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Ukraine war's impact on emerging markets and China

A summary of the webinar on 27 April 2022

A quick resolution to the Russia-Ukraine conflict not likely

If one looks back to the end of 2021, the biggest risks then facing emerging markets (EMs) were high inflation, rising interest rates, COVID flareups and political noise around elections and regulatory changes. Most of those risk factors have unfortunately materialized in some ways, but what's worse, we have seen the tragic outbreak of a full-blown war in Ukraine. Our thoughts are with the people of Ukraine as we hope for a de-escalation of the war. It is however impossible to predict how this conflict will develop, with the situation being highly fluid and changing almost by the hour.

In our opinion, geopolitical and political considerations are the main drivers for this war, as we see no economic benefits to any of the parties involved. The economic damage to Russia has been dramatic, while the human and economic tragedy for Ukraine cannot be fully assessed at this point. Given that there are no signs of ceasefire talks or peace negotiations, our base case is that there will be a prolonged period of fighting in eastern Ukraine and there will be not be a quick resolution to the war.

Energy and commodity prices to stay elevated

It's important to keep in mind that countries directly affected by the war are a small part of the EM universe, which is made up of ~80% Asia, ~10% Latin America and ~10% Middle East and Africa. The most obvious and immediate macroeconomic impact from the war has been in energy and commodity prices. Russia is the world's main exporter of crude oil and gas, and we see risk to that supply from multiple fronts: sanctions, the technical ability to keep production at current levels, the decision by European countries to stop buying energy from Russia, and Russia's refusal to deliver energy to what it calls "unfriendly nations." We expect energy prices to stay elevated for some time.

Moreover, Russia is also the world's largest producer of palladium, which is used in catalytic converters, and is a large producer of aluminum, nickel, copper and coal. And it is a large exporter of soft commodities. It will take time for the world to adjust to the expected shortages. However, energy and commodity exporting countries in the Middle East, some countries in Latin America and Africa, including South Africa, will gain from the higher prices. Indonesia and Malaysia are well positioned as commodity exporters, but other Asian countries are generally not.

Inflation cycle nearing an end

Inflation and high and rising rates have been and still are a major drag on the economic recovery in many EM economies, but we see some signs of the cycle coming to an end. Several EM countries including China and Brazil have raised interest rates ahead of developed markets. With inflation starting to come off and real rates turning positive in some areas, we see the potential for first rate cuts to come through in the third and fourth quarters of 2022. Emerging markets are generally much better positioned today for higher rates than they were in 2013-14, when many countries were running large twin deficits. That said, EM equities experienced a difficult first quarter, with one of the strongest corrections in many years.

These included our overweights to Hungary and Poland, and the underweight to the Middle East. Several countries, including Saudi Arabia, Kuwait, Qatar and UAE, are benefiting strongly from rising oil and gas prices, and have seen their stock markets rerate to levels that we consider very demanding. We have seen weakness in China, Taiwan and Korea. The major drivers for China beyond the COVID flareups have been supply chain issues globally and general risk aversion toward risky asset classes.

Putting China in perspective

There is a lot of noise about China. We believe it is helpful to take a step back and look at the big picture. China has been in a boom over the past decade, punctuated many times by the expectation of a hard landing or a meltdown. But each time, China has made its way out. Today, the big picture in China is driven by the overarching objectives that the Chinese government would like to achieve. These include: improving security, financial stability, common prosperity, the environment, dual circulation and demographics. Most of these long-run goals are positive for the long-term development of the China economy. However, there could be potential short-run implications for various sectors and companies.

Understanding China's overarching objectives and the potential implications for sectors and companies have been increasingly important considerations in our stock selection process. We maintain our focus on the fundamental value of the companies. We believe that our strategy of buying strong, well-managed companies will work for investors in the long run. Within the portfolio, we have seen some performance issues in the past year due to the impact of regulatory concerns. But our longer-term historical track record is strong, and we believe that actively managed portfolios will continue to deliver value for investors. We view today not as a time to panic, but as a time to invest where we see opportunities.

Structural case for emerging markets still intact

Though we believe in the case for emerging markets, the asset class has experienced some deep and partially unexpected breaks. Over the last 24 months, EM growth has been muted to an extent we had not expected. However, we believe the factors that caused the slowdown—rising rates, COVID restrictions and slow vaccine rollouts—are likely to play a much less important role in the second half of 2022.

We think some of the headwinds could turn to tailwinds, and lead to an uptick in domestic growth, for several reasons:

- EM companies are healthy: Compared to historic levels, EM companies have high levels of cash and low levels of debt. These sound balance sheets should allow companies to weather future difficulties, and enable them to start investing in growth once they feel the macroeconomic backdrop is safer.
- EM countries are strong: While the unexpected political and regulatory noise may have increased, fundamental macroeconomic data for EM countries has improved substantially. Many of the countries that ran twin deficits 10 years ago are in a much stronger position today. In addition, EM countries tend to perform well in a rising rate environment. Many of them have already raised their interest rates, and we could be close to the point at which they need to stimulate their economies, as in China and Brazil.
- EM valuations are inexpensive: Both in absolute and relative terms, EM countries are trading at a discount to history, and at a deep discount to developed markets. Investors have been taking money out of what they view as risky asset classes. But after the most recent correction in April, the price-to-book values in the EM are at levels that we have hardly seen over the last 20 years. Many companies offering large upsides to their intrinsic value.
- EM currencies look attractive: Especially now as we see inflation peaking in many countries, and starting to offer solid real yields again.

