Emerging and Frontier Market insights

For professional investors and advisers only

How the green wave is influencing emerging markets

Portfolio Manager John Malloy explores the opportunities in emerging markets with a look at China – specifically addressing why he holds a positive view on the outlook for the region, despite the challenges that it has faced over the last 12 months. John touches on the emerging market credit cycle, the impact of low rates and how that may change over the coming years with respect to inflation and provides some further thoughts on the continued technology disruption within these markets. John shared these insights during a recent investor webinar held on 24 November 2021.

Overview of emerging market performance

The RWC Emerging Markets Equity strategy performance has been strong during 2021, in what has been a distracting year for emerging markets generally. In fact, over the last 10 years, we've seen a real decoupling between developed and emerging markets – with US equities in particular performing strongly. These long-term cycles are not unusual and, looking at the underlying structural trends, we believe there will be a reversal of that US dominance moving forward.

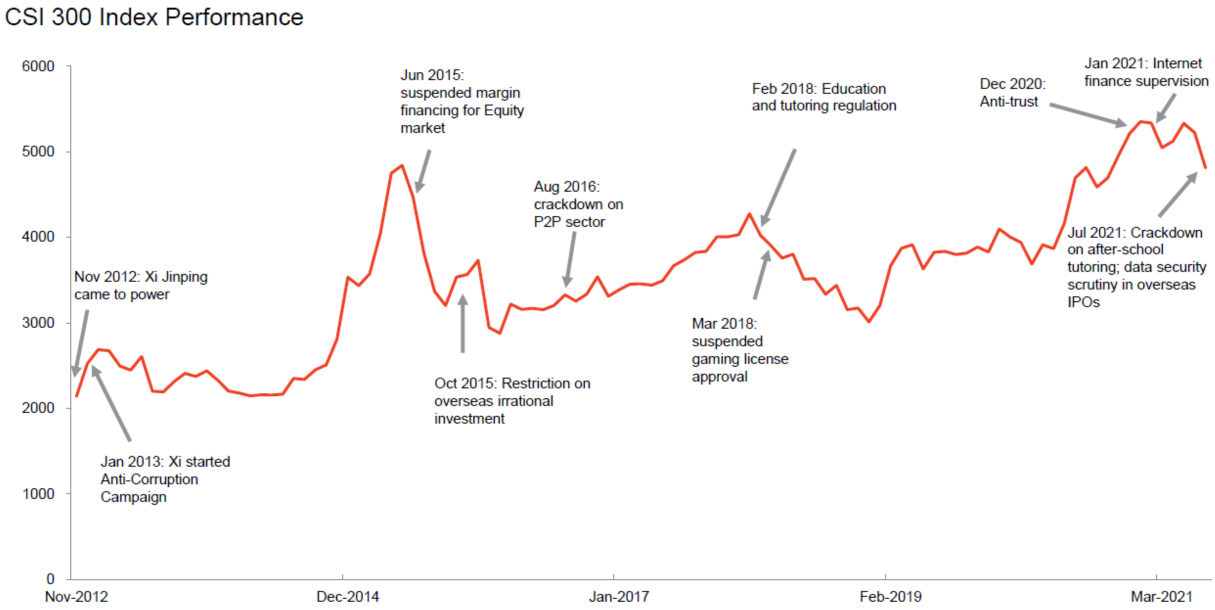
It's been a particularly difficult year for China, coming off a very strong market last year from the COVID lows, and ending with a frothy IPO market − a market where some stocks were up literally hundreds of percent. Right now, this situation has changed, with the current wave of regulation forcing some companies to change the way they do business, and in turn impacting the equities market.

Historically, China has seen multiple waves of reform and regulation. Experience tells us that these reform cycles have lasted anywhere between six months to twelve months, before eventually subsiding. A year ago, we had the shock cancelation of the ANT financial IPO, and at that time, we removed our position completely in Alibaba. We sold a tremendous amount of our internet exposure within China, moving to a 9% underweight portfolio position compared to the index.

