PORTFOLIO MANAGER COMMENTARY – GLOBAL EMERGING MARKETS TEAM
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Global Emerging Markets Strategy Update

MARKET OVERVIEW

2016 marked a year of relative economic stabilisation across many emerging countries following five years of deterioration. Part of this was due to China loosening monetary policy and accelerating fiscal spending, both of which provided an economic stimulus, as well as helping commodity prices in general. However, as we have discussed consistently throughout the year, various "automatic economic stabilisers" kicked in during 2016. Principally, weaker currencies in most emerging countries, slower growth in particular in certain Latin American and EMEA countries, and lower commodity prices which have been beneficial for many Asian countries. These factors helped establish a new equilibrium level for growth.

Most emerging economies are facing relatively weak economic growth, volatile inflation and poor external account positions, resulting in limited prospects for new investment. The dilemma of either defending currencies or pursuing a pro-growth policy (the former corresponding to high interest rates and potentially lower growth, while the latter equates with lower interest rates and potentially faster growth) is being solved naturally as a consequence of either the depletion of foreign currency reserves, a dangerous growth in debt and/or accelerating inflation. This choice has already been forced on some of the weaker economies, with the central banks in both Egypt and Nigeria, for instance, being forced to accept significant devaluations. Other large economies, such as Turkey, Malaysia, South Africa and Brazil, all face, to a greater or lesser degree, similar situations. While some of these issues are pertinent to China, we continue to believe that the country has more flexibility and leeway to manage its situation, not least because of its high savings rate and the closed capital account.

Without major structural reforms, a number of emerging economies remain vulnerable to external shocks, and external shocks have of course been in large supply of late. Indeed, it is quite possible that we will continue to face such unexpected challenges in the coming quarters. It would seem we are living in interesting times where the widely considered impossible becomes possible. As such, 2017 could well see a number of emerging economies choosing capital controls as a response to the discussed internal and external pressures.

A key question we have regularly been confronted with since the election of Donald Trump as the next US President is what are likely consequences for emerging markets? Although it is impossible to provide a full answer to this question at present, it is fair to assume that the status quo of the last few decades is unlikely to remain. Donald Trump was elected on a populist and protectionist agenda and will accordingly very likely introduce certain laws that affect trade and migration most notably. At the same time he is also likely to try to boost the domestic US economy.

With regards to the issue of protectionism, it is clear that de-globalisation is not good news for emerging markets. An increase in protectionism is likely to reduce the transfer of wealth from developed to emerging markets that has taken place over the last thirty years and which was partially responsible for the significant economic convergence of the emerging to the developed world. However, while not wanting to minimise this risk, it is important to put it in the context of today's multipolar world where the role of both the US and Europe as growth engines is less pronounced than it has been. Regardless of the election outcome, the fact is that global trade has already contracted by 20% since early 2012 (source: CPB World Trade Monitor). Encouragingly it has been stabilising over the past year. In addition, the growing middle class across many

emerging countries are increasingly able to expand their spending without reliance on external funds as they are significantly less indebted than their developed counterparts.

However, protectionism is but one element of the broader issue of populism, which could have a more important impact on economic growth and stock market returns over the long term.

Judging from the various electoral results witnessed in 2016, the era of openness initiated by Margaret Thatcher and Ronald Reagan might well be at an end. Surprising though the electoral results were, it is worth looking at them in the context of the stagnation in real incomes for much of the developed world population – and in particular the middle classes – over the past 20 to 30 years. This initially went unnoticed for two main reasons.

First, the downward move in interest rates substantially increased consumers' ability to leverage: debt availability and its increase in absolute terms masked the real drop in purchasing power of a large part of the developed world population. Secondly, the rise of China as the world's manufacturing hub resulted in massive deflation in most consumer goods. Independently, various services, notably travelling, also became cheaper. Although not actually wealthier, households had the impression of living better, with lower expenses. The Global Financial Crisis (GFC) brought all this to an end. Faced with excessive debt burdens on the one hand and rising inflation in food, education, health, rental and asset prices on the other, households began to face up to the new reality. Central banks globally have attempted to maintain the pre-GFC status quo by pushing interest rates into negative territory in an effort to further increase debt accessibility. However, the monetary experiment has not translated into any tangible improvement in broad economic growth, leading to electorates feeling increasingly marginalised. This sense of 'being forgotten' by their governments while an increasingly small elite appears to be increasingly benefiting from the maintenance of the status quo has been partially responsible for the surprising election results of the past year. It is likely in our view that this trend towards populism and attempts at a fairer wealth rebalancing will continue to be reflected in election results in the coming years.

From a corporate perspective, part of the resulting higher profits may now increasingly be redistributed from shareholders to employees, in one form or another. Having said this, there is a difference between the approach taken in the US and in Europe. Trump has chosen a number of billionaire business people in his new cabinet and is talking about significant de-regulation and tax reform as ways to boost living standards for the average American. This is almost diametrically opposed to the European populist agenda which is centred on higher taxes and a bigger state. However, both models seem to agree on limiting the role of free trade.

