Global Emerging Markets Update

May 2021

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

Market Review

Over May the EM US$ index rose +2.1%, increasing the 2021 YTD gain to +6.6%. EM outperformed the US$ DM index which lifted +1% for the month, taking its YTD gain to +10.7%. It was certainly a game of two halves for EM over May. The first part saw the EM index fall -4% by 12 May reflecting:

- Higher than expected inflation in the US, which saw US Treasuries retest the peak of 1.7%.
- Increased COVID cases in Brazil, Malaysia, Thailand and Taiwan.
- A flash crash in Taiwan – following a rapid rise in retail activity due to new stock trading Apps and increased geopolitical risks with China.
- The Chinese government announcing tighter regulations on the internet sector.

However, from this low point the EM index began to recover, rising +6% from 12 to 31 May. This was triggered by COVID case numbers declining in India (as forecast in our April report), positive data on global growth and a weaker USD, which encouraged capital flows back into EM equity and debt assets. Additionally, rising commodity prices - WTI crude rose +3% to US$68.73/bbl and the S&P Industrial metals index rose +4% (led by steel up +10%) - also assisted flows into EM capital markets over the past month.

The US dollar index (DXY) fell -1.6% over May, which fed the carry trade into higher yielding EM currencies. The strongest EM FXs were the South African Rand (ZAR +6%) and the Brazilian Real (BRL +4%) – both receiving the additional benefit of stronger commodity prices boosting their terms of trade.

The best performing EM markets were Russia (+7%), Brazil, Mexico and India (+6%). These markets were linked to global growth (especially US growth), commodities, and/or better COVID-19 outcomes. Portfolio performance was negatively impacted by an underweighting of Brazil and Russia and overweighting of Malaysian PPE stocks. Overweight positions in India and Mexico assisted performance.

Importantly, given ongoing COVID-19 risks and higher commodity prices, virtually all companies in the portfolio have no 2021 guidance or are set at relatively conservative levels. This will help limit disappointment risks over the balance of this year.

Government and Central Bank Policy Response to COVID-19

After a dramatic period of policy rate cuts in 2020 (in the wake of the COVID-19 growth shock), 2021 has seen more countries raising rates than cutting. Over May there were three countries that raised policy rates on a net basis. We continue to ask the question; is this a sign of more widespread inflation and policy rate tightening to come?

We reiterate - not yet.

Recent statements from central banks in advanced countries continue to be more dovish than hawkish. Concerns over the sustainability of the economic recovery once income support/COVID-19 relief programs expire and worries about persistently high unemployment dominate central bank narratives. Plus, it still seems central banks are convinced the inflation spike of 2021 is transitory – reflecting the very low base effect from COVID-19 disinflation of 2020. It also seems that present headline inflation is in part spurred by the fact that the re-opening of the global economy post COVID-19 has been extremely uneven in 2021.

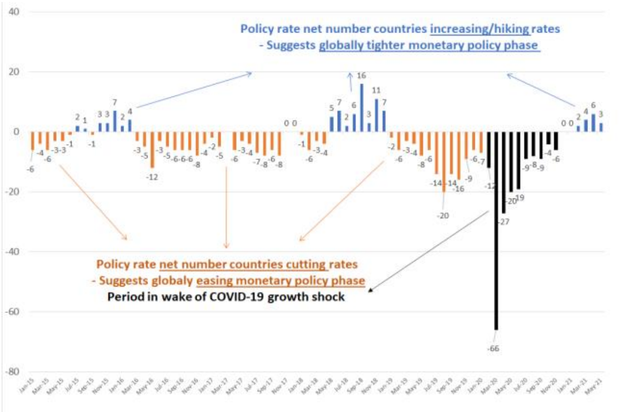
This has created various bottlenecks and upward pricing pressure in supply chains over the short-term. Central banks argue this drag will reverse when the global economy is fully reopened and eventually places downward pressure on output prices. To that end, monetary authorities seem unpanicked by the inflation spikes of late, and 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.

