INFORMATION FOR INVESTMENT PROFESSIONALS

Q&A: Emerging markets and the coronavirus

Global Emerging Market Equities | 31 March 2020

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What is the Emerging Markets (EM) team's take on the current environment?

We are seeing a level of volatility across global markets that hasn't been witnessed since 2008, in what feels like a global liquidation event. Emerging markets are no different. Unsurprisingly, price moves aren't necessarily rationale or reflective of a company's long-term fundamentals.

It's imperative in times like this that we keep our pencils sharp, trust our process and focus on our price target work. When we underperform on a given day, it's not necessarily because we own bad companies, and even though there's stress in the credit markets the companies we like have not been going out of business. Sometimes people are selling what they own just because they need to.

As long-term investors, we use this as an opportunity to purchase companies we want to own for one or two years and beyond at attractive valuations and upgrade the quality of the portfolio. We try to separate the emotions between what we're seeing on our screens to how we felt when we last met the companies – take decisions back to the stock level!

What is the EM team focused on in portfolios?

Prices are all over the place – the portfolio can be up 100 basis points (relative to the MSCI Emerging Markets Index) one day and down 100 the next – often dependent on the performance during different time zones and where our overweights lie. So, our focus is on the companies we want to own over the long term. When you look back six to 12 months from now, you may be surprised at the price levels at which you were able to buy great companies.

We may make mistakes in selling individual stocks as we move into others, but the idea is to be tactical and upgrade the quality of the portfolio as opportunities present themselves. We recognize the change in outlook for some of our companies and markets but must not get overwhelmed by the fear gripping the market.

We take it back to the company level and look for those long-term secular compounders, those healthy enough to come out on the other side better positioned. We ask ourselves: how is the business potentially affected by what's going on today; what does the balance sheet look like; how strong is the company's free cash flow; what impact does it have on their competitive advantage; how did we feel the last time we visited the company; what are the multiples that we would currently pay for that business? We must trust the process and have the courage to focus on owning companies with the potential to outperform for the next few years, or longer.

While today's headlines may be focused on the impact of the coronavirus, volatility in emerging markets is no stranger. At the turn of the year markets rallied into positivity surrounding the phase one US/China trade deal, when our process led us to take profits and actually be underweight China leading into the virus outbreak. The same process sharpened our focus in 2018 when markets rotated into value with concerns surrounding those escalating US/China tensions. We upgraded the portfolio and that positioning set us up for the outperformance in 2019.

What are your main sector and county allocations?

On a sector basis, the largest overweight positions are currently to consumer discretionary, information technology, healthcare and communication services. Our largest underweights are to materials, consumer staples, financials and energy. In terms of country allocation, the largest overweights are to Brazil, Indonesia and India, the portfolio's weight in China/Hong Kong is approximately neutral relative to the MSCI Emerging Markets Index, and our largest underweight positions are Taiwan, Saudi Arabia and Malaysia.

What has liquidity been like over the last few weeks?

Liquidity has been a massive part of the conversation. We have witnessed stocks, both inside and outside the portfolio, move down on little news and little change to long-term fundamentals, making it clear that sellers are being forced to exit positions. We have been trying to take advantage of these dislocations and have been very fortunate that we have seen very little client flows – some accounts have seen small outflows and some small inflows – so have not had to participate in any forced selling.

What is the EM team's view on the coronavirus?

First and foremost, it's terrible to hear of the loss of life and people suffering. As the virus has spread, and with governments around the world making guidance more stringent, it is hard to forecast the exact economic impact, but it is clear we are heading for a sharp but hopefully short-lived recession. This is a very different scenario to what we were hearing from our portfolio companies heading into the year, when many were talking about stronger economic growth and an improving global economy.

There is some encouraging news though – notably the countries that had the first outbreaks, namely China and Korea, seem to have the virus contained and life on the ground is getting back to normal. Even in Italy, the most tragic story so far, there are signs of hope in that the societal lockdowns seem to be working with the number of new cases levelling off, even if only for a few days so far. After a very slow response, the US government, on a national and local level, is now responding. We are hopeful that the level of panic and fear, and subsequent quarantine and social distancing, will result in a flattening of the curve so we can avoid the overload of the health care system that Italy has experienced.

