EMERGING WEALTH UPDATE

Week Ending October 8, 2021

Market Performance

For the week ended October 8, 2021, Emerging Market (EM) equities, as measured by the MSCI EM Index, increased by +0.9%. EM Growth and EM Value were also up +0.8% and +0.9%, respectively. The strongest sectors for the week were Energy (+3.2%), Consumer Discretionary (+4.1%) and Communication Services (+3.2%), with the latter two enjoying a bounce back based on valuation and the expectation that improvement in vaccinations and new COVID-19 medicines will help economies continue to recover. The weakest performers were Health Care (-4.7%), Utilities (-3.3%) and Real Estate (-1.2%). The best performing countries were oil rich Russia (+5%), Indonesia (+7%) and Peru (+9%), while Chile (-7%), Korea (-2.4%) and Brazil (-2.0%) were among the worst performing countries for the week.

For the YTD, EM returned -0.1%, with EM Growth and EM Value returning -6.2% and +4.9%, respectively. Consumer Discretionary (-19.9%), Real Estate (-15.6%) and Health Care (-10.3%) were the weakest sectors, while Energy (+30.2%), Materials (+13%) and Financials (+9.7%) continue to be the strongest sectors. For the YTD, the updward pressure on energy prices have propelled Saudi Arabia (+40.5%) and Russia (+38%), while India (+27.6%) and Taiwan (+14%) also performed well. China (-15.2%) is still the worst performer among large countries YTD, while Brazil (-11.2%) and Chile (-13.7%) have once again returned to the bottom of the list. Finally, although EM equities slightly outperformed Develop Market (DM) equities for the week, +0.9% versus a +0.7% return for the MSCI World Index, DM equities continue to outperform EM equities for the YTD with returns of +14.5% versus -1.0% for EM equities. EM equities continue to be challenged by the regulatory oversight which started in China, elections and rising inflation in Latin America, while DM equities continue to be supported by accommodantive fiscal and monetary policies on both sides of the Atlantic Ocean.

Latin America: Is Stagflation and the Resurgence of the Left a Problem?

Among the largest Latin American economies, inflation has surprised negatively for the past 12 months and Central Banks have had no other choice than to significantly raise interest rates, which is having an impact on the economy. Indebted consumers are feeling the pinch and the recovery is faltering. Although the mainstream consensus is that higher interest rates will bring price indexes under control down the road, the economic impact could have a long-lasting effect on the political cycles ahead.

Brazil's inflation has climbed to 10%, Mexico's topped 6% (the highest in 20 years), Chile's approaches 5% and Argentina leads the pack with last twelve months inflation of more than 50% YOY. Brazil, due to its size is by far the best example where stagflation has become a serious concern. Brazil's central bank rate has gone up to 6.25% from a historic low of 2.0% earlier in the year, and retail sales in August contracted -3.1% YOY versus expectations of +0.7%. And this is before higher oil prices hit gasoline prices at the pump in full force. It is becoming apparent that a combination of lower consumer confidence and rising interest payments on high household debt are having an impact on consumption and the pace of economic recovery post-pandemic. Like many other Latin American countries, Brazil is going to see further rate hikes before inflation trends are reversed and this will have continued negative impacts in growth, both in Brazil and the region.

The recent electoral cycle in Latin America has seen the left raise to power in both Argentina and Peru. Chile's presidential elections will take place on November 21st this year, and Brazil's presidential elections follow in October 2022. In the case of Chile, all polls give clear leadership to 35 year old Gabriel Boric, whose center program is to dismantle market driven policies implemented during Pinochet era. In the case of Brazil, Bolsonaro's approval ratings have sunk to 20% and it is increasingly likely that Lula will win next year's elections. It is increasingly likely that the economy in Brazil will deteriorate rather than improve. Thus, it is possible that in the aftermath of COVID-19, all major Latin American economies will be governed by clearly leftist governments, which could have a lasting impact in economic growth and middle class incomes.

Why Should Investors Care About Latin America, and EMEA for that Matter?

For almost a decade, Latin American consumer incomes have not grown in USD, and equity returns have lagged meaningfully. A clear turn to the left in major Latin American economies is likely to prolong this period of underperformance for Latin American equities. Despite this, most EM managers continue to have meaningful allocations to companies in Latin America. It is possible that a certain nostalgia from the go-go years of the great commodity cycle of the early 2000's still lingers among managers. We disagree with most managers. In our view, commodity rich regions such as Latin American and EMEA will participate in commodity swings, however, they have not and will not be able to translate these cycles into sustainable middle class income growth.

What is Then the Best Way for Investors to Have Exposure to EM Equities?

In our judgement, the best way to get exposure to EM equities is by owning best in class companies which are serving Asian consumers, with China and India at the center. India is performing well this year as investors recognize the long-term growth opportunity as the country emerges from COVID-19. In contrast, China has severely underperformed most countries globally with a decline of -15%, primarily due to regulatory concerns. As a result, a number of best in class companies in China sell at high FCF yields. Not only is today's valuation of Chinese companies compelling, we believe the low correlation and high liquidity of Chinese equities can offer great diversification benefits and alpha generation especially to U.S. investors.

Tom Masi
Portfolio Manager

Nuno Fernandes
Portfolio Manager