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A good time to consider emerging markets?

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Robust fundamental analysis, applied during heightened uncertainty, often leads to attractive investment returns. We believe an opportunity to do just that is presenting itself.

At the turn of the century, emerging markets (EMs) entered a decade-long period of strong and synchronised growth. This was driven by an opening of their markets, excess liquidity, increasing foreign direct investment (FDI), booming trade, and rising commodity prices.

This outperformance ensued until the arrival of the global financial crisis (GFC). Between 2009 and 2013, developed markets (DMs) began to rerate due to superior earnings growth. By the end of 2015, a survey of global fund managers (conducted by Bank of America and Merrill Lynch) found that the preference for DM over EM equity was at its highest level in 15 years. That translated into the S&P 500 trading at a +40% premium to the MSCI EM equity index. What followed was a two-year period where EM equity outperformed.

The chart below illustrates that we are back to those same extreme levels of relative valuation seen in 2015:

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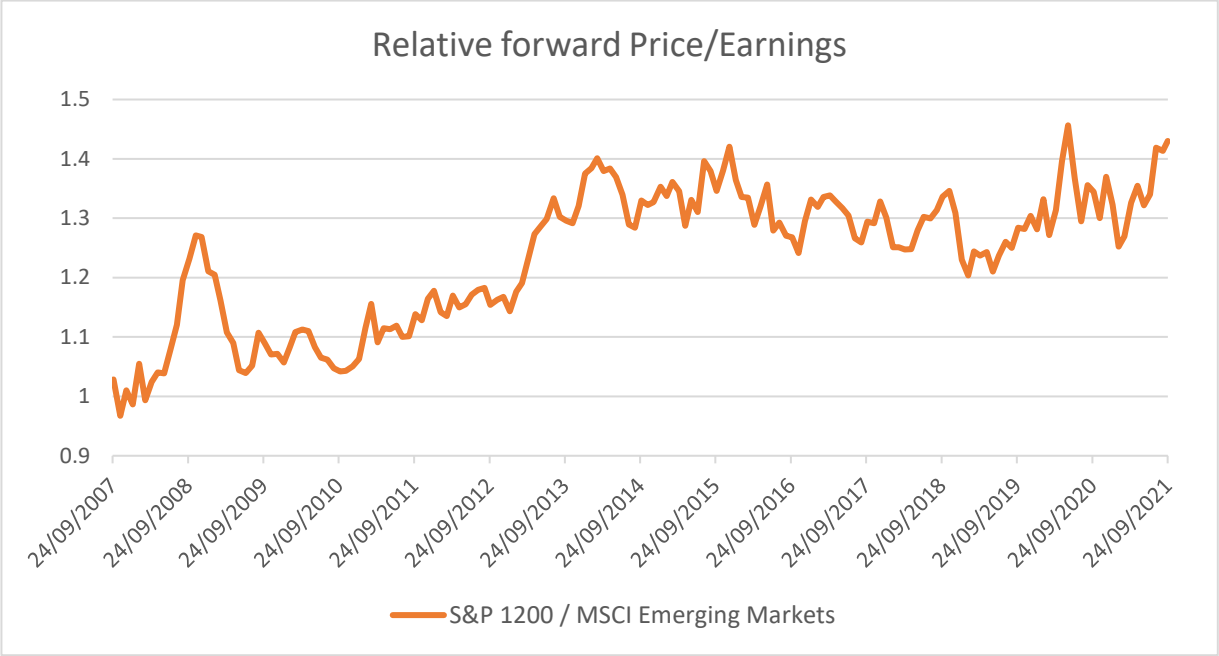
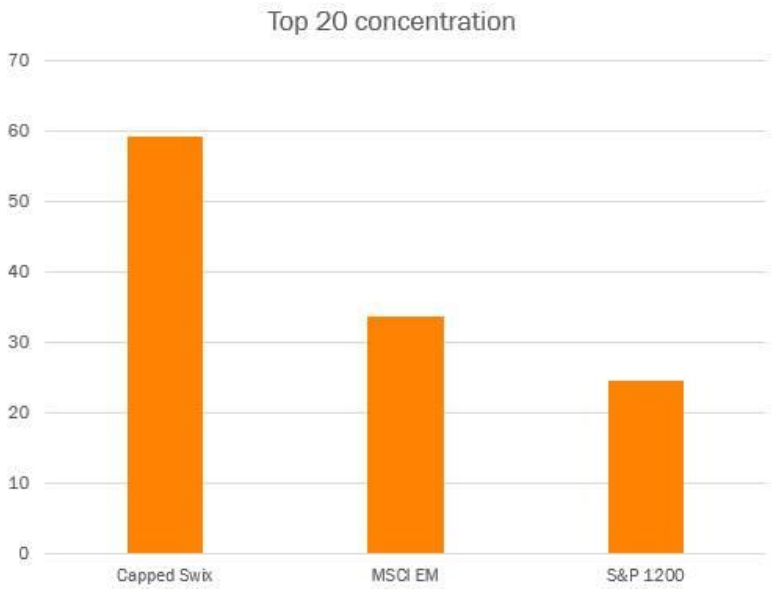


