Global Emerging Markets Update

January 2021

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

Market Review

Despite some profit taking in the final week of January, EM capital markets started 2021 on a reasonably strong note. Thereby continuing the market buoyancy of the December quarter 2020. To some extent EM is still basking in the glow of the Democrat victory (with ensuing benefits to EM trade and investment). This was boosted by Democrat Party gaining control of the US senate on 5 January (winning both seats in Georgia).

The rally in EM continues to shrug off persistent risks around COVID-19 cases remaining stubbornly high and vaccination programs running behind schedule.

That said, the main driver of EM over January was largely China, whereas over the December quarter gains were propelled by a wide range of countries: Brazil, Mexico, India, Russia, Taiwan and South Korea. These markets took a back seat over the past month.

Over January the EM US$ index rose +3% (although it was up +9% until 25 January). Note from the COVID-19 equity market nadir (23 March 2020) the EM index is now up a massive +75%. This is the fastest recovery from a -30% decline since the launch of the EM index in 1988, accordingly the -6% correction over late January was, in our view, not unexpected.

The US$ DM index fell -1% over January. It was impacted by the correction in US markets with concerns over stimulus delays, volatility created by GameStop and risks that the COVID-19 vaccination program is falling behind schedule.

In the case of EM, the best country sector performer for January was China communication services (+18%). Essentially this sector includes the internet heavyweight stocks like Alibaba, Tencent, Baidu, etc. – which all benefited from US Treasury announcing on 13 January the planned blacklisting of these companies would be scrapped. As such these stocks can still be owned by US resident investors. This news obviously created some short covering across the whole sector.

The US dollar (DXY index) rose +1%, partially reversing recent declines. Nonetheless, the DXY index has fallen -13% since its March 2020 peak. The best EM currencies over January were the Turkish Lira (TRY +2%), the Chinese Yuan (CNY +2%) and the Hungarian Forint (+1%). All the high yielding EM currencies that had been strong over the December quarter, declined over January; the Brazilian Real (BRL -5%), the Colombian Peso (COP -4%), the Mexican Peso (MXN -3%) and the South African Rand (ZAR -3%) were the weakest.

At the time of writing a number of companies in the portfolio have reported their 31 December 2020 results. We are pleased to say the reports have been generally better than expected, and more crucially outlook comments are positive (quite bullish in some cases). This, as always, is what we want to see, and these results and outlook statements will serve to underpin performance.

Government and Central Bank Policy Response to COVID

After the big burst of policy rate cuts in the wake of COVID-19 economic shock, we can see that the pace of plain vanilla cutting has clearly slowed in recent months (just 13 in past 3 months). Rates are now got so low that we increasingly expect to see even more aggressive bouts of money printing (referred to as quantitative easing, QE) to sustain easy monetary policies.

Recent statements from central banks in advanced countries suggest concerns over the sustainability of the economic recovery once income support/COVID relief programs expire. To that end central banks are recommitting to keep rates lower for longer and in some cases stepping up the pace of QE.

However, 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 (i.e. Biden's US$1.9trn spending package). This is undoubtedly positive for global growth.

For EM the level of fiscal support has been generally much lower than advanced countries, so there is less of a "cliff" to economic growth once the COVID-19 support programs expire.

Widespread, effective vaccinations are critical to re-establishing economic growth in stability in EM – and we worry that the programs are falling well behind schedule. Therefore, many EMs may well run deeper fiscal deficits in 2021 than what most investors currently expect, and this will put pressure on debt sustainability for some countries (we see Brazil and South Africa being most at risk of the major EMs).

EM Economic Activity Update

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 November and December data showed that the rate of improvement has tailed off in EM – it seems activity levels improved again over January – an encouraging sign.

EM 10-year government bond yields are still offering substantially higher nominal returns than the DM average of just 0.31%: e.g., South Africa, Brazil, Russia, Indonesia, Mexico and India all still hovering between 5-8%. In our view, these higher yields should continue to support fund flows back into EM capital markets when EM growth eventually stabilises.

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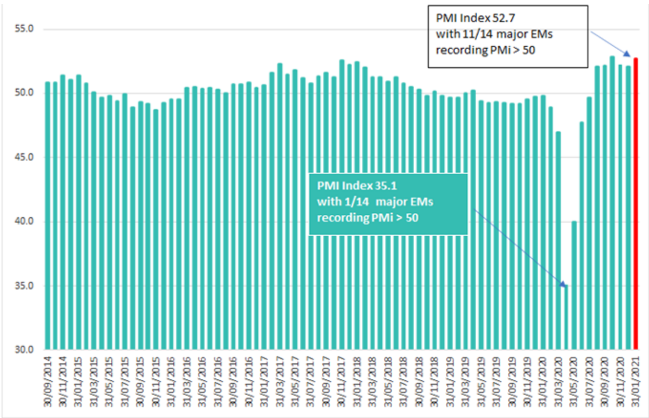
PMI Composite Index
Sept. 2014 – Oct. 2020

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



Source: Bloomberg, Northcape

Importantly, for countries like Brazil and South Africa, it is critical that debt sustainability is achieved, otherwise there is a risk that their current high yields may not be enough to attract foreign debt and equity capital.

Continued deflation is our ongoing base case scenario (reflecting the impact of aging populations and technology undermining labour markets in advanced countries). COVID-19 has increased long-term deflation risks in our view too by increasing economic uncertainty and savings rates.

Accordingly, low bond yields (by historical levels) will be around for some time yet, and this makes those companies that can grow their cashflows in real terms over the long-term even more desirable. 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 low global growth and deflation. On top of earnings growth, these stocks may also get an additional valuation boost from P/E expansion.

Market Outlook

Accommodative monetary and fiscal policy played a critical role in 2020's recovery from the earlier growth shock and risk-off capital market response. Central banks cut rates in many cases towards near zero, often in conjunction with guidance of sustained low levels for several years, complimented by non-conventional policy including bond purchases to maintain stability of the financial system and pressure yield curves lower.

Complimentary fiscal policy was significant in targeting emergency relief packages but resulted in rising budget deficits across both developed and emerging economies, along with record local government debt-to-GDP ratios.

The US appears set to persist with elevated twin deficits in budget and trade, as the Biden administration's substantial proposed stimulus programs are likely to gain approval from Congress, maintaining the recent record high both in nominal and real terms in broad money supply.

In our view, this represents an important positive tailwind for EM equity markets by attracting foreign investment, encouraging higher commodity prices and easing funding pressure on external sourced debt. Although, one potential headwind concern of a weaker USD is a stronger RMB, thereby reducing relative competitiveness of China's exported goods, and also those EM with "managed currencies", such as Hong Kong and Taiwan.

Successful suppression of COVID-19 infections is critical to keeping businesses open, staff employed and goods moving. In this respect Korea and Taiwan have performed well, and their 2021 2021 annual corporate earnings are forecast to grow approximately +20% YoY, aided by significant technology industry representation, boosting the region's aggregate earnings recovery.

As we commence 2021 the world continues to grapple with significant challenges, yet as always there are appealing opportunities with which to focus attention and capital. EM remains an attractive asset class but requiring very careful and consistent application of active equity investment.

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.

*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 of Emerging Market businesses with clear opportunities for growth.*

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