Similar to previous periods, we believe that the current reforms will subside. 2022 is a very important year for the Communist Party, as Xi Jinping looks to extend his power and lengthen his time in office. Additionally, China will host the Winter Olympics in the first quarter of 2022 as well as rollout its first digital currency.

At this time, we believe the opportunities within the Chinese market are very attractive. While some sectors such as education may never recover from recent policy actions, many will adjust and continue to thrive. We haven't seen additional regulation over the past few months and as we move toward the new year, we're confident the People's Bank of China will start to ease monetary policy.

Policy cycle in China



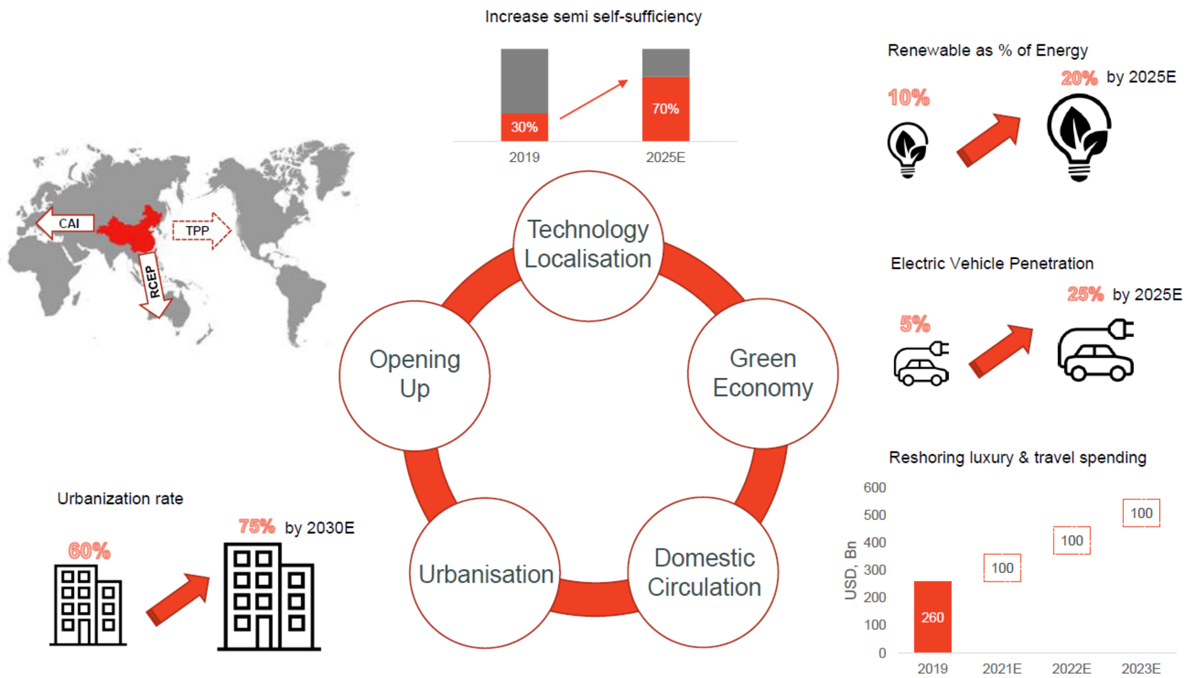
Source: Wind and RWC Partners as at 31 August 2021

*Past performance is not indicative of future performance.

We expect to see cuts to the reserve requirement ratio for Chinese banks and a reduction in interest rates as the central bank looks to restimulate growth.

The Chinese share market has continued to broaden and mature in recent years, resulting in a tremendous landscape of opportunities within local China. The themes of the Green Revolution, Technology and Urbanisation are developing on the ground in China today.

China's long-term plan



Source: RWC, Bloomberg, Government sources as at 28 May 2021.