Source: Bloomberg, Fairtree

As a South African investor with exposure to our local equity market, it might seem reasonable to look at the above chart and do nothing. After all, we are an emerging market country that should benefit if the broader EM universe starts to outperform. There's some truth to that thinking; but it's not the whole truth.

Diversification at the right price

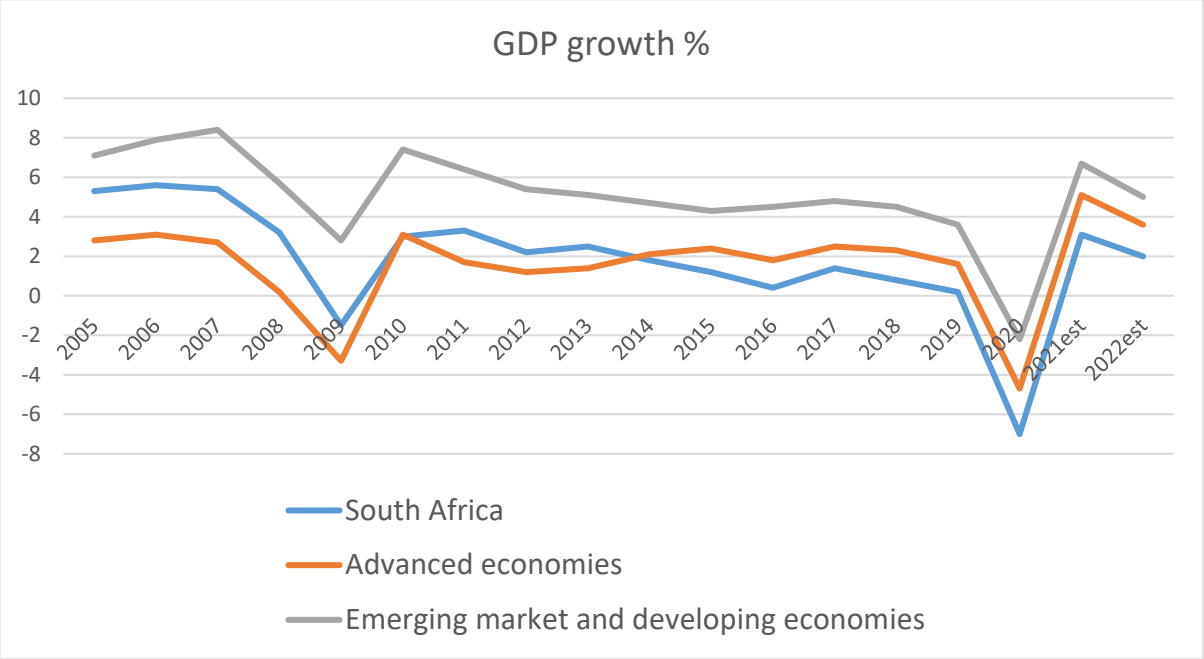
When it comes to stock selection, we are still finding value on the JSE. But it's important to recognise that our market represents less than 2% of the world's listed equity by market capitalisation; there are whole industries, sectors, and investment themes missing from our opportunity set. It's also a very concentrated market, with the top five stocks in the JSE All Share Index (ALSI) accounting for ~40% of the total market capitalisation. The next graphic illustrates this dynamic relative to other global equity indices. Bear in mind that the capped SWIX is the least concentrated index we have:



Source: Bloomberg, Fairtree

Investing in the MSCI EM index also gives you exposure to far more than just Tencent and resources – Chinese growth vectors like local athleisure brands, hardware companies, clean energy producers, and electric vehicle (EV) manufacturers populate the index.

