

MORBID SYMPTOMS

EMERGING MARKETS

Will Sutcliffe, Investment Manager. First Quarter 2017



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	2014	2015	2016	2017	2018
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MSCI Emerging Markets	-1.1	0.8	-11.7	17.7	25.4
MSCI Emerging Markets Growth	0.9	3.9	-11.4	17.4	32.0
MSCI Emerging Markets Value	-3.2	-2.5	-12.1	18.0	18.7

Source: Baillie Gifford & Co, MSCI. US Dollars.

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WILL SUTCLIFFE

Investment Manager

Will graduated MA in History from the University of Glasgow in 1996. He joined Baillie Gifford in 1999 and worked as an Investment Analyst in the UK and US Equities teams before joining the Emerging Markets Equities team in 2001, where he is an Investment Manager. Will became a Partner in 2010.



*‘The crisis consists precisely in
the fact that the old is dying,
and the new cannot be born; in
this interregnum a great variety
of morbid symptoms appear.’*

ANTONIO GRAMSCI

MORBID SYMPTOMS – EMERGING MARKETS

BY WILL SUTCLIFFE

It has been an interesting year. Gramsci is back in fashion: the famous quotation, written during his long period of incarceration at the hands of Mussolini's fascists, may offer a useful prism for those that have been left perplexed by recent political events. As Gramsci himself noted, however, interregnums can persist for decades. The verdict of most commentators is that the world has suddenly become a much less predictable place. We are sailing into uncharted territory; the only certainty is that the waters will be choppy.

As full-time investors and occasional students of history, most of us have the sense that we are living in interesting times. After an extended period in which our portfolios have been characterised by stability of conviction and very low levels of turnover, should we now be re-assessing our views? There are nuances to discuss, and we shall come to those. However, we see remarkably

little to suggest that the broad shape of our Emerging Market portfolios needs to be rethought.

Like Gramsci, we have long been preoccupied by the death of the old and the birth of the new. Growth in emerging economies is no longer a function of the old models of industrialisation, manufacturing and commodity-intensive demand. It is about new services, new business models and new consumers. The mobile internet is at the heart of this: there were 3.5 billion mobile broadband subscribers in 2015; a further billion joined them in 2016, and by 2022 the figure is expected to nearly double. The vast majority of these incremental subscribers will be in emerging markets, where the paucity of legacy infrastructure in the old economy is driving a relationship between consumers and the internet that is far more intensive than anything we are seeing in more advanced economies.

The verdict so far has been unequivocal. The new is winning. Nothing that occurred in 2016 suggested otherwise. Indeed, in some cases, the pace of change appears to be accelerating: Tencent, for example, grew its revenues at 30% in 2015; in 2016 the figure is likely to be closer to 50%. The speed with which China has embraced the mobile internet may be extraordinary, but we are seeing something similar across the rest of the emerging markets – witness a similar re-acceleration in growth at companies such as Mercadolibre, for example – as the digital economy finds more and more segments of the old world to cannibalise. The rewards have not just accrued to the internet companies: excitement around the proliferation of new product cycles is good news for a plethora of hardware manufacturers and innovative component suppliers, and has helped to send the share prices of companies such as Samsung and TSMC to all-time highs.

For this reason, when we are asked to peer into the gloom and speculate what the next five years will look like, our answer remains fairly simple. It will probably be a bit like the previous five, only more so. Astonishingly, less than 10% of all internet traffic in 2016 came from mobile data: Ericsson's most recent mobility report projects that this number will grow eight-fold by 2022. The secular drivers are all established – video, vision, AI, AR, VR – and the long-term commitment of the leading players is clear. The only mystery is why so little of this is given any attention in conventional economic analysis.

From the perspective of our Emerging Market portfolios, however, 2016 was not about what we owned. It was about what we didn't own. The dominant dynamic in terms of stock market performance last year was the sharp mean-reversion in commodity prices – iron-ore up 80%, crude oil doubling, coal prices up by more than 100% – and the accompanying rebound in a variety of beaten-up assets. The old economy fights back, if you like. Or to put it another way,

the return of value: in 2016, the MSCI EM Value index provided dollar investors with roughly double the return they saw in the MSCI EM Growth index.

Even if the long-term direction of change is clear, the value of equities associated with the old economy can hardly be expected to fall metronomically each year. But a number of more interesting questions arise. Are our views now consensus, with markets already pricing in something similar to the views outlined above? And has anything fundamentally changed that should encourage us to look more favourably on parts of the market that we have shied away from in recent years?

