Global Emerging Markets Update

March 2021

Warakirri ASSET MANAGEMENT

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

Market Review

After the strong performance in recent months, EM capital markets corrected over March. This was mainly influenced by the continued rise in US treasury bond yields, and a renewed surge in COVID-19 cases across many EMs. Over March the EM US$ index fell -1.7%, reducing the 1Q 2021 gain to +1.9% (at one stage the index was up +9%). EM underperformed the US$ DM index which lifted +3.3% over March, taking its 1Q21 gain to +4.8% – refer Table 2. There were also some idiosyncratic factors that beset EM over March:

- Intel announced that it is planning to re-enter the microchip foundry business, which negatively impacted TSMC with its stock price dropping -6% in March (note: TSMC is the largest stock in the EM index with a 6.5% weighting).
- President Erdogan of Turkey sacked the country's central bank governor undermining the independence of its monetary authority and caused a very sharp correction in its stock market (-17% for March). This also led some traders to think is this type of dangerous action contagious.
- US and Europe stepped up sanctions against China in relation to human rights abuses in Xinjiang and Hong Kong – which engendered a fall in China's equity markets.
- China's US listed companies (mainly the internet VIEs like Alibaba, Baidu, etc.) were also weak (-6% March). The SEC's update on Holding Foreign Companies Accountable Act reinforced the de-listing risk for these ADRs if they continue to prohibit US authorities from independently investigating their accounts.

WTI crude was volatile over March, but in the end fell -4% as concerns over renewed lockdowns grew, offsetting the benefits of OPEC+ recommitment for production cuts. That said, WTI finished 1Q21 +30%.

In the case of EM, the best country sectors were Korea financials (+14.4%), India materials (+11.7%), Mexico financials (+10.4%) and Mexico consumer staples (+9.9%). Worst country sectors were: China communication/internet services (-10.4%), China consumer discretionary (-9.2%), China IT (-7.7%) and China consumer staples (-5.9%).

Over March the US dollar (DXY index) firmed (+2.6%), adding to the 2% gain in January and February – reflecting the impact of higher bond yields drawing capital back into USD assets. The EMFX index fell -2.5% - the flipside of the DXY rebound. The weakest EM currencies were the Turkish Lira (TRY -10%), the Polish Zloty (PLN -5%) and the Czech Koruna (CZK -3%). The strongest EM currencies were the South African Rand (ZAR +2%) and the Mexican Peso (MXN +2%).

At the time of writing virtually all companies in the portfolio have reported their 31 December 2020 results. And like previous reports over January and February we are very pleased to say results have been generally better than expected, and more crucially outlook comments are positive (quite bullish in some cases).

Government and Central Bank Policy Response to COVID-19

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 cuts has come to a halt. February saw a net of two policy rate increases and March had four countries raising rates (including Turkey, Russia and Brazil). For the first time in two years the number of countries raising interest rates was more than those that reduced. Is this a sign of more widespread inflation and policy rate tightening to come?

Recent statements from central banks in advanced countries continue to suggest not. Concerns over the sustainability of the economic recovery once income support/COVID-19 relief programs expire, and persistently high unemployment dominate central bank narratives. Plus, it seems central banks see the inflation spike of 2021 as transitory – reflecting the very low base effect from COVID-19 disinflation of 2020. To that end monetary authorities for now are still recommitting to keep rates lower for longer and in many cases keeping the pace of QE up in the face of higher headline CPIs in 2021.

Widespread and effective vaccinations are critical to re-establishing economic growth and stability in EM – and we worry that the programs are falling well behind schedule over this year. Full vaccination penetration across EM is running at less than 3% of the population (tracking well below most DMs).

Meanwhile COVID-19 cases have also rebounded over the past two months across virtually all EM countries. The most notable being India, rising from 10,000 new cases per day in early February to over 100,000/day in April (which is above the previous peak of 95,000/day in August 2020). Therefore, despite some recent hikes - it remains unclear to us that we are on the verge of a period of major monetary policy tightening in EM, given the potential for mobility restrictions anew, creating weaker economic growth (especially relative to DM).

This is also the reason why we maintain a strategic overweight on the EM personal protection equipment sector – specifically by way of our exposure to two Malaysian glove companies (Top Glove and Hartalega).

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Market Outlook

We believe solid cases can be mounted for both a pick-up in inflation and also a continuation of the disinflation/deflationary trends that have persisted for nearly four decades now. Our best assessment today is that there does appear to be risks of a short-term spike in US inflation (which may already be priced in).

Longer-term inflation is nearly impossible to forecast accurately – just ask the more than 400 PhD's at the Federal Reserve! Given less aggressive monetary and fiscal stimulus in EMs, as well as greater room for policymakers to allow rates to rise if necessary (as EMs are not as indebted), we see lower risks of inflation derailing the EM economic recovery relative to the US. This could translate into US Dollar weakness, which would be positive for EM assets.

Regardless of whether we see the return of inflation or continued deflation, we believe we are well-positioned for whatever economic environment prevails. We do not anticipate a significant change in our strategy or current portfolio holdings. We will continue to seek out and favour companies that:

- Have real pricing power, which allows them to raise prices over time regardless of the inflationary environment
- Are led by exceptional management teams who can steer the business through whatever macro environment they encounter
- Are underpinned by structural growth drivers, which should see them grow at a healthy clip over the long run
- Have strong competitive positions which allows them to consistently capture market share from their rivals, and perhaps even acquire them during periods of stress
- Have appropriately geared balance sheets, which reduce the chance of liquidity risks if interest rates where to unexpectedly rise
- Can consistently earn above their cost of capital and reinvest in their core business, which helps drive shareholder wealth creation
- Are attractively valued according to our DCF valuations which factor in our assessed cost of capital which reflects inflationary and other macro risks in its key markets

*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