCI Brazil price index has fallen 20.8% in US dollar terms, to a 12-month forward price/earnings ratio of just 10.2x. The potential for large moves up or down certainly exists. We remain cautious in the face of all this, but equally are alert for the opportunity to participate in a powerful upward move should the political environment improve.

Source: Bloomberg

An investor should consider the Fund's investment objectives, risks, and charges and expenses carefully before investing or sending any money. This and other important information about the Fund can be found in the Fund's prospectus or summary prospectus, which can be obtained at www.johcm.com or by calling 866-260-9549 or 312-557-5913. Please read the prospectus or summary prospectus carefully before investing. The JOHCM Funds are advised by J O Hambro Capital Management Limited and distributed through FINRA member Foreside Financial Services, LLC. The JOHCM Funds are not FDIC-insured, may lose value, and have no bank guarantee.

RISK CONSIDERATIONS: The Fund invests in international and emerging markets. International investments involve special risks, including currency fluctuation, lower liquidity, different accounting methods and economic and political systems, and higher transaction costs. These risks typically are greater in emerging markets. Such risks include new and rapidly changing political and economic structures, which may cause instability; underdeveloped securities markets; and higher likelihood of high levels of inflation, deflation or currency devaluations. Emerging markets involve heightened risks related to the same factors, in addition to those associated with their relatively small size and lesser liquidity

The small- and mid-cap companies in which the Fund may invest may be more vulnerable to adverse business or economic events than larger companies and may be more volatile; the price movements of the Fund's shares may reflect that volatility.

The views expressed are those of the portfolio manager as of September 2018, are subject to change, and may differ from the views of other portfolio managers or the firm as a whole. These opinions are not intended to be a forecast of future events, a guarantee of future results, or investment advice.

Data sourced from JOHCM/Bloomberg unless otherwise specified.