The green wave

With the recent real estate slowdown, we believe that the government has recognised the impact the slowdown is having on broader economic growth, and as a result, has enforced local policies to help alleviate the stress in the property market. We are not building positions in Evergrande, but there are companies within real estate services that are very interesting at this point, and we're starting to add those to the portfolio.

The portfolio has increased its China exposure and has about an equal weight to the index, which is approximately 34%. We believe the risk-reward can be very attractive in China due to the market dramatically over correcting, particularly for active managers who can selectively add positions. We're currently finding attractive opportunities within our themes, and one that is related to the green wave is solar energy.

We have recently made an investment in LONGi Green Energy and it currently represents one of our top ten positions (3.9% of the portfolio[1]). The company is the largest solar panel manufacturer in the world − controlling about 25% to 30% of the global market. With the demand for solar accelerating and the need to address the climate crisis, solar is one of the key solutions that we believe will continue to be an area of focus for China.

Copper

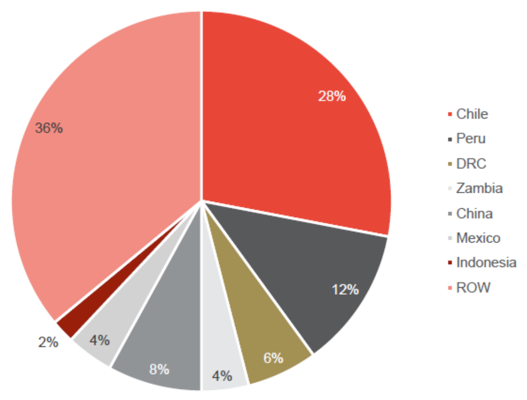
The portfolio has focused on the Copper theme for some time now. Some might say we have invested early in this theme, but we believe it will be a continued long-term thematic. Whilst the US and other developed markets have their challenges, the world is moving forward on building out electric vehicles and expanding the electrical grid, with China and India continuing to assemble their electric networks.

China at this point is the world's largest electric vehicle market, and as we know, electric vehicles consume 4 to 5 times more copper than a traditional vehicle.

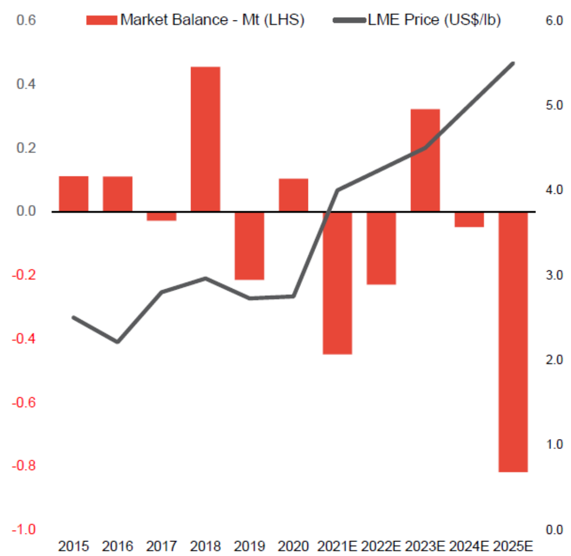
At the same time, there has been a dramatic under investment in new copper supply in recent years, despite the outlook for demand. Our forecasts suggest that by 2025 we are looking at a supply deficit of 4% to 5% of the global copper market.

Building out a new copper mine typically takes at least 7 to 8 years with costs running into the billions of dollars, meaning that this supply gap is likely to persist which could be positive for the base commodity price.

