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Emerging Market Spotlight

JOHCM Emerging Markets Opportunities Fund

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Highlights

James Syme discusses Mexico being the latest emerging market to undergo volatility as a result of politics-related trade uncertainty.

Mexico is the latest emerging market to undergo volatility as a result of politics-related trade uncertainty. As we are currently overweight Mexico, we wanted to provide an update on our views.

For context, Mexico is one of the more stable and institutionally robust emerging markets, with an established democracy, OECD membership and an investment-grade credit rating. That is not to downplay some of the country's challenges (such as violence and crime, or corruption, or the standard of the education system), but Mexico has smaller challenges than those faced by newer democracies such as South Africa or Russia.

The Mexican economy has performed moderately well since the Tequila Crisis of 1994/5, with real GDP growth averaging 2.6% p.a., with the benefits of exports via NAFTA membership being a key driver. Despite this modest economic performance, Mexican equities have performed relatively well, with the MSCI Mexico index averaging 9.1% p.a. in US dollar terms from December 1995 to December 2018, ahead of both peer Brazil (the MSCI Brazil index has annualised 8.6% over the same period) and the broad MSCI Emerging Markets index (up 6.0% p.a.). This outperformance of equities relative to the economy is amongst the best in emerging markets; we attribute this to the competitive strengths of many large Mexican companies, from both good corporate management and also a less competitive structure to many key industries.

We have held a modest overweight position in Mexican equities since May 2017. At that time, we felt that the constructive approach of US Trade Representative Robert Lighthizer was indicative of easing external geopolitical risk for Mexico. We also felt that external demand from exports to the US was strong, domestic demand conditions were reasonable, and that the valuations of both the equity market and the Mexican peso were attractive. Since we initiated that position, our Mexican holdings have contributed positively to performance.

However, we have to recognise that the threat by President Trump to impose steadily increasing import tariffs on Mexico is a significant change in the opportunity. Over 75% of Mexico's exports go to the US and the degree of integration of the two economies means there will be a meaningful impact on both if the threat is carried through. More importantly, the change of direction in the Trump administration's policy must cast doubts about the final form of the USMCA trade agreement that replaced NAFTA, and was previously thought settled following the signing in November 2018. For ratification, the agreement must gain legislative approval in both in the US and Mexico. The Democratic majority in the US Congress was already a challenge to overcome, but with President Trump seemingly also opposed to free trade with Mexico, it would seem that USMCA enjoys little support in the US and may well be in doubt, despite a continuing constructive approach from the Mexican government.

Political risk has just stepped up in Mexican assets, but we are not immediately turning bearish for a number of reasons. Firstly, Mexican equities look extremely cheap against their history (generally down to levels previously seen in the Global Financial Crisis), in a world where many asset classes look historically expensive. Secondly, real interest rates are historically fairly high and interest rates should follow inflation lower over the next year, providing further support to equities. Thirdly, we own a set of high quality, defensive stocks with very limited exposure to either exports or exporters. It has mostly been the good results from these companies that have supported returns over the last two years.

Finally, and with bigger implications, we believe that trade enables countries to exploit comparative advantage and seek larger markets than their own domestic base. The US protectionist turn is negative for US growth, and financial markets have moved to rapidly price in US interest rate cuts. Any such cuts are likely to drive US investors towards higher carry, higher growth and cheaper valuations, which will benefit emerging markets, including Mexico. It may be that more compelling country opportunities appear, and our process is designed precisely to identify those opportunities, but for now we retain confidence in the part of the Mexican equity market we are exposed to.