Let's start with the possibility that our portfolios simply reflect market orthodoxy. After all, we are often told that our favourite emerging market tech stocks have become consensus overweight positions. Take this from Bernstein's Asian strategy team, for example:

'The long-standing gripe about investing in Asia – where are the companies with rapid earnings growth, high RoIC, good management, large competitive advantages, and strong balance sheets? – has, in 2016, narrowed down to: I cannot possibly own any more Tencent'.

And yet our friends at Copley Research – with a database covering 127 Global Emerging Market funds with combined assets under management of US\$255 billion – reach a rather different conclusion. Top underweight stock positions in China? Tencent and Alibaba. Top underweight stock position in South Korea? Samsung Electronics. Taiwan? Hon Hai. South Africa? Naspers. But everyone is overweight the tech sector, surely? Wrong again, according to Copley: the average fund position is a 1% underweight. We mention this only in the spirit of balance – anyone can mine data to suit their own arguments – but hopefully you get the idea.



... talk of bubbles in the particular growth stocks that we are fondest of seems a little misguided.



Another argument we hear a lot comes from the quantitative strategists, who tell us that the divergence in valuations between the parts of the emerging markets that they define as ‘growth’ and ‘value’ – notwithstanding the slight narrowing that took place in 2016 – remains close to the extremes of the early 2000s tech bubble era. We are happy to listen to their arguments; in return, we trust they will be polite enough to stifle their laughter when we point out that mean reversion is of limited relevance in a world where the future is unlikely to resemble the past. In any case, it’s unlikely to affect the way that either of us goes about our jobs. For our part, we will continue to seek out those companies with the most substantial growth prospects,

while remaining careful not to conflate this with substantial upside in the value of the equity. There will come a time when the companies mentioned earlier are no longer worth owning in size: indeed, clients will be aware that one or two have been trimmed of late to fund ideas elsewhere. But for now – given near-term P/E multiples that range from the mid-twenties down into single-digits – talk of bubbles in the particular growth stocks that we are fondest of seems a little misguided.

A more interesting question is whether anything has changed fundamentally to give renewed growth impetus to those parts of the market that have been less well-represented in our portfolios in recent years. In particular,

the possibility of a shift in attitudes towards fiscal policy in developed markets – with Trump’s proposed US\$1 trillion of infrastructure spending leading the way – has led a number of commentators to speculate that the recent bounce in the commodity complex is just the start of a longer-term trend. Perhaps, but let’s put this in context: Chinese demand for cement, steel and a host of other industrial metals is around seven times greater than that of the USA. One trillion dollars over ten years is a big number, but it’s roughly the amount of credit that the Chinese financial system extends in four months. When it comes to shifts in demand for most global commodities, policy fluctuations in the G7 will simply



be tinkering at the edges relative to anything that comes from Beijing.

That's not to say that we haven't been troubled by some of the data here. The ratio of total domestic debt in China has climbed by a whopping 30 percentage points over the past 12 months or so, and now stands at around 240% of GDP. Of course, for an economy with a closed capital account, zero funding risk and enormous liquidity at the disposal of the authorities, there's no reason that this sort of trajectory can't be maintained for many more years. But, with the industrial sector now in much better shape than it was when Beijing first began to ease policy in mid-2015, and clear signs of overheating in a

number of property markets, most economists had hoped to see more evidence of a slowdown in the pace of credit expansion by now. However, to jump to the conclusion that Beijing is no longer serious about sacrificing short-term growth for long-term macro stability seems unduly pessimistic. For sure, there may be an element of political expediency in allowing growth to remain firm as we head towards this autumn's party congress, at which Xi's authority is expected to be consolidated. But, official commitment towards rebalancing remains clear in every policy pronouncement, including – perhaps most significantly – Xi's recent discussion on abandoning the 6.5% growth target.



St. Petersburg, Russia.



We remain sceptical, therefore, that there has been a fundamental shift in the long-term demand outlook for most industrial commodities. We are not on the cusp of a new super-cycle, and for associated equities, we continue to think that a permanent discount in valuation multiples relative to historic norms remains appropriate. However, there may be exceptions: oil is the one commodity where demand from the US matters far more than China, and one where there have also been recent hints of a structural change on the supply-side, with Saudi apparently distancing itself from its previous policy of trying to kill off the US shale industry. We are also open to the idea that a stabilisation in the price of oil or other commodities may help to provide a more supportive external environment for a number of economies in our region over the medium term. In turn, this opens up the possibility of an inflection point in dollar earnings growth for a number of the consumer-facing companies operating in such regions whose fundamentals have been swamped by macro headwinds for much of the past five years.

