
Global Emerging Market Equities: an unexpected Q1

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Looking back over an extraordinary first three months, and trying to gauge what the future might bring, we remain on the lookout for quality top-tier companies

Coming into the year we were positioned for growth, with signs of pickup across emerging markets, notably in China and Brazil. This was playing out nicely in January, especially with what seemed to be thawing US-China relations following the signing of the phase one trade deal. But the world was turned upside down with the arrival of the coronavirus, first in China and then the rest of the world. Instead of growth we are now getting perhaps the steepest and fastest recession in history. Hopefully, it will be one of the briefest.

The market was remarkably resilient in January and early February when the virus first took hold, and this perhaps made us too complacent when it spread around the globe. The “hyper” bear market came so fast and led to dislocation in so many areas it made it difficult to make changes in the portfolio. On a sector level, financials, healthcare and industrials were least helpful, but communication services and materials were positive. On a country basis, overweights to Brazil and Indonesia detracted, as did the underweight to China/Hong Kong. Selection within Brazil also didn’t help but was more positive within China and South Africa.

Market volatility has increased dramatically with the coronavirus, in what has felt like a global liquidation event. While we agreed with the direction of some of the moves, the magnitude was so large we feel it is now creating some substantial opportunities. As such we are attempting to upgrade the quality of companies we own, so we can lean into the volatility with our highest conviction ideas. Price moves aren’t necessarily rational or reflective of a company’s long-term fundamentals, and we are going to make mistakes in selling individual stocks as we move into others. But the idea is to continually evaluate the dislocation between fundamentals and valuations, then focus on those companies we want to own over the long term, which are better positioned to weather the storm and come out the other side stronger.

Three areas of focus

We have focused our corporate research coverage on three areas: beneficiaries, short-term pain and impaired. The beneficiaries potentially gain from the situation, such as cloud-related companies, e-commerce players or online entertainment. The second group are those likely to feel short-term pain but which might potentially emerge in a better market position. Finally, the impaired companies are those we expect will require bailouts and we question their survival, such as airlines.

All in all, those firms that are able to take balance sheet strain and have access to liquidity will be better placed. As such we have focused our efforts higher up the market cap, on solid businesses where we are certain of their competitive advantage. We see a lot of opportunities within tech, given the disconnect between opportunities and stock prices. We have been adding to our semis exposure, with such firms benefitting from the “stay at home” economy, while memory makers have been holding up well, supported by NAND (a type of flash memory used in storage devices) pricing improvement.

Data out of China is improving, with stores and factories beginning to reopen. The government has been pragmatic with stimulus, initially focusing on addressing health issues. In Brazil, however, the virus is starting to take hold. It is also almost winter and the weather could potentially make the situation worse. We have concerns over the country’s lack of fiscal ammunition, and the recent unwinding of leveraged vehicles created further pressure on the market. With stocks in Brazil falling exceptionally hard and quickly we are finding valuations attractive, so our modest overweight at this point weighs the concerns of the virus effect versus these stock opportunities.

Conversely, Russia is better prepared given its large cash reserves and current account surplus, and there is support from significant dividend yields. Furthermore, the normalisation of oil prices could provide a supportive tailwind.

India has recently introduced stricter confinement measures. However, the informal nature of its economy means it may be difficult for the government to plug the output gap. It is important to note that it will, however, benefit from a current account surplus due to falling oil prices.

Portfolio positioning

Given all this we have reduced the overweight to Brazil, with concerns over challenges to revenues within the consumer space and fiscal ability to stimulate. We have increased our weight to China and Korea, mainly through tech exposure and the “stay at home economy”, and with the macro environment benefitting from a tentative post-Covid re-emergence. We have also reduced our exposure to financials as a result of concern around asset quality and non-performing loans, and to energy due to the slump in oil prices.

We would be remiss to not point out some reasons for optimism:

- Valuations are a whisper off global financial crisis lows – but this is not a financial crisis, it is a health care crisis. This is an important distinction as the financial system is a part of the solution when we move past the virus.
- Michael Hartnett, a strategist at BofA Merrill Lynch, often says markets stop panicking when central bankers (and politicians) start – this is clearly happening. There has been a huge amount of monetary and fiscal response, which is currently oxygen for the economy, but when the recovery starts it will be a very strong stimulus.

- There is, seemingly, progress on beating the virus. China and Korea are on the road to recovery, Europe is beginning to flatten the curve, as is the US. There are a tremendous amount of healthcare projects focused both on the treatment of Covid-19 and eventually a vaccine. We are seeing a big increase in testing, and are excited about a potential antibody test which is meant to come to market this month and which will tell people if they have been exposed and are now immune – a big catalyst to get the world working again. Life will never be truly normal until we have the vaccine and herd immunity is reached.



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