EM is an Important Source of Copper



Copper Market Balance



Source: RWC and Company Reports as at 25 March 2021

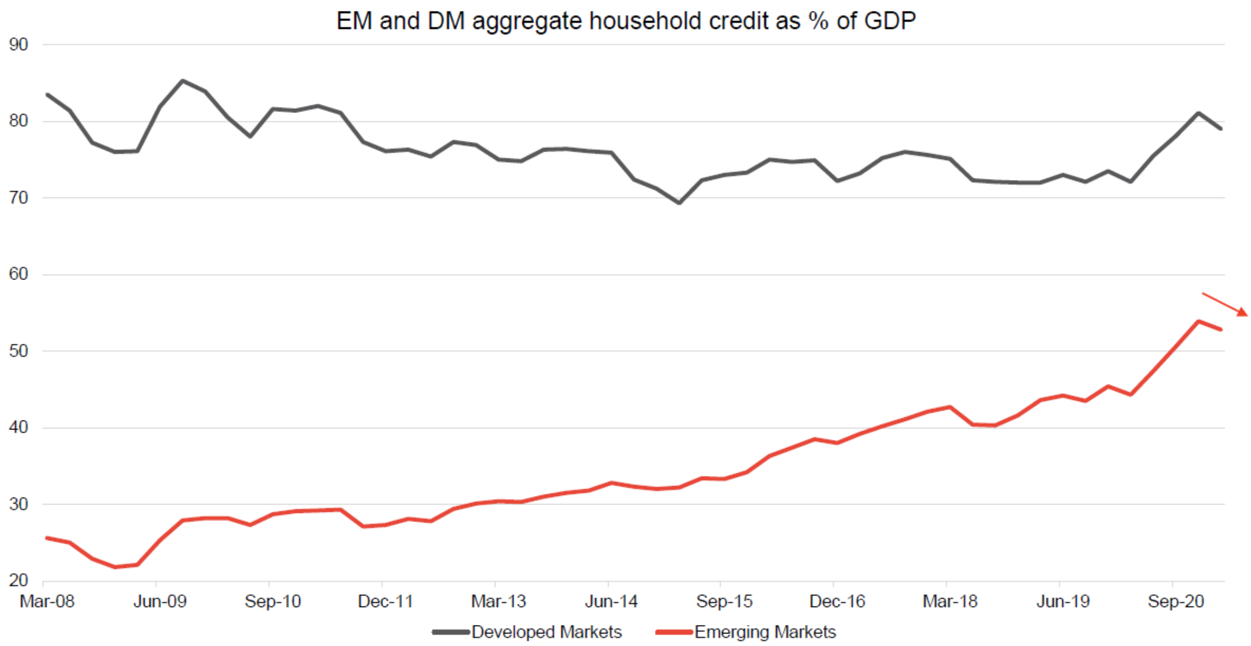
[1] Source: RWC, FactSet, as at 29 October 2021.

We believe that the next driver of commodities over the ensuing decade or so will be the investment in the green wave as we transition away from hydrocarbons and try to address the climate crisis, with the primary beneficiaries being emerging markets.

The credit cycle in emerging markets

There is a view that emerging markets are over-levered, which we think is misinformation. Looking at emerging market household credit to GDP, we can see there's a very large gap with developed markets. While that gap is closing, there is still a long way to go which should be positive for consumption trends.

There is a similar story with respect to corporates. Emerging market corporates appear less leveraged than US corporates with less net debt to 12 month EBITDA[2].