Whilst vaccination programs are well underway, there are also concerns that current vaccine efficacy against new mutant COVID-19 viruses could disappoint. This may lead to a global third wave. We note the UK, where 60% of the population has been vaccinated with at least one dose (41% with two), COVID cases are rising rapidly again.

It seems central banks, especially in advanced countries, want to be sure vaccination programs are truly effective for economic re-openings to be sustainable, and accordingly feel that there is not enough evidence yet to declare the pandemic war has been won. Hence the recommitment for continued dovish monetary policies.

For EM, while we are positive on medium to the long-term vaccination outlook, the short-term progress is tracking well behind DMs. EMs on average have less than 6% of the population fully vaccinated versus the UK and US (41%) and Europe (20%). Therefore, many EM countries remain exposed to yet another wave of COVID-19 under the latest variants over the next 12 months or so.

Policy Rate Changes
(Net Number of Country Change = Hike – Cut)



Accordingly, most EM central banks still feel they are not on the verge of a period of systemic monetary policy tightening. The potential for mobility restrictions anew, creating weaker economic growth (especially relative to DM) remains a central risk for EM central banks in the short term.

This is also the reason why we maintain a strategic overweight in the EM PPE sector.

EM Economic Activity Update

The EM composite manufacturing PMI index fell -0.4pts to 53.1 in May – the first decline of note in 7 months. Such a reading is still very high by historical standards and would suggest at the margin that the momentum of EM economic activity has peaked – a point we mentioned in our April report. Indeed, we believe there is a reasonable probability that this turns out to be the case for 2021 with the growing prospect of a flattening or even lower PMI readings over second half of 2021 due to:

- While we do not expect a big bout of monetary policy tightening in EM, policy rate reductions appeared to have stopped (for now)
- China is deliberately slowing its economy to prevent risks of overheating from the sizeable 2020 stimulus
- Vaccination penetration is proceeding too slowly in EM – heralding risks of lower economic growth from mobility restrictions anew (both domestic and international)

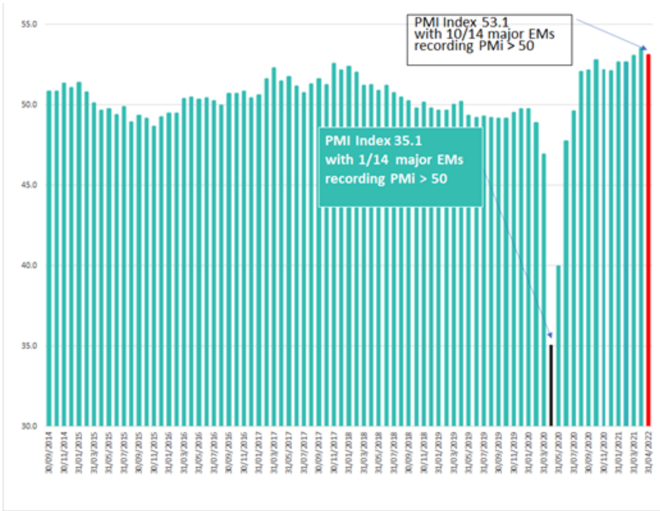
Declining EM PMIs (especially China) may imply that commodity prices could also ease over the second half of 2021.

In terms of the individual country manufacturing PMIs, it is interesting to observe the following:

- Over May there were improvements across 6 out of 14 major EM PMIs that we monitor, with the largest improvements from Poland (+3.5pts to 57.2) followed by South Africa (up +1.6pts to 57.8), Russia (+1.5pts to 51.9) and Brazil (+1.4pts to 537) – the commodity Ems.
- 10/14 countries now have PMI readings above 50 (down from 12/14 in March) – with Turkey and Thailand slipping into negative territory, joining Mexico and the Philippines.

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

PMI Composite Index – Sept. 2014 to May 2021



Source: Bloomberg

At the sovereign level we remain collectively overweight Malaysia, Thailand, Mexico, South Korea, India and Indonesia, and underweight our assessed riskier, volatile EMs such as Turkey, South Africa, Brazil, Argentina, Russia, the Middle East and China.

We continue to covet companies with high returns on capital, and little or no debt. 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.

*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