We are seeing a tremendous response from world central banks, with the US Federal Reserve basically announcing quantitative easing to infinity, cutting rates to all-time lows, and passing a massive stimulus package. While China has been more measured following the Fed's surprise rate cut, it has already announced an injection of 1.2 trillion yuan ($173 billion) into markets and has pledged a commitment to use monetary policy tools to ensure liquidity remains ample and supportive of firms affected by the virus[1]. We also expect a pickup in fiscal stimulus from China now that it is clear global demand falloff will be another headwind for China. Hopefully, all of this means we have seen the peak in volatility and perhaps the low in the market (though this is likely to be re-tested), as long as the US is able to flatten the virus curve.

Clearly, consumption and supply will be impacted. While consumption will be hit hard in the short term, and a significant portion of the drop lost forever, our view is that it will be back on

[1] theguardian.com, 1.2tn yuan to be pumped into Chinese markets to fight coronavirus slump, 2 February 2020

trend within six-12 months. In terms of supply, there is evidence of critical component shortages and, like consumption, it will miss consumer demand and a portion will ultimately be lost. Furthermore, companies are likely to experience a period of negative earnings revisions. But if this is transitory the market will look through any earnings misses or reduced guidance once containment is in sight.

Weather and central banks both matter in the coming months. As with the flu season, the SARS and MERS coronavirus infections ebbed as the weather warmed, and warming trends in April/May will perhaps help limit the spread of the current virus. We also have faith in the private sector and the vast brainpower that is keenly focused on finding treatments, and ultimately a vaccine, which may help in subsequent outbreaks next year.

Are things getting any better in Asia versus developed markets?

Parts of Asia are seeing glimmers of light. In China, coffee shops and factories are reopening in large numbers, with no new instances of coronavirus cases (though there are imported cases)[2]. Korea approached the situation with a different strategy, testing like crazy – even opening drive-through testing stations (a model the US is trying to adopt). As such, the country dealt with the quick escalation of new cases, moving swiftly to isolate those who were sick, enabling companies such as Samsung to reopen and operate at full capacity. Interestingly, there have been no massive outbreaks in Taiwan, Singapore or Hong Kong other than travel-related instances. While we cannot say for sure that weather was a major factor, the possibility that the virus did not transmit well in the hot, humid climate is encouraging.

While parts of emerging markets seem to be on the path to recovery, others are potentially just starting their journey. Governments in the Philippines, India and Brazil are now taking steps toward lockdowns and quarantines, very similar to what we are seeing in most of the Western world. All are trying to learn from Italy's mistakes and focusing on "flattening the curve" – taking whatever steps necessary to at least slow down the spread of the virus, with the hope that their health care systems will not be overwhelmed.

The economic impact has already been painful and will continue to be so in the short term. While we expect volatility to continue, we remain constructive about the outlook for emerging markets and China, especially long-term trends. Our belief is that in 12 months we expect to look back at the price levels we are currently paying for certain stocks and be stunned.

What long-term secular themes do you see changing or developing as a result of this crisis?

Often periods of extreme volatility can provide the impetus to accelerate trends that were already in place. For several years we have seen the growing spending power of the middle-class consumer making a tremendous impact in emerging market economies. It has been an overarching theme that cuts across multiple sectors from consumer discretionary to health care, financials and communications services.

The acceleration for online shopping as a result of the "stay-at-home economy" benefits the likes of Alibaba, Magazine Luiza, and JD.com. With new and potentially "sticky" users on their platforms buying products ranging from groceries and electronic goods to even ordering meals online for the first time, it has the potential to not be just a short-term/crisis-related surge, but rather more long lasting.

On the flipside, there will obviously be a delay in travel and tourism with normalisation still many months away. The CEOs of commercial airlines, global hotel chains and large resort casinos have no choice but to be candid that the next several months will be extremely tough. People are not going back to travelling right away and they will be hesitant to go back to places with large crowds.

Within financials, banks in China and Korea are likely to do "national service". For example, as companies struggle with the impact of coronavirus on their business, governments may

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[2] Reuters, China delays college entrance exam as fears grow over risk of coronavirus second wave, 31 March 2020

encourage the banks to provide liquidity to avoid potential mass unemployment issues. Financials have been some of the hardest hit as the outlook for growth has quickly turned to recession. Some of these falls have been justified, and others we see as opportunities to build positions in quality franchises for the long term. We see this in developed markets too, with banking executives visiting the White House to discuss how they can help support small businesses. What is different for financials in this crisis than in 2008 is that they are part of the solution, not part of the problem. We do not see the need for large capital raises in emerging markets, or US banks for that matter.