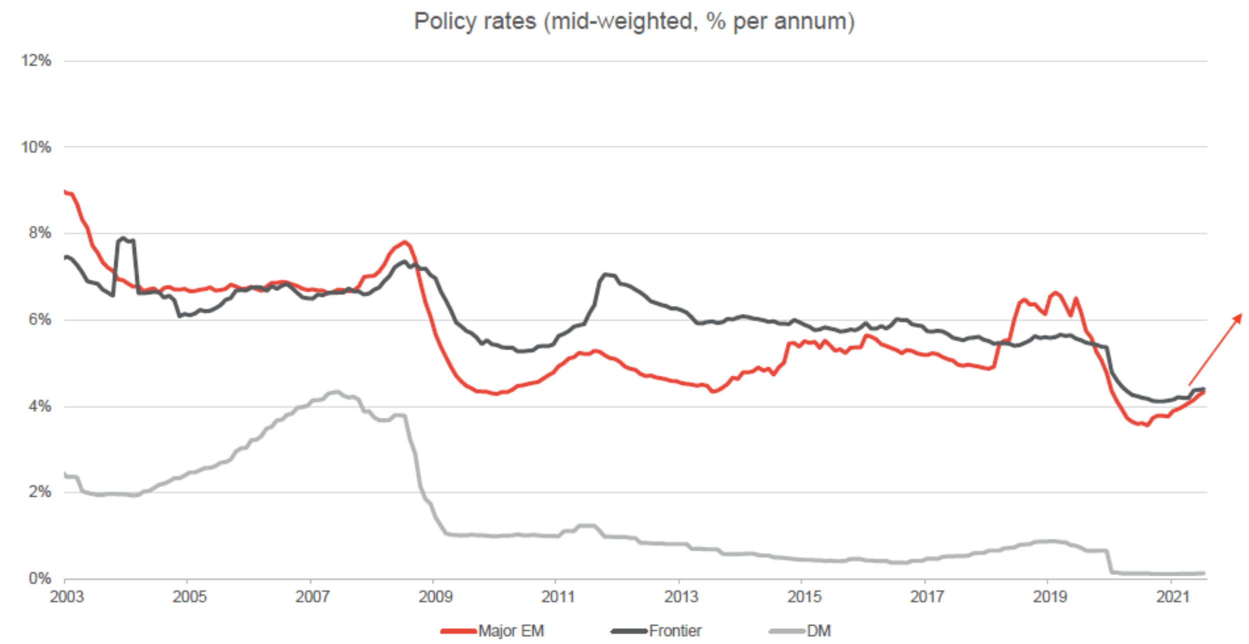
Source: BofA Global Research as at 2 November 2021.

Importantly, interest coverage ratios for emerging market corporates, whether that be for investment grade or high yield borrowers, are for the most part looking very healthy. This is reflective of both the relatively low levels of debt and strong cash flows being generated by corporates in the region.

The chart below highlights the large difference between interest rates in emerging and frontier markets and developed markets. The spread has widened this year with emerging market central banks tightening monetary policy to control the risk of inflation, as they attempt to get ahead of the curve. Although emerging market debt has underperformed this year, we think it's setting up to potentially do well in 2022 and 2023 because of these higher interest rates and very competitive currency valuations.

[2] Source: BofA Global Research as at 2 November 2021. Earnings before interest, tax, depreciation and amortization.

Emerging markets are well prepared to cope with changes in global financial conditions



Source: RWC, Emerging Advisors Group and and Bloomberg as at 2 November 2021. Based on the latest Information available.
The information shown above is for illustrative purposes only and is not intended to be, and should not be interpreted as, recommendations or advice.
No investment strategy or risk management technique can guarantee returns or eliminate risks in any market environment. Past performance is not a guide to future results. The prices of investments and income from them may fall as well as rise and an investor's investment is subject to potential loss, in whole or in part

Continued technology disruption

The growth in smartphones continues to be very strong − not only with handsets but also applications. The EMEA region for example, offers very strong growth as well as the African Region.

As smartphones bring services closer and closer to the consumer, the rise in food delivery is seeing tremendous growth in this area. It sounds simple as it's basically groceries, but certain companies are moving their ecosystem into other areas, for example dark stores, where they are not just providing prepared foods, but also offering convenience goods, health and beauty goods and other items that really enhance the consumer experience. This is a huge opportunity for companies like Meituan, who has 70%-80% market share[3] in the Chinese market.

Another portfolio company that has an addressable market of just under a billion customers within their footprint is Delivery Hero. The company represent a great opportunity having increased their top line results by an impressive 100%.

We think that this technological transformation is just part of the story because of the ongoing broader development in their ecosystems and the disruption that these food delivery providers offer.

ESG in practice

The focus on ESG is gaining greater momentum. We see that consistently with our investors, portfolio companies, and our stakeholder engagement. We are proud to be signatories to the UN PRI. As part of our commitment to ESG and our involvement with the UN PRI, we have the pleasure of co-chairing a committee which forms part of the Climate Action 100.