We believe the opportunity to generate alpha in a more stable and normal top-down environment is very attractive. We have been through one of the most challenging periods in EM history, but our team believes in the value of actively managing EM equities in the long run. While we gave back some significant alpha in 2021 and 2022, we remain confident in our active approach and our ability to add alpha when the environment is more stable.

Adjustments to our process in a top-down environment

Our investment process works best in an environment where bottom-up sector- and company-specific factors are the main drivers of companies' earnings and free cash flow potential. The last 24 months have been heavily influenced by top-down factors, which we admittedly did not expect to happen to the extent they did. We continue to focus our efforts on identifying long-term winners within industries, but have put emphasis on strengthening a layer of scenario analysis in our bottom-up analysis. At the company, sector and country level, what could go wrong and what could we miss? This goes beyond sensitivity analysis to anticipate what could be an unexpected event that changes the entire investment thesis.

Sector-wise, our global emerging markets strategies have large weights invested in semiconductors, where we continue to see a good structural case, even in the current down cycle, which we we think will be shallower than typical down cycles in semiconductors. Almost a quarter of the portfolio is allocated to financials, which is how we are investing in the reopening of EM economies and the potential for renewed above-average growth. We believe EM growth will pick up by one to two percentage points, on average, in the more stable environment that we anticipate.

Beyond China, we see good opportunities in Southeast Asia and India, where we think growth should be sound and at a higher level than we have seen. Latin American companies and countries have been facing a long period of low growth to negative real growth. The entire region was heavily impacted by COVID, as these countries lacked widespread access to vaccines and treatments for some time. But now, Latin America has caught up. Vaccine levels in these countries are sometimes at higher levels than in the western world. We see potential for a renewed economic growth cycle in Latin America.

The investment outlook for the Middle East has changed quite a bit over the last 12 months, and it is a bit unclear. Based on our macroeconomic assumptions, for most countries in the Middle East, their budget breaks even somewhere between $60 to $80 per barrel for oil. Today we are at $100. What has been more of a problem for the area was the volatility of energy prices and the volumes they produced, rather than the absolute levels. It was more of a boom/bust cycle—and less of a stable growth pattern for the Middle East. Right now, the market is pricing in the expectation of elevated energy prices for years to come, forcing us to be extra careful when evaluating the best way to have exposure to the region.

Chinese sectors that could do well in the long run

Despite the current volatility, we are confident in our long-term investment thesis and feel positive about an actively managed China equity strategy as the country continues in its transformation. We have always believed that investing in China is about picking the right stocks in a fast-changing environment. And we are in a fast-changing environment. Over the past few months, valuations have declined to attractive levels—down almost 40% from their recent peak. We believe it is a good time for long-

term investors to look to China for bottom-up opportunities.

Longer term, for the China Opportunity strategy, there has been no period of underperformance over a three-year rolling return basis. Despite the current challenges, our China portfolios have held up relatively well. We believe a significant part of the performance is due to the fact that we have been adhering to our investment philosophy and investment process. We are focused on the fundamental story and the fundamental value of the companies we own. We do not get carried away by the hype in certain sectors, such as the renewable energy, particularly the electronic vehicle (EV) industry. There was a big gap between the valuations these EV companies were trading at and their fundamental valuations, even after government support were taken into consideration. Share prices of a lot of these companies came down significantly over the last few months. By not being invested in this part of the market, it contributed positively to our relative performance.

On the other hand, we have identified opportunities in the health care sector, especially in the Contract and Research Organizations (CROs). The share prices of these CROs have been impacted by US-China tensions, with fears that their exposure to research and development (R&D) and clinical trials for international pharmaceutical companies could harm them. We thought that the concern was overdone and increased our bets in some of these companies. We continue to watch the situation and believe CROs are a good long-term opportunity for our portfolio.

As with the EM portfolio, the China portfolio has a big overweight to the financial sector. It offers an attractive way to participate in the reopening story. While part of the country is still in lockdown, we believe it will eventually follow the path of many other countries and open up. The banking sector has lower regulatory risk because it is a heavily regulated sector to begin with. Many of the banks also satisfied provisions for their non-performing loans (NPLs). So when we look at market conditions and possible economic slowdowns, the bank provisions could create a cushion to buffer the earnings of these companies.

Why zero tolerance for COVID

With its zero tolerance COVID policy and extended lockdowns in Shanghai and other cities, the Chinese government is taking a conservative approach, clearly putting social welfare ahead of economic concerns, including market sentiment. There are concerns that, if the government opens the economy further, the increase in cases will also increase the death rate. One of the issues is that China has been relying on inactivated vaccines.. Now, the Chinese government is investing significant resources to come up with its own mRNA vaccine, and it is confident that it can contain the spread of the virus just as it has been doing so for the past two years.

While the lockdowns have led to stoppages in logistics, in road transportation and in productivity we might see economic figures that are not as good as previously anticipated. However, the market has already priced this in, and it should not be a surprise. The government has reshuffled more of the container traffic from roadway to waterway, trying to ease some of the pressure. And recent policies that are designed to buffer the overall growth shock could also bring relief. These include lowering the down-payment requirements to support the housing sector, as well as considering more investment in infrastructure and renewable energy to help China get through this rough period. These efforts should carry a bigger weight toward the second half of the year, when COVID is under better control. In the end, we believe the Omicron variant will have a short- to medium-term impact on the economy. We are closely monitoring developments in the country, and will allocate our portfolios in an effort to benefit from the current situation.

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