If some redistribution eventually happens, corporate profit margins will suffer, especially in developed markets where they have benefited the most and are at close to record levels. This is unlikely to be good for shareholder returns in the short term, although it may enhance GDP growth over the longer run.

Paradoxically, emerging countries could be relatively less impacted: although inequality has increased, the absolute overall income levels have generally risen (i.e. a reasonably sized middle class has emerged) while profit margins are not at inflated levels.

Many emerging companies were badly affected by the global downturn that began around 2010-2011. The companies that suffered most were those with excess capacity and poor cost structures, thereby suffering from negative operating leverage. This led to declining returns and earnings contraction, thereby explaining the weak performance of emerging equities over the last five years.

However, there is increasing evidence that many emerging companies have readjusted their cost structures to this weaker sales growth environment, have reduced capacity and frozen capex, resulting in an end to the decline in profitability levels. This in turn has led to some positive earnings revisions over the last 12 months (adjusted for higher energy and commodity prices). Any pick-up in economic growth should have an important operating leverage impact, which in itself would improve returns.

Overall, 2016 was a good year for emerging equities. The US election surprise accentuated the ongoing sector rebalancing towards cyclicals and recovery stories, an environment that is typically more challenging for our investment style. The performance of Comgest's GEM strategy was also negatively affected by a number of factors:

- The strong performance of energy and material stocks, which are structurally very under-represented in our portfolio. This trend was particularly noticeable in Brazil which explains weak stock selection contribution in that country.
- The performance of banks was strong and better than insurance companies, which suffered from declining emerging bond yields within their investment portfolios, a situation that was particularly noticeable in China.
- Some companies with solid fundamentals suffered from a poor economic backdrop in their respective countries (for instance, BHEL in India, Mail.ru in Russia), weak currencies (CK Hutchison (Sterling/Brexit), Femsa (Mexican peso)) or regulatory issues and geopolitics (MTN in Africa, Infosys in India).

PORTFOLIO POSITIONING AND COMPANY SPECIFIC NEWS

Although the geographic and sector breakdown is a consequence of stock selection, it is important to note that the resulting portfolio is overweight in China, India and Brazil relative to MSCI Emerging Markets as well as to consumer staples and telecommunications. The fund is underweight in Korea and in Taiwan as in both of these countries sustained growth and quality have been more difficult to identify. Banks, energy and materials are not represented in the portfolio, although we continue to monitor stocks in these sectors for opportunities which accord with our investment style.

TSMC performed well throughout 2016, including in the last quarter. It benefits from sustainable, although somewhat lower than historical, growth of high-powered computers (to handle virtual reality), the Internet of Things as well as more generally from its leadership position within the semiconductor industry which it has steadily built over the years.

Kweichow Moutai was another solid performer, driven by good financial results, an easing of the anti-corruption pressures in China and a degree of multiple rerating. The company continues to deliver against a somewhat volatile consumer environment in China.

The Brazilian infrastructure operator **CCR** benefited from the expectations of a stabilising economy and an accelerating decline in interest rates. Company cost-cutting measures helped to offset the continued weakness of highway traffic, enabling margins to improve. CCR has significant operating leverage to benefit from a recovery in the economy, declining interest rates and from recent projects increasingly close to maturity. Infrastructure is a key focus of the new Brazilian government: the first tenders for the new projects should take place in early 2017, creating potential growth opportunities for CCR.

On the negative side, **CK Hutchison** was a victim of the macroeconomic environment. Generating almost 40% of its EBIT in the UK (telecom, utilities, retail), the depreciation of the pound has had an impact on its results while weak global trade detracted from the company's port operations. The stock is inexpensive, supported by its dividend yield and buybacks, but needs better economic growth to generate higher returns.

Chinese life insurers, **China Life** and **Ping An**, have been discussed in several of our recent reports. The unexpected drop in Chinese bond yields over the past two years as well as the weak stock market have negatively affected the investment returns generated by both companies on their respective investments, thus depressing earnings. While it is difficult to predict the direction of interest rates, it does seem to us that China cannot afford a further easing of its monetary policy if it wants to protect its currency without resorting to totally closing its capital markets. We believe that it is unlikely that the situation will deteriorate further for Chinese life insurers:

investors are likely to look increasingly at the fundamental results of the underlying business results, which have continued to be very strong.

Bharti Airtel, the leading Indian mobile services provider, suffered as a result of the launch of the new mobile brand, Jio, by its rival, Reliance Group. Although anticipated for a while, the entry of Jio was more aggressive than initially expected; for instance, SIM cards were distributed for free. It is not yet clear what the long term implications of Jio will be for Bharti's business. However. Jio's initial strategy is likely to adjust over time to face economic and financial reality. With its 4G offering, Jio is targeting only the sophisticated smartphone owners, while its fairly new network is of relatively poor quality compared to that of Bharti Airtel. In an industry where client churn is high and depends on "web surfing" satisfaction level, once Jio starts correctly pricing for its service, the relative attractiveness of its offering is likely to decline in our view.