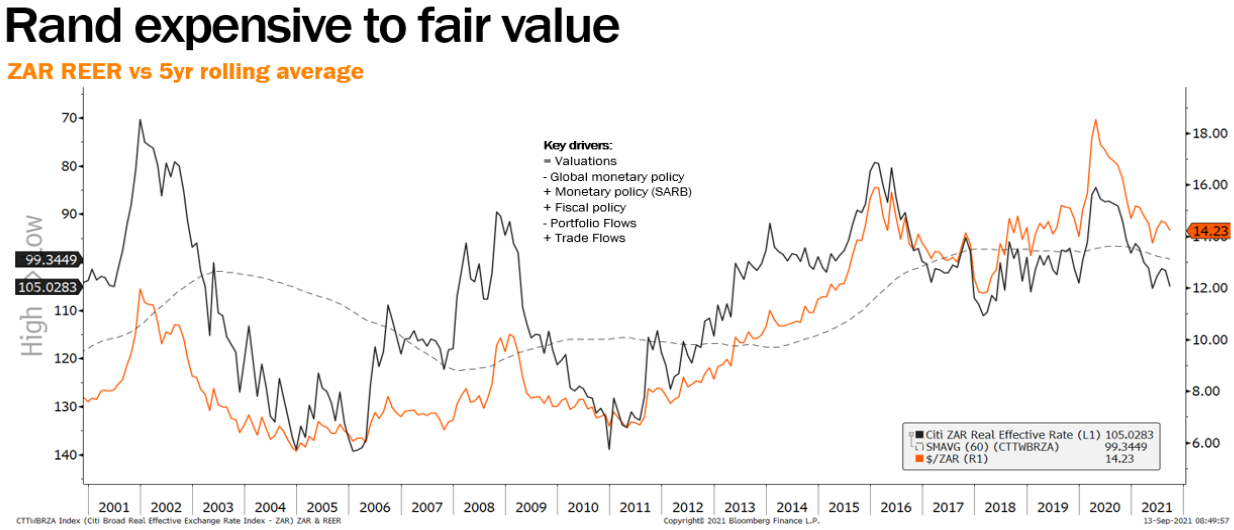
In addition to the above limitations, domestic growth is very low compared to what one might enjoy in other offshore markets. The South African economy has consistently underperformed in the past decade; our GDP per capita is down 35% in US dollars since 2011. Our government needs to make real, hard-to-come-by progress in implementing business-friendly reforms to change that reality.



Source: IMF

The takeaway here is that diversifying into offshore markets remains a prudent strategy. If you can do so when the rand gives you more bang for your buck, even better.

During the height of the pandemic, when the rand was at its least favourable level against the dollar (R19.26), investors rushed to take assets offshore. With the rand now trading at ~R15/$, it's a more opportune time to consider taking similar action.



Source: Fairtree, Bloomberg, as at Sept 2021

To summarise so far: the valuations of EM equities seem very attractive; our SA domestic equity market has its shortcomings; and the strength of the rand is presenting an opportunity to diversify offshore. The next question is why would we choose to allocate to EM equities rather than the likes of the S&P 500?

Focus on the fundamentals

It is important to limit the impact of emotion when making an investment decision. Despite the uncertainty that the haphazard global recovery has brought, vaccinations are trending higher, as is global capital expenditure. We think a compelling case can still be made for investing into risk assets offshore.

An allocation to EM equities in favour of the DM alternative is premised on the following line of reasoning:

