Global Emerging Markets Update

October 2020

This report has been prepared by Northcape Capital, the underlying investment manager for the Warakirri Global Emerging Markets Fund.

Market Review

After the September correction, EM capital markets resumed their recovery over October driven primarily by the prospects of Biden-Harris ticket winning the US presidential election (positive for global trade and investment which EM in very leveraged too). Lower new COVID-19 case numbers and deaths – especially in Brazil and India assisted the EM bounce back as well. The past month saw the EM US$ index rise +2% taking the 2020 YTD return to -1%.

On the contrary the US$ DM index fell -3.1% over October – reflecting the polar opposite to EM. A Democratic victory would herald tougher regulations on big technology companies (NASDAQ Index fell -7% in October) and may see higher corporate tax rates. The sharp rise in new COVID-19 cases over the month raised fears of economic damage as new lock downs were imposed in Europe (and possibly in US in some form under a Democratic leadership in 2021). As such the DM index YTD 2020 return fell back into negative territory at -2%.

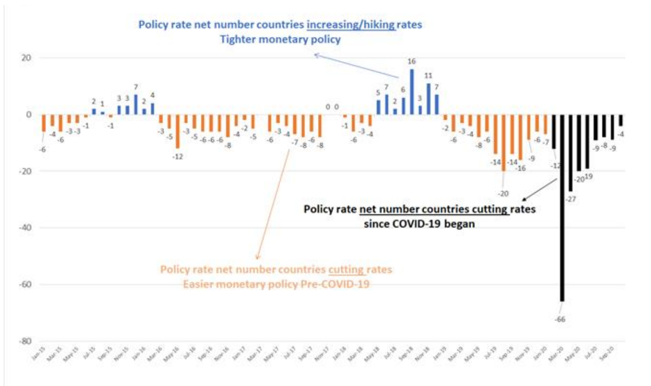
Despite these cross currents between EM and DM the US Dollar was flat for the month (DXY Index unchanged), whilst the EM FX index slipped -1%. The strongest EM currencies over October were The Mexican Peso (MXN +4.4%), the South African Rand (ZAR +3.1%) and the Korean Won (KRW +2.5%) – the trade sensitive currencies.

For most EM countries the growth rates of new COVID-19 cases are slowing (even with increased testing). This started to happen in September and the trend has accelerated over October – which is positive for economic recovery as the all-important mobility rates start to normalise. For example, in the two largest COVID-19 countries; India and Brazil new cases have dropped materially. India from 100k/day in August to 46k/day in November and for Brazil from 70k/day in August to 21k/day in November. There have been similar trends in many other EMs. The only EMs reporting increased COVID-19 cases were in Eastern Europe, for example; Poland (like rest of Western Europe) is up sharply from 800/day in August to 18k/day in November.

In the wake of the global COVID-19 economic slump, the breadth of central bank easing across global capital markets is totally unprecedented with a net 178 policy rate cuts over the past 9 months alone, since COVID-19 became a pandemic in February – see Chart (black bars).

In advanced countries, widespread policy rate cuts have taken rates close to zero – accordingly the pace plain vanilla cutting has clearly slowed in recent months (just 4 in October).

Policy Rate Changes
(Net number of Country Changes = Hike - Cut



Instead, with economic fallout of more lockdowns, we increasingly expect to see even more aggressive bouts of money printing (referred to as quantitative easing, QE) and new fiscal policies (including another round direct loans to companies, and sustained increases in unemployment benefits) – especially for Europe and the US.

Away from rate cuts, EM policy initiatives in terms of GDP continue to be comparatively restrained. We reiterate that EM central banks are acutely aware of potential currency vulnerabilities if they attempt aggressive QE – without "reserve" currencies. Additionally, many EM governments have a general commitment to conservative fiscal policy (some dictated by legislation), typically a result of past experiences during episodes of economic/fiscal crises. In sum, this has led to a much milder monetary and fiscal response from EM to the economic shock of COVID-19 relative to DM.

Despite rising cases and tragic deaths, lockdowns were eased across most EM countries from June. Even the worst hit COVID-19 countries of Brazil, Mexico and India exited lockdowns in the face of rising cases. Whilst we do not rule out the possibility of national lockdowns recurring (under second wave risks) – our base case for EM is no significant reversion, rather at most surgical/localised restrictions to try and limit the economic fallout. In fact, the recent decline in COVID-19 cases across EM (ex-Eastern Europe)implies short-term lock downs risks are a lot lower for EM compared to Western Europe and the US.