Although we consider that **Femsa** remains a very well-run company with a series of strong franchises, it was negatively affected by the general decline in the value of all Mexican assets following the election of Donald Trump as the next US President. The Mexican peso was particularly weak both in the run-up to the US election and subsequently. The decline in Heineken's share price, a company it has a stake in, also contributed to Femsa's share price weakness.

PORTFOLIO CHANGES

Six new companies were added to the portfolio in 2016.

Hikvision, the leading surveillance camera provider in China with growing international presence and global market share of 18%, is one of these new additions. The video surveillance industry is expected to benefit from the surge in growth of Internet of Things as network cameras capture images/data. Cameras are also essential in various smart city strategies in improving safety and overall quality of life. Hikvision should also benefit from the replacement of existing analogue cameras by new digital equivalents. The company currently trades at 15x 2017 earnings, has an ROE of 35%, is net cash positive and forecast to deliver double digit earnings growth.

Suzuki Motor was added as a discounted way of purchasing a stake in Maruti Suzuki, its Indian subsidiary, which is responsible for about 70% of group profits.

We are still building positions in four additional holdings which will be discussed in detail at a later date.

We increased our positions in **BB Seguridade** and **Inner Mongloia Yili** on share price weakness and reduced our position in **Power Grid** on share price strength.

Natura in Brazil was finally completely exited. We saw no meaningful progress in its strategy to address market share loss in Brazil. In Russia, **Yandex** and **Magnit** were sold due mainly to the reduced medium-term visibility of their earnings.

OUTLOOK

2017 looks likely to be as uncertain as 2016 proved to be. Elections and geopolitics will likely continue to impact stock market returns and volatility. At the same time, our ability to add value here is limited and we remain instead focused on finding "shock-proof" quality growth businesses and attempt to own them at valuations which provide a margin for error. In any case, forecasting short term is a difficult sport that we don't practice at Comgest; we prefer instead to take a longer term view which in our experience makes "being approximately right" possible. That is the approach we take for the companies we hold but this also is how we approach the challenge of understanding the global picture.

We continue to believe that emerging markets represent an interesting investment opportunity. There are some clear structural pillars of support for emerging economies over the coming years and decades: demographics, urbanisation, ongoing reforms (emerging countries cannot count on powerful central banks to maintain the status quo indefinitely), the continued ascent of the Chinese economy, technological disruption, and the increase in financial and credit penetration of local populations, to name but a few.

It is likely that longer term many of these countries may improve relative to those in the developed world. Debt levels, interest rates, wealth redistribution, corporate profit margins and share buybacks are among the elements that are likely to be challenged in the “advanced world”, with a possible negative impact on shareholder returns. In emerging markets, debt levels are more reasonable, real interest rates are positive, wealth has become less concentrated, and profit margins are not at record levels, while share buybacks have never been widely used because of the often prohibitive cost of money. At the same time, valuations in many of the emerging markets are reasonable relative both to historical averages as well as the developed world. Finally, record outflows in the last quarter of 2016 mean that equity investors are generally underweight compared to recent historical levels.

Of course, there are always short-term risks such as a serious problem in one of the larger global economies, the overall issue of the credit bubble and if/how this could unwind, US dollar appreciation, and the current unpredictability of the incoming US President, Donald Trump.

At mid-single digits, the 2016 EPS growth of our GEM portfolio was below that of the MSCI Emerging Markets for the first time in four years, with the index benefiting from the rebound in the profitability of energy and materials companies. The portfolio’s EPS growth was affected by a few exceptional situations (MTN, Baidu, Brazil Foods and China Life) that we feel are unlikely to be repeated. As we increased the positions in the first three of these stocks during the year, the negative impact on portfolio EPS was further exaggerated. Were one to exclude the above names, portfolio EPS would have shown double-digit growth. As an aside, this also means that the portfolio has become cheaper compared to its potential growth.

Set against this context, at the beginning of January our GEM portfolio trades at 16x 2017 earnings, which are expected to grow by 13%. The portfolio is differentiated by its high exposure to several fast-growing quality companies in China’s “new economy” as well as through its exposure to the life insurance sector in Africa, Asia and Latin America; companies that should benefit from an increase in middle class demand for protection. We believe that our portfolio remains well-structured and balanced to navigate any of the difficulties mentioned above.

The GEM portfolio mentioned in this commentary refers to Comgest’s Global Emerging Markets Representative Account, an open-ended investment vehicle that has been managed according to the strategy discussed since inception of the strategy.
Sources: Comgest, Factset (e.g. actual and forecast earnings/EPS growth/financial rations – data at end-December 2016 except where stated otherwise), Bloomberg (market and macro information), most recent company reports for TSMC, Kweichow Moutai, CCR, CK Hutchison, China Life, Ping An, Bharti Airtel, Femsa, Hikvision, Suzuki Motor, BB Seguridad.

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