Global Emerging Markets Update

December 2020

Warakirri ASSET MANAGEMENT

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

Market Review

The Biden halo continued to buoy global capital markets over December. Indeed, it has continued into January 2021. This is notwithstanding Trump supporters' horrific disruption to the election certification proceedings at the US Capitol on 6 January and ongoing negative news on COVID-19 (new, more contagious strains found in the UK and South Africa). A Biden win was always going to be a clear positive for EM capital markets and the renewables sector – and negative for the US dollar and this has clearly already turned out to be the case.

Similar to November, the rise in stocks over December was characterised by an ongoing rotation into cyclical names across both EM and DM equity markets. In the case of EM, the best country sectors for the December quarter were all highly cyclical: Brazil materials (+55%), Mexico financials (+54%) and Brazil energy (+54%).

The US dollar continued to decline with the DXY index dropping -2% over December and has fallen -14% since its March peak. The best EM currencies over December quarter were the South African Rand (ZAR +14%), the Colombian Peso (COP +12%) and the Mexican Peso (MXN +11%) – essentially high yielding currencies benefitting from the carry trade out of very low yielding DM fixed interest markets.

Unlike Europe and US, many EM countries (due to constraints over production and distribution) will not receive vaccines in sizeable volumes until 2022, and some much longer. In fact, vaccination programs are already falling behind plan in most developed countries, which highlights the risk that COVID-19 will linger in many EM countries for much longer than generally expected. Indeed, even Moderna's CEO recently said he believed COVID-19 will be "endemic".

Meanwhile, social distancing is very hard to enforce in very densely populated EM countries, and with limited fiscal capacity, most EMs simply cannot afford sustained lockdowns in any case. This reinforces the need for everyday PPE, like gloves and masks for some time, if not years as a COVID-19 preventative measure.

The supply side of medical glove PPE remains very tight, given capacity growth is limited due to the difficulty in building new glove factories. This means glove PPE pricing will very likely remain elevated for much longer than generally anticipated – perpetuating the materially strong profit growth of these companies.

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 11 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 3 months). Instead, with economic fallout of more lockdowns, even more aggressive bouts of money printing (referred to as quantitative easing, QE) are expected along with new fiscal policies (including another round of direct loans to companies, and sustained increases in unemployment benefits) – especially for Europe and the US in 2021.

Consequent upon winning Georgia's two senate seats on 5 January, the Democrats now control all branches of the federal government in the US, thus paving the way for even more aggressive fiscal policies for the next two years at least.

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!

Market Outlook and Portfolio Positioning (cont.)

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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