September 2019

FOR PROFESSIONAL INVESTORS ONLY

J O Hambro Capital Management Group

Emerging Markets Spotlight

James Syme, JOHCM Global Emerging Markets Opportunities Fund

In August, the Trump administration formally designated China a 'currency manipulator' (following a tweet to this effect from the presidential Twitter account). The term has formal meaning in US law, with the US Treasury required to produce an annual report identifying countries engaging in currency manipulation. China does not meet the technical criteria laid out in 2015 legislation (current account surplus, bilateral trade surplus and evidence of one-sided intervention), and, although legislation from 1988 does give more flexibility, the timing of this designation, away from the formal annual review, suggests a political rather than technical motivation.

China's current account surplus is forecast by the IMF to be only 0.4% of GDP, which is effectively at balance. China does run a bilateral trade surplus with the United States (currently averaging US$ 27bn/month), but there really is no evidence of 'one-sided intervention'. Chinese foreign exchange reserves have been steady at around US$3.1 trillion for several years now, the currency moves broadly in line with the reference rate from a basket of currencies and, crucially, if the currency has deviated from the basket reference rate in recent months, it is to the stronger side.

Followers of our process will be aware of our view that a focus on currency valuation is a core part of the work when investing in emerging markets, as well as our preference for real effective exchange rate (REER)-based methods to do this. We are big fans of the IMF's External Sector Report, in which every July, the IMF guides towards its views on the fundamental valuations of 26 leading currencies, focusing on how much a country's REER would need to move to drive stability in that country's current account balance. The 2019 External Sector Report concluded that 'China's external position was assessed to be in line with fundamentals and desirable policies, as its current account surplus narrowed further'. It also noted that 'the identified policy gaps are small on net (-0.3%), reflecting largely mutually offsetting forces: loose fiscal policy and excessive credit growth on the one hand and inadequate health spending on the other hand.'

What is most interesting in the report is the consistent focus on policy-driven external imbalances in other economies: 'In many countries with higher-than-warranted current account balances (Germany, Korea, Netherlands, Thailand), a tighter-than-desirable fiscal stance contributed to those external imbalances'. There is plenty of imbalance that the US Treasury could be focusing on given 2019 current account surpluses in those four countries are forecast by the IMF to be 7.0%, 4.6%, 9.3% and 7.1% of GDP, respectively. For the record, in the last three years the foreign exchange reserves of Thailand have increased by 23%, very much suggesting one-sided intervention there.

In a sense, China is merely the lightning rod for American perceptions that the US dollar is overvalued. The IMF's report concludes that the dollar was 8% overvalued at the end of 2018, and the desire of US policymakers to have a more competitive exchange rate is clear. Unfortunately, the desire of other countries to accumulate US dollar assets is very rational. As Mark Carney, Governor of the Bank of England, noted in a speech in August, the US represents 10% of world trade and 15% of global GDP but 50% of global trade invoices, while two-thirds of EM external debt and global foreign exchange reserves are in US dollars.

We remain, then, in a position where structural economic imbalances are driving global geopolitical tensions, and the potential exists both for an escalation of US-Chinese conflict as well as an extension of these stresses to other countries, both developed and emerging. Someday, this war's going to end. That would be just fine for emerging market investors. Until then caution is warranted.

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

Discrete 12 month performance (%):

	31.08.19	31.08.18	31.08.17	31.08.16	31.08.15
A GBP Class	3.16	-0.93	25.46	32.34	-10.15
Benchmark	2.12	-1.77	26.45	31.76	-17.02
Relative return	1.02	0.85	-0.78	0.44	8.28

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 August 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.

Past performance is no guarantee of future performance.
The value of an investment and the income from it can fall as well as rise as a result of market and currency fluctuations and you may not get back the amount originally invested. Investing in companies in emerging markets involves higher risk than investing in established economies or securities markets. Emerging Markets may have less stable legal and political systems, which could affect the safe-keeping or value of assets. The Fund’s investments include shares in small-cap companies and these tend to be traded less frequently and in lower volumes than larger companies making them potentially less liquid and more volatile. The information contained herein including any expression of opinion is for information purposes only and is given on the understanding that it is not a recommendation. Issued and approved in the UK by J O Hambro Capital Management Limited, which is authorised and regulated by the Financial Conduct Authority. JOHCM® is a registered trademark of J O Hambro Capital Management Ltd. J O Hambro® is a registered trademark of Barnham Broom Holdings Ltd.