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JOHCM Funds

Emerging Market Spotlight

JOHCM Global Emerging Markets Opportunities Fund

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One of the defining characteristics of emerging markets (possibly even the defining characteristic) is that there are positive price (and liquidity) correlations between bond and equity markets. If you hit a crisis and your equity market sells off and bond yields spike, congratulations – you're an emerging market.

For us as equity investors it means that we need to pay attention to bond markets, including credit ratings of emerging market sovereign issuers. That is where two interesting stories have been developing recently – South Africa (and its relationship with parastatal power company Eskom) and Mexico (and its relationship with parastatal oil company Pemex).

South Africa (long-term foreign currency debt) is currently rated Baa3 by Moody's and BB+ by Standard & Poors. These ratings are respectively just above and just below the critical investment grade threshold at which many investors will choose to disinvest. Key to this is the parlous state of South Africa's state-owned electricity utility Eskom. Eskom has struggled for years with high operating costs and a steadily increasing debt burden. The costs are from a variety of problems, including poor choices for capital investment (specifically two of the world's largest coal-fired power stations, both behind schedule and over budget), poor execution of those investment decisions (including serious operating problems at those power stations), low employee productivity and failure to collect receivables from local municipalities. Eskom currently has a total indebtedness of ZAR 420bn (US$29.6bn) and trailing 12-month EBITDA of only ZAR 44.3bn (US$ 3.4bn).

Without major financial support from the state, Eskom will be bankrupt. But this is simply not an option as the lights must be kept on. South Africa is already struggling with a series of crippling rolling electricity blackouts, and Eskom must be rescued both as a financial entity and as an operating concern. Analysts estimate that Eskom needs around ZAR 150bn of financial support, or ZAR 23bn per annum. Finance Minister Tito Mboweni's maiden budget in February included a promise of ZAR 69bn of aid for the next three years, sparking statements of concern for South Africa's sovereign credit rating.

Mexico, despite better credit ratings of A3 (Moody's) and A- (S&P), has also seen the ratings agencies express concern about state support for a huge parastatal. Pemex, the state-owned national oil company, has debts of MXN 2.1trn (US$ 106.7bn) and trailing 12-month EBITDA of MXN 494.8bn (US$ 25.8bn). Fifteen years of declining oil production and underinvestment have created a powerful short-term funding squeeze – a quarter of its debt matures in the next three years, which with capital expenditure requirements more than exceeds the company's available financial resources. Meanwhile, oil output per employee runs at about 15 barrels per day (Colombian peer Ecopetrol manages 80).

We remain far more positive on the outlook for Mexico, however. The Mexican finance ministry has said that it will exhaust its other options before offering an explicit guarantee of Pemex's debt, whilst the unpalatable alternative of seeking foreign joint venture participation in Pemex is, at least, a possibility. The South African treasury is already bailing out Eskom, and the chances of attracting foreign capital into Eskom are nil. Finally, the Mexican economy (2019 forecasts: current account deficit 1.5%, fiscal deficit 2.5%) remains in fundamentally better shape than the South African economy (deficits forecast at 3.6% and 4.0%, respectively). Whatever opportunities may exist in exporters in these markets, it is clear to us that the domestic opportunity in Mexico has a better fundamental underpin than in South Africa, and we are positioned accordingly.