Take Russia: an economy which, in contrast to many other oil producers in emerging markets, has already taken a great deal of the macro pain associated with lower oil prices. The ruble has already depreciated massively, domestic demand has been collapsing for several years, and the current account surplus is already back to the level it reached before oil prices collapsed. Corporate earnings fell in dollar terms for the fifth successive year in 2016, and the stock market – notwithstanding last year’s bounce – remains roughly 50% below the previous peak. Our attention has therefore returned to old favourites like Sberbank. With around 250 banks falling by the wayside over the past three years, Russia’s leading bank has emerged from the crisis even more dominant, in a structurally underbanked market, with enormous long-term growth potential. The economy remains far too dependent on oil, but even if we see a stabilisation around current levels – which now looks a lot more likely than it did six months ago – it should be enough to underpin a recovery.

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Of course, it may not just be oil that has changed for Russia. The potential for a rapprochement with the new administration in Washington has been the subject of intense speculation in the press, and we are often asked about the broader ramifications of a Trump presidency for emerging market investors. Any verdict on this should probably be subject to a greater number of caveats than usual: the former vice president may be a biased source, but when even he claims to have ‘no freakin’ idea’ what Trump will do, the rest of us should probably be a little wary of extrapolating from a handful of excitable 3am tweets. The apparent unanimity of views on Wall Street – where Trump’s election has been hailed as great news for the US economy – is interesting in this context, but this is a debate we shall leave to others. However, what we would like to address is the associated view that a Trump presidency – entailing greater protectionism and a retreat from globalisation – must automatically be ‘bad’ for emerging market equities.

Our own views on this are partly formed by acknowledging our limitations. We may not be political pundits, but we do know something about companies. Our faith in the ability of,

say, Hon Hai to remain relevant is a function of competitive advantages that have taken decades to build up. The company’s integration into the global supply chain is deep, complex and irreversible. Remember, Hon Hai has already relocated its entire workforce once within the past five years, and it is now in the process of deploying hundreds of thousands of robots. Perhaps factories in the US are part of its future – if asking Americans to pay substantially more for their iPhones is deemed an acceptable political cost of Trumponomics – but this is business as usual for the remarkable Terry Gou. Hon Hai will remain a global leader well beyond the current incumbent of the White House.


We do not wish to gloss over the risks that a more protectionist US poses to certain chunks of emerging markets. In many cases, we suspect they are vastly overstated – if the largest cost component of your Nikes comes down to a trade off between wages of US\$3,000 per month in the US and US\$150 per month in Vietnam, even a triple-digit tariff is unlikely to do much more than raise prices for the end consumer. But this election was won by paying attention to the long-ignored losers of trade liberalisation. Mexico-bashing in particular has arguably been the most consistent part of Trump’s policy platform, and with exports to the US making up 80% of Mexico’s total – and concentrated in those categories that the new administration has in its sights – the vulnerabilities are obvious. But, even here, we wonder if there may be contrarian opportunities. The peso had already lost nearly half of its value against the dollar in the three years leading up to the US election. To some extent this reflects Mexico’s fiscal dependence on crude oil, but it also reflects the tendency of investors to trade the peso as a proxy for the rest of the emerging markets. Despite external accounts that look far less stressed than many of its regional peers, this may be why Mexico appears to have suffered disproportionately amid the broader emerging market malaise. Is the outlook for dollar earnings growth from here really as miserable as valuations imply?



More broadly, in a year in which political change in developed markets has been grabbing all of the headlines, we wonder if investors are paying enough attention to the changes underway in a number of emerging markets. While economists spend most of their time worrying about the scale of China's debt, for example, there is plenty that is going right: the anti-corruption campaign has continued relentlessly for the past four years, and is a fantastic longer-term positive. In India, after two years of relatively lacklustre progress, Modi finally seems to have found his mojo: changes to FDI legislation, new bankruptcy codes, the successful reform of the Goods and Services Tax and even the notorious and highly unusual demonetisation programme hint that his administration is likely to go far beyond previous

governments in an attempt to modernise and formalise the economy. In South Korea, while the international press has tended to focus on the lurid details of President Park's relationship with her spiritual advisor Choi Soon-sil, the longer-term repercussions are likely to involve an acceleration in the process of disentangling the chaebols from the state. And in Brazil – where the longer-term outlook remains a topic of vigorous debate within the team – even the sceptics have been surprised by the speed at which the new government has been able to galvanise efforts behind the substantial task of improving governance at Petrobras in the wake of the 'car wash' scandal. Not since the mid-2000s can we recall such breadth of reforming momentum across the emerging markets' larger economies.





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In summary, we find much to encourage us. We remain very happy with our long-standing enthusiasms, and beyond this, are starting to be drawn to a broader range of opportunities than has been the case in recent years. Perhaps it is fitting, then, that we return to Gramsci, who famously referred to 'pessimism of the intellect, but optimism of the will'. We need not be unrealistic about the challenges that remain. But there is certainly hope for better times.

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