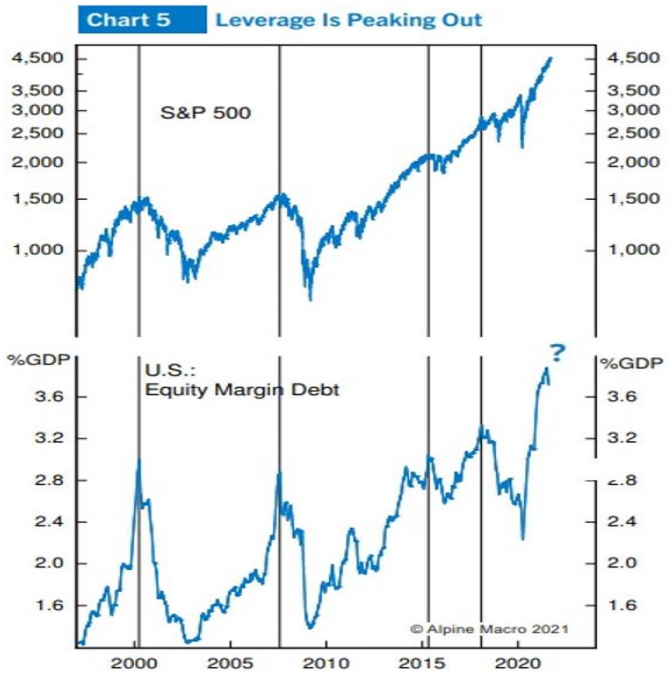
1. China makes up a large portion of the EM equity universe (~35% of the benchmark). Its equity market has priced in a significant amount of bad news, and now looks to offer good growth at a reasonable rating. Although the speed of implementation is uncomfortable for a Western investor, the regulatory announcements look very pragmatic and makes sense from a long-term perspective.

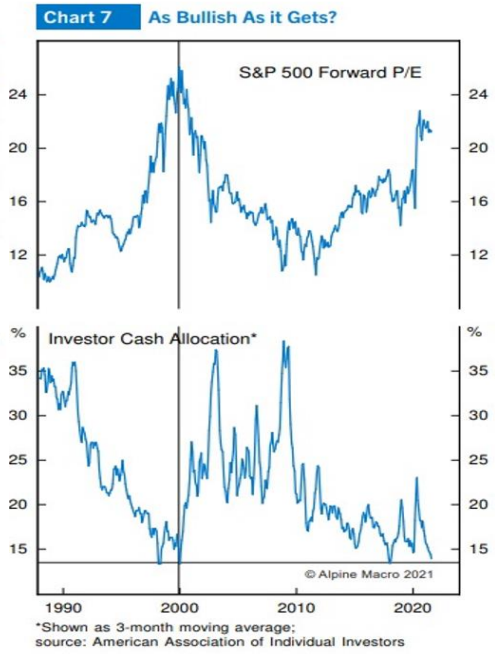
2. Strong economic growth and 'greenification' will lead to strong demand for commodities. Resource companies are showing good supply discipline and capital markets are unwilling to support investment into fossil fuels (coal, oil). This bodes well for commodity prices and shareholder returns from this pocket of the market that makes up 14% of the index. Other industries in commodity-dependent regions like South Africa, Russia and Latin America will also see the benefits of higher prices.

3. The chip shortage bodes well for the demand for tech-heavy countries like Taiwan and South Korea, that constitutes 28% of the benchmark.

4. Worsening US twin deficits and rising inflation may push the US dollar lower. This is favourable for debt dynamics of EM countries.

Our positive outlook for the EM equity universe, and China in particular, is juxtaposed against our concerns about excesses in the US equity market, the meat of which can largely be explained by the following collection of charts, which shows that investors have used the majority of their cash and leverage to buy into the market, driving up valuations:





Downside protection, upside potential

We are not suggesting it is time to abandon the S&P 500 and developed markets. Rather, that an allocation to an EM equity basket comes with both downside protection benefits, through improved diversification and lower valuations. and we think this offers attractive potential returns as uncertainty around China settles and global growth continues its rebound.

It is natural to obsess over political and economic headlines. But the key to successful active management is to take advantage of these opportunities as they arise. Outsourcing that responsibility to a skilled asset manager with a disciplined, fundamental investment process can improve the chances of participating in, say, the next bull run in EM equities.

Glacier Research would like to thank Cornelius Zeeman & Edna Sibanda for their contribution to this week's Funds on Friday.

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Cornelius Zeeman is the co-portfolio manager of the Fairtree Global Equity Prescient Fund, Fairtree Global Emerging Markets Prescient Fund and Fairtree Global Equity Fund, an Irish collective asset management vehicle. He joined Fairtree in 2015 as an equity analyst and has been co-portfolio manager of the Fairtree relative value hedge funds since 2018. He is a chartered accountant and CFA charter holder.

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Edna manages institutional client relationships at Fairtree Asset Management. She has six years' experience in the asset management industry in various roles, more recently moving from managing retail clients to institutional clients upon joining Fairtree Asset Management in 2019.

She holds a Bachelor of Business Science degree from the University of Cape Town in Finance and Economics.