Pendal Global Emerging Markets Opportunities Fund Update

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Here we present the latest COVID-19 related insights and activities relevant to our Global Emerging Markets Opportunities Fund clients.

FACING a market sell-off and a shift in macro-economic expectations unparalleled even in the history of emerging markets, a few key drivers of returns in this asset class are very clear in terms of magnitude and direction – even if precise levels are not yet visible.

Firstly, OECD GDP faces a very sharp decline – at least in the first half of 2020 and possibly longer. This immediate fall-off in global growth, and with it global trade volumes, is negative for emerging markets.

Secondly the oil price has fallen to levels not seen since 2002-03. This is partly driven by global growth and partly by a price war between major producers. This has a markedly differential effect on emerging markets that are net importers or exporters of oil.

Thirdly, there is a rolling global financial crisis, focused on leveraged assets and financial structures.

Fourth, interest rates have fallen heavily around the world, both at the policy end and at longer maturities.

Fifth, flight-to-safety has driven a huge rally in the US dollar against almost every other asset, even gold.

And sixth, at the time of writing, it does seem as though a number of Asian emerging markets have managed through a spectrum of policies to contain the spread of coronavirus.

Some things are still uncertain. Of particular importance is a seeming lack of coronaviruses taking-off in tropical countries. A continuation of this pattern is key for the future of the emerging market asset class.

Another key uncertainty is the efficacy of the aggressive monetary and/or fiscal stimulus applied by leading OECD nations.

As a starting point, and drawing on *Harvard Business Review's* What Coronavirus Could Mean for the Global Economy, we are proceeding with the following assumptions:

- The global economic downturn will be v-shaped, but with a very, very deep V.
- The duration of the downturn will be quarters rather than years
- The pattern of more tropical countries being less affected will continue

If any of these assumptions change, we will adjust accordingly.

In looking for country-based opportunity in emerging markets, we focus at this time as which countries have the greatest ability to support growth through policy.

We accept that backwards-looking economic data and current forecasts are useless at this time.

While monetary and liquidity drivers, currency outlook and valuation are all important components of our process, we think there is only limited work that monetary policy can do at this time.

The extreme cheapness on historical measures of pretty much every emerging equity market and currency will be of no importance until economies begin to recover.

There are a number of key markers we feel identify the markets with the strongest potential to support growth.

The first is fiscal deficit –a key point of analysis for us at all times. Fiscal deficits are interesting when analysed in the context of both the level of local yields, and also the recent change in bond yields.

We have found in previous crises and recoveries that moves in bond yields and CDS levels are key data points for emerging equity markets during crises.

Another marker is the impact on the country's oil import bill of a $US40/bbl decline in oil prices. This size of decline is material, benefitting Taiwan by an estimated 4.4% of GDP per year, and hitting Saudi Arabia by 15.9% of GDP.

These are very large numbers and might be of dominant importance were it not for coronavirus.

The following areas are of particular interest to us:

- **China and Taiwan:** Both have shown high levels of state capacity and social cohesion, combined with low levels of dollar sensitivity. Both are large oil importers. While each will take a hit from a sharp fall in exports to Europe and North America, there should be the ability to offset this with government action. Correspondingly, Taiwan and China have been the best performing of the main emerging markets.
- **Korea:** Similarly, Korea has seen a strong state and social response to coronavirus, and as a low dollar-sensitivity oil importer. Some features of the Korean equity market (short-volatility savings products), plus Korea's role as an easily-traded market with a deeply liquid futures contract, have seen significant selling in Korea. The market has underperformed Taiwan and China despite a broadly similar set of drivers. We feel Korea is a substantial opportunity at this time. In particular, the excessive cash that many Korean companies hold is a strong defensive characteristic.
- **Central Europe:** Hungarian yields have sold off as the central bank remained too loose for too long, driving a spike in inflation. Poland and the Czech Republic have seen low and falling bond yields but equity market weakness. The heavy weight in banks in both markets must serve as some offset. But these are fundamentally well-run, high state-capacity countries that benefit from EU membership and may offer opportunity.
- Other markets that look to have been very weak given their fundamentals include **Chile, Peru, India and Indonesia**, all of which are oil importers and which have seen equity returns much worse than might otherwise be expected. Chile and Peru have performed worse than oil-exporter Mexico, while Indonesia has performed more in line with Russia and South Africa. The recently announced 21-day lock-down in India will have a significant impact on economic activity there, hitting an already weak economy. But local bond yields suggest the government will have substantial ability to support the economy, given the current account and inflation implications of the move in the oil price.
- Three countries look to have very significant risk: **Brazil, Colombia and South Africa**. In each case, a combination of fiscal and current account deficits before the crisis acts as significant constraint on the ability of the government to support economic activity. Serious fiscal stress can emerge here without any easy resolution. With the possible exception of Egypt, we assess these three markets as the most risky in emerging markets right now and have aggressively moved to reduce exposure.
- Other markets we are watching closely (and where we still hold positions) are **Russia, UAE and Mexico**. All are oil exporters and have started from reasonably promising fiscal positions and State capacity. However, with the impact from the downturn in global trade and tourism (Mexico and UAE) and the collapse in the oil price (Russia and UAE), these markets face a long recovery from here. That said, there are stocks in these markets, particularly in the mid-cap space, at valuations (based on actual cashflows and dividends rather than earnings) that seemingly justify the risk of owning those stocks.

While we do not make global sector allocations, when looking for stocks in preferred countries we are aware of sector and industry dynamics. In the current environment we identify the following risks and opportunities:

- Banks generally carry a triple threat in this environment: from the cyclical impact of the downturn; from reduced net interest income as rates fall; and from taking part in loan repayment holidays. We remain significantly underweight financials.
- Defensive cashflow-generating assets are extremely valuable in this environment. This includes consumer staples, but can also include transport assets, telecoms, utilities, some real estate-related businesses and even precious metals miners.
- The disruption to the global economy is acting as a huge accelerant for the migration of activity online. In emerging markets there are online companies that will benefit from this (which has largely been recognised by markets), and also a significant ecosystem of hardware manufacturers feeding into the infrastructure that supports online activity. We believe the medium-term outlook for companies here is very strong and are actively seeking out new names in this space in our preferred countries.
- Strong balance sheets are absolutely key. The single most important aspect of any stock investment is that it survives the downturn without bankruptcy or dilution. The portfolio went into the crisis with a significant style skew towards stronger balance sheets and that has been maintained.
- Finally, just as the State is now the prime mover in economies, so it is at the company level. State support (from solvent governments) can be a huge opportunity in this environment, and there are stocks we own in some markets like UAE, Russia and China where we see State ownership as a key feature.

Every emerging market crisis is different, and this one features some very challenging dynamics.

We remain firm in our belief that country drivers (in this instance, State capacity and its deployment to support economies) will remain the key differentiator.

We will maintain our approach of not taking a directional view, but rather focusing on preferred stocks in preferred countries.

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