We are engaging in ESG and have integrated this into the investment process. An example includes our active engagement with portfolio company Reliance Industries − one of the largest Asian conglomerates with a

[3] Source: RWC, FactSet, as at 29 October 2021.

petrochemical refining business. The firm also has a large business in mobile telecommunications as well as retail, e-commerce, and bricks and mortar. We have had extensive engagement with management to assist in cutting their emissions, and as a result, the firm is taking steps to become carbon neutral by 2035 via a US$10bn[4] investment in renewable generation.

Another common issue that we encounter with companies is around governance and disclosure. This is also an area that we have engaged heavily on with Reliance (and other firms and seen significant improvement).

As companies within emerging and frontier markets continue to embrace ESG, we'll start to see a re-rating of firms, presenting an alpha opportunity for investors.

Portfolio positioning – top ten holdings snapshot

As a snapshot, our top ten holdings are provided below. Tencent is now the number one position, having built up that exposure earlier this year. Tencent is in a very different position to its e-commerce competitors, like Alibaba or PDE, and we believe Tencent is set up to recover given its gaming platform and strong relationship with Beijing. In addition, our positions continue to be completely off index or quite different in size from the overall size of the index, for example LONGI Green Energy is 0.10% of the index and almost 4% in the portfolio.

The portfolio currently trades under 14 times earnings yet has potential earnings growth of almost 30% over the next three to five years – potentially producing a strong return on equity.

Position No.	Company	Position Size (%)	Benchmark Weight	Country	Sector	Theme
1	Tencent	5.9	4.5	China	Communication Services	Technology Disruption
2	First Quantum Minerals	5.2	--	Zambia	Materials	Copper
3	LONGi Green Energy	3.9	0.1	China	Information Technology	Sustainable Energy
4	TSMC	3.9	6.6	Taiwan	Information Technology	5G
5	SQM	3.7	0.1	Chile	Materials	New Auto Tech
6	Reliance Industries	3.6	1.2	India	Energy	Technology Disruption
7	Meituan	3.5	1.8	China	Consumer Discretionary	Modern Retail & Malls
8	Housing Development Finance	2.8	0.8	India	Financials	Financial Inclusion
9	MediaTek	2.7	0.6	Taiwan	Information Technology	5G
10	SK Telecom	2.6	--	Korea	Communication Services	5G
Top Ten Total		37.7	15.7			

Source: RWC, FactSet, as at 29 October 2021. Figures may not add up to the total figure due to rounding.

A positive backdrop for emerging markets into 2022

As we look to 2022, we see a positive backdrop for emerging markets, especially given the outlook for China. Although the sentiment in China is negative, we see it turning positive, making the relative valuation attractive.

The central bank policies of hiking interest rates in emerging markets across Brazil, India, and Russia has led to a reduction in the level of domestic inflation, not seen in developed markets to date. As we look to 2022, we should expect rates to come down. China is a perfect example having held rates high above 3%[5], much higher than other large markets and with monetary policy potentially start to ease, this should bring the cost of capital down.

[4] Source: RWC, FactSet, as at 29 October 2021.
[5] Source: RWC, FactSet, as at 29 October 2021.

Tap into RWC's emerging markets expertise

In partnership with RWC Partners, Channel Capital offers local investors exclusive access to the Underlying Fund via the CC RWC Global Emerging Markets Fund ('the Fund').

A proven global emerging markets manager, RWC Partners pragmatically combines top-down macroeconomic and thematic research with bottom-up fundamental analysis to uncover medium-to long term growth opportunities, investment themes and valuation inefficiencies. The Underlying Fund's philosophy and style can be best described as growth-at-a-reasonable price.

As at 31 December 2021, the Fund returned 12.44% per annum after fees since its inception in February 2019 outperforming the MSCI Emerging Markets Index by 4.39%.

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