As with equity markets, economic activity globally has started to recover over the past 6 months. Year on year growth is still in decline, but sequential months are improving – in some cases sharply. Although it is very clear from our October data that the rate of improvement has tailed off.

Market Review (contd.)

By way of illustration the EM composite manufacturing PMI only rose to 52.8 in October from 52.1 in September. In terms of the individual country manufacturing PMIs it is interesting to observe:

- Over October there was a recovery across 9 out of 14 major EM PMIs that we monitor, with the largest improvements from South Africa and India
- At October there are 9/14 countries with PMIs above 50 – indicating sequential (month-on-month) expansion in economic activity
- China's PMI, which collapsed from 50 in January to 35.7 in February (below its GFC nadir) – bounced to 52 in March has pretty much held this level over the past six months – although did slip a touch in October
- The key laggard remains Mexico, and while its reading has improved over past 3 months it remains quite depressed at 43.6
- PMIs weakened in 4 countries (Russia, Malaysia, Philippines and China)

Note that PMI indices are calculated to reflect the net improvement in activity relative to the prior month.

There were US$4bn of net subscriptions into the EM equity asset class over October – the fourth monthly inflow in succession (see Chart 7). Total EM equity outflows for 2020 YTD stood at -US$42bn (see Chart 8). EM bond funds continue to fare considerably better than EM equities with US$39bn of inflows over April to October. Total equity and debt redemptions at August YTD were -US$42bn, which is almost equivalent to the peak GFC outflows in late 2008.

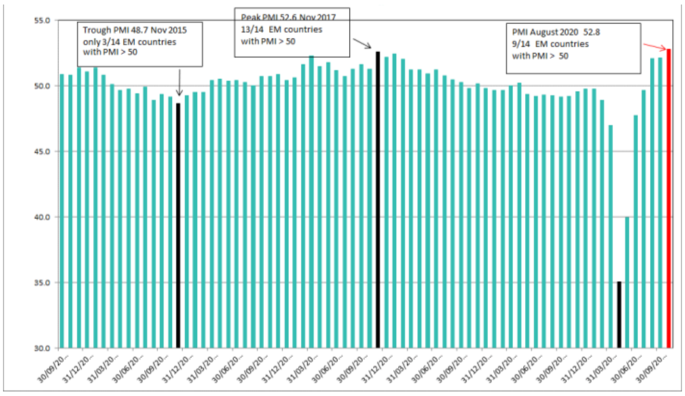
We reiterate these severe outflows (and only small inflows of late) have naturally had a large negative impact on some EM currencies. Although the EM MSCI FX weighted index has fallen only -5% 2020 YTD and Asian currencies have been quite resilient, many others have been very weak 2020 YTD; BRL -30%, TRY -29%, ARS -23%, RUB -22%, ZAR -14% and MXN -11%.

However, we continue to note the deflationary forces of COVID-19 are material, by enlarging existing and creating new output gaps (primarily excess supply from mass labour shedding). The shock to income security is seeing households save a lot more, being much more careful, thrifty and risk averse. Higher saving rates, if sustained, are very negative for long-term consumption, investment and GDP growth and have a profound deflationary impact. The onset of COVID second waves in Europe and the US, and associated lockdowns, will only harden households resolve to save more as we move into 2021.

And when added to the structural deflation impact of aging demographics in advanced countries and relentless march of labour-saving digital disruption – inflation risks, globally are clearly to the downside.

PMI Composite Index
Sept. 2014 – Oct. 2020

Includes Brazil, China, India, Indonesia, Malaysia, Mexico, Philippines, Poland, Russia, Sth Africa, South Korea, Thailand, Taiwan and Turkey



Source: Bloomberg, Northcape

This is despite all the COVID-19 monetary stimulus, in our view, and implies the current low interest rates will be here for a long time.

One can clearly see why the US Federal Reserve is not worried about inflation risks, as such has effectively pledged (and reiterates at every chance) its plan to target a policy rate at near zero for at least the next 3 years. It is prepared to accept much higher levels of inflation (if indeed they occur). With deeper deflation risks, the average 10-year bond yield of the OECD countries has dropped from 45bps at end of March to 27bps at end of August and by another 14bps over the past two months to a mere 13bps. There were 10 out of 24 countries with a negative 10-year government bond yield at end of October (versus only 5 countries with negative yield in March).

