Global Emerging Markets Update

November 2020

Warakirri ASSET MANAGEMENT

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

Market Review

After the September correction, EM capital markets resumed their recovery over October and this continued, in fact intensified, over November. We knew Biden's win would be positive for risk assets, but the impact to the upside surprised most market commentators. Growing speculation that COVID-19 vaccines were to be imminently approved further boosted market sentiment (Pfizer-BioNtech vaccine was authorised by UK government on 2 December).

The combination of these two forces over November saw the EM US$ index vault +9% (the largest monthly gain since March 2016). The gain took the 2020 YTD return back into positive territory (+8%). We recall at the COVID-19 equity market nadir (23 March 2020) the EM index was down -32% YTD – it is up a whopping +60% since then.

The US$ DM index (up +12.5% over November), gained more than EM – not only taking its cue from the US election, but also due to the perception that it is a greater beneficiary of a vaccine in the short-term.

The rise in stocks were characterised by a massive rotation into cyclical names across both EM and DM equity markets. In the case of EM, the best country sectors for the past month were all highly cyclical: Brazil energy (+41%), Brazil materials (+32%) and Russia financials (+28%).

The US dollar continued to decline with the DXY index dropping -2% over November and has fallen -12% since its March peak. The best EM currencies over November were very strong: the Brazilian Real (BRL +8%), the Colombian Peso (+8%), the Turkish Lira (+7%) and the Mexican Peso (+5%). These are the more trade sensitive, cyclical currencies benefitting most from a Biden presidency and vaccines development.

For many EM countries the growth rates of new COVID-19 cases continue to slow in recent months. However, a growing cohort of EMs has seen some reacceleration in COVID-19 cases of late. Essentially, as lockdowns were removed and borders partially reopened in some cases, an opportunity has been recreated for the virus to spread in the absence of a vaccine. For example, in Brazil new cases dropped from 70k/day in August to a low 21k/day in October, only to rise back to 40k/day over November. Similar trends to Brazil have been exhibited by Mexico, South Africa, Russia and Indonesia. Nonetheless, from an equity market viewpoint, the negative of rising COVID-19 cases in EM was overwhelmed by the positives from the Biden victory and vaccines forthcoming.

A critical laggard over November was China. Trump's move to ban US investors to accessing 31 Chinese companies that have identified PRC military ties impacted China's A shares in particular.

Moreover, Chinese US listed ADRs (including the high-profile, index heavy weights like Alibaba, Baidu, etc.) now face heightened delisting risks as the US House voted for new audit inspection rules on Dec 2. ADRs that fail to comply with the audit rules in the next three years could be forced to delist from US exchanges.

Government and Central Bank Policy Response to COVID

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 180 policy rate cuts over the past 10 months alone since COVID-19 became a pandemic in February.

In advanced countries, widespread policy rate cuts have taken rates close to zero – accordingly the pace of plain vanilla cutting has clearly slowed in recent months (just 12 in past 2 months). 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 of direct loans to companies, and sustained increases in unemployment benefits) – especially for Europe and the US.

We are run the risk of sounding like a broken record – but 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.

EM Economic Activity

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 clear from our November data that the rate of improvement has tailed off. By way of illustration the EM composite manufacturing PMI fell from 52.8 in October to 52.2 in November – the first decline since April 2020.

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Market Outlook and Portfolio Positioning

At the sovereign level 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.

Our overweight cohort also appears much less exposed to US alienation risks under a Democrat White House foreign trade and investment policy. 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 geopolitical 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

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