How do you approach country allocation given the differing impacts of the coronavirus?

What we always remind our clients is that when you invest in our Emerging Markets portfolios you are buying companies, not countries or political regimes. More specifically, you are buying their earnings and cash flows. So, the key is to look at macro effects through the lens of the company – ask yourself how the companies are impacted by the coronavirus. Having said that, we have used the volatility to close our underweights in the countries that seem to be through the worst of the impact of the virus, namely China and Korea.

Alibaba is our top holding in the portfolio and is the largest e-commerce platform in China. The company has evolved beyond an "everything store" into a data-driven tech company, integrating multiple business components such as advertising, media, financials, logistics and local services. Alibaba's GMV (gross merchandise volume) growth rate is almost 30%, year over year, and the commission it earns on its platform is approximately 4% (compared to the likes of Amazon at 20% or eBay at 13%)[3]. The company has free cashflow at $15 billion and is trading at 22x earnings. The company's investment in the cloud, currently benefiting from the .masses working from home, is the rather large icing on the cake. It has 60% market share and a 90% retention rate; however, margins are at -0.5% given the massive investment into its cloud platform. When it does start to turn a profit (margins were -20% one year ago) it will certainly justify an even higher valuation.

Another top holding is Tencent, a company where many of its verticals are benefiting from recent events. Tencent is a leading online platform with more than a billion monthly active users; it is a comprehensive internet services company, encompassing communication, entertainment, socialising, online shopping, information searching and more. Monetising this user base is the key to its success. Advertising has been weak recently, but when it does come back it may well be positioned to gain more market share, as advertising companies focus on Tencent's ecosystem to get the highest return from their advertising budget. Given the diverse verticals and ecosystem, just imagine the extent of knowledge Tencent has on its customers – both online and offline data. After all, 50% of all offline transactions in China are done through either Tencent or Alibaba's payments systems via QR codes.

The likes of Samsung, SK Hynix and TSMC, meanwhile, are beneficiaries of the long-term themes such as cloud and 5G, so are also great opportunities. While we will certainly see a delay to the 5G cycle, it will still happen. We believe these are healthy and innovative companies which aren't in danger of going out of business. Therefore, we look at current valuations with excitement.

Do you have a comment on valuations?

It is hard to predict what will outperform in the short term. The valuation case for emerging markets equities was compelling at the turn of the year. We believed then that emerging markets equities should be trading at a premium relative to developed market counterparts, given the improved composition of the universe which favours higher quality names. The asset class was offering investors an attractive opportunity into solid businesses supported by structural growth trends. Now, we would argue that the massive dislocation in individual stocks provides an even more compelling case to invest in emerging markets in the months and years ahead. At the lows this week, valuations were within a whisper of the lows during the global

[3] Alibaba Group, Alibaba Group Generated RMB268.4 Billion (US$38.4 Billion) of GMV during the Global Shopping Festival, 11 November 2019

financial crisis. Valuations probably don't matter until investors see the light at the end of the tunnel regarding the virus, but once they do so, valuations will matter tremendously.

Furthermore, financial vulnerability has dropped dramatically in emerging markets – there is not systematic weakness such as there was in years before; most countries are now on a path of genuine reform. Such reforms have the potential to be transformational in unlocking growth potential. Following national elections over the past 18-24 months, reform momentum may increase in countries such as India, Indonesia, Malaysia and Philippines, paving the way for greater macro stability and stronger structural growth.

Any signposts that markets have bottomed?

Timing markets is very hard. Perhaps they have already bottomed, but it's impossible to say for sure. A global strategist we follow put it well: Look for five peaks – volatility, US dollar strength, credit spreads, capitulation and virus fears. And look for two troughs – in oil and rates. I would add that the lead indicator for virus fears is flattening the curve – first in Italy and then in Germany and Spain. This will give confidence to markets that the US will also be successful.

In the meantime, we spend our days talking with the management teams of our companies, understanding the fundamental impacts of what is happening, dialling in our valuation work and trying to take advantage of the volatility in markets for our portfolios and ultimately our clients.