Conversely, EM 10-year government bond yields, (whilst they have fallen over April to October on average -50 to -150bps) are still offering substantially higher nominal returns than the DM average of just 0.13%: e.g. South Africa 9%, Brazil, Russia, Indonesia, Mexico and India all still hovering between 5-8% and Malaysia 2.5%. In our view, these high nominal and real yields should support fund flows back into EM capital markets when EM growth eventually stabilises. Indeed, we have started to see this trend emerge more strongly over the past five months with much stronger net inflows into EM bonds.

Importantly, we stress again the onset of deflation and low bond yields will make those companies that can grow their cashflows in real terms over the long-term even more valuable. This underscores the value an active fund manager can provide by essentially investing in EM companies that can "structurally grow" their cashflows in an environment of global deflation.

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Market Outlook and Portfolio Positioning

Occasionally such coveted structural growth companies can be indiscriminately sold off during periods of liquidation – as we saw with the COVID-19 exogenous shock in March. We will continue to take advantage of future volatility to further lift our clients' returns over the long-term by acquiring these companies at very attractive valuations.

In our view with certain executive powers of the President on foreign policy a Democratic Whitehouse is a net positive for the EM equity asset class. This reflects US (under President-elect Biden) would reembrace multi-lateral protocols, which have largely been shunned by President Trump in favour of his America first one-on-one transactional deals. It would help create a sort of global peace dividend, which enhances global trade by generally reducing ad hoc policy risks of disruptive tariffs, quotas, trade sanctions – overall a more cooperative paradigm for most countries to trade in. This would potentially increase capital flows into EM debt and equity markets (ex-China and Russia) and would be a negative for the USD (than under Trump).

However, a Democrat government will retain the hawkish stance and policies on China, although it will likely be much less vocal, as such the public perception of the China-US relationship could be better (although the policies on China will remain negative). Russia may not fare so well with a Democrat administration potentially launching policies to punish Putin and many Russian companies tightly aligned with the regime.

This outcome suits our current portfolio positioning. In terms of our portfolio strategy going forward we remain collectively overweight India, Malaysia, Thailand, Mexico, South Korea, Taiwan and Indonesia, and underweight our assessed more riskier EMs such as Turkey, South Africa, Argentina, Russia, the Middle East and China. We think the former are collectively better placed to undertake policy responses to lessen the impact of growth shocks (including COVID-19) and subsequent economic slowdowns. This cohort appears much less exposed to US alienation risks under a Democratic Whitehouse. These countries crucially have added benefits of an array of good quality companies to invest in and stand to benefit from a growing share of foreign direct investment (as it pivots away from China).

In terms of common themes from the bottom-up, we continue to covet companies with high returns on capital, and little or no debt. In fact, many of the companies on our Approval List and in the portfolio are "net cash". This is a deliberate conservative strategy we adopt. Why?

In EM if there is an exogenous shock in financial markets – the ability to raise capital (debt or equity) can become near impossible for many companies. Accordingly, highly leveraged companies in EMs are at times extremely susceptible to selling their most prized assets at precisely the wrong time – at the bottom of an asset price cycle – the nadir! This risks permanent capital loss – a prospect we are not prepared to put our investors in front of. Indeed, recent EM geo-political events suggest that capital adequacy is becoming even more paramount.

We want to be positioned on the other side of this phenomenon. Owning the companies that are well placed to make opportunistic, yet sensible acquisitions from distressed sellers, from which they will create greater shareholder value over the years ahead. Or alternatively, pay more cash back to shareholders.

We still feel investors under-appreciate the capital adequacy and financial flexibility aspects of the stronger, quality companies of EMs on a long-term basis. We also prefer companies that address large populations with favourable demographics (one of the key attributes of EM), servicing industries that are growing structurally and are not highly cyclical (such as IT/data). Further, the companies in our portfolio are typically privately owned and have a tight focus on balancing stakeholder interests, whilst creating shareholder value. These companies also exhibit visible, robust internal cashflow generation – and generally can self-fund all their capital expenditure needs, as well as continue to pay attractive cash dividends from their retained earnings.

The Warakirri Global Emerging Markets Fund is long only, low turnover (30-50% p.a.) and selective. As such it will hold between 20-40 stocks. These stocks come from a concentrated "approved list" of at least 60 stocks of Emerging Market businesses with clear opportunities for growth. The Fund is focused on building real wealth over the long-term, by limiting downside risks, whilst capturing steady growth.

For more information, please contact us on 1300 927 254 or visit warakirri.com.au