

From the desk of

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Fidelity Global Emerging Markets strategy

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Navigating a challenging period for emerging markets

Global emerging markets are facing multiple challenges: ongoing conflict between Russia and Ukraine, and the resultant surge in commodity prices adding to already prevailing inflationary pressures; a slowdown in China due to rising COVID cases and well-intended but disruptive regulations, and the delisting risks for Chinese ADRs. However, overall, we think risks are peaking, and emerging markets are now better placed for economic growth and market returns over the medium to long term. While the macro environment is important, it is difficult to predict. Hence, we use our strength in bottom-up fundamental analysis to construct a portfolio of high-quality, sustainable companies that we believe will tide over short-term volatile periods like these and generate alpha for our clients.

The Russia and Ukraine conflict has led to a lot of volatility in GEM equities. What is your view on Russia and how is the portfolio positioned there?

Broadly, we view Russia as a place where macro risks happen with a higher frequency than market expectations. However, it is our bottom-up stock selection that drives our country and sector allocations. Every company that is selected for the portfolio needs to be a strong and competitive business with robust sustainability and corporate governance practices.

With our focus on investing in companies with strong corporate governance, many Russian companies have not met our investment criteria for some time. We held a very conservative positioning in this region at the beginning of this crisis. On 25 February, 2.2% of the portfolio was invested in Russia (vs the Index of 2.8%) and we have since decreased our exposure.

We were able to sell most of our holdings in the two companies we had in the portfolio before the markets closed, leaving 1% exposure, which has since been valued at zero. The index has also been marked to zero, but overall, Russia has been a net contributor to returns for us this year.

How are you looking at the surge in commodity prices and its impact on the portfolio?

Given Russia is a large exporter of commodities, the Russia-Ukraine conflict has led to dislocation in commodity prices. Across emerging markets, there are winners and losers as a result. Brazil and South Africa are net exporters of commodities and we have already seen stocks in these markets moving up. We do have exposure to some of these which have done well for us.

That said, we remain cautious on most commodities because consumers of commodities are at a tipping point on pricing. They expect to see a significant decrease in demand if they pass increasing commodity prices through to end consumers. Hence, in our view, despite the price rise, there will not be any incremental supply, but rather a decrease in demand if prices stay high.

One exception is copper, where demand remains strong from alternate energy and electric vehicles. The Fund is invested in two of the leading copper producers globally, First Quantum Minerals and Southern Copper Corporation.

With regard to oil, while governments across the world may look to subsidise end-consumers with restricted supply constraints, we do not have exposure to oil companies. Large oil companies are based in Russia, which is now closed and out of the index. Elsewhere in emerging markets, oil companies are mostly government-owned, with below-standard corporate governance and unfavourable capital allocation policies. As quality-focused, bottom-up investors, we are completely averse to owning them.

The surge in commodities, inflation and the resultant monetary tightening in the US is bringing back taper tantrums memories. How are emerging markets placed in this scenario?

Russia is a large exporter of commodities, and hence the Russia-Ukraine conflict has led to dislocation in prices of commodities. Meanwhile, US inflation as well as interest rate expectations have been moving up and the surge in oil, copper, aluminum, coal, and iron ore prices means inflation will be stickier in the next six to nine months than what was expected earlier.

Inflation and monetary conditions are varied across markets:

In **North Asia (China, Korea, Taiwan)**, inflation is in low single digits and monetary conditions are more benign. In fact, China has recently cut interest rates two times. While inflation is expected to move up in these economies, it is expected to remain lower than in other parts of the world.

In **Latin America**, inflation is higher, but these markets have also been proactive in tightening monetary policies. For example, Brazil has already taken interest rates up to about 10%. This is a good sign because real rates are relatively better than in other parts of the world. As exporters, they also gain from the rise in commodity prices.

Meanwhile in **India**, inflation is somewhere in the middle and around the central bank's target range. The central bank has not raised interest rates yet, although long-term yields have already moved up. Importantly, food inflation, which is a large part of the CPI bucket, is domestically driven and remains well under control and lower than global prices.

In summary, there are inflationary pressures in emerging markets which will cause interest rates to move up, but we believe a situation like taper tantrum is now less likely, because in some emerging markets where inflation has increased, they have already increased interest rates, while in regions like China, North Asia and India, we tend to believe that inflation on aggregate will be lower than what we see in developed markets.

China is seeing a sustained slowdown from regulatory headwinds and COVID-related lockdowns. More recently, Chinese ADRs have been hit by delisting fears in the US. What is your outlook for the biggest emerging market of the world?

It is true that Chinese equities continue to be volatile amid concerns of an economic slowdown and ADR delisting concerns. Let's look at these factors one by one.

ADRs delisting: This is clearly a result of China-US tensions. The US SEC is asking for more data from US-listed Chinese companies, which is not compatible with the Chinese government. This could lead to a wave of de-listings in the next two to three years. The process is complex: While most companies are dual listed in Hong Kong, they must take care of a large majority of their shareholders present on the US exchange. We remain underweight in such businesses as capital allocation is an important long-term driver of anything we own in the portfolio.

COVID-related lockdowns: China continues with its dynamic zero-COVID-19 policies in the wake of rising Omicron cases. Recently, we have seen harsh lockdowns in Shenzhen and Shanghai, which are very important economic centres. However, the country is recognising that they will need to gradually loosen some restrictions. For instance, they've already permitted home testing for residents. We believe there will be more clarity on China relaxing its COVID-19 handling in the next six to nine months.

Regulatory scrutiny: We think higher regulations are part and parcel of every Chinese business and investors underestimated this fact. In the past, we have seen regulations focus on areas such as telecom, financials, and property, and now this regulatory oversight is expanding to sectors like digital and e-commerce, private education, and healthcare. We continue to be cautious of such businesses. Many now talk about investing back in society and common prosperity, which makes minority shareholders like us take a back seat.

Property slowdown: This sector is already seeing a 20% decline in new starts and sales. Despite stimulus measures in recent months, monetary benefits are not flowing to the property sector. We expect continued weakness in the next six to 12 months. These measures may cause short-term problems, but we think it will be good for long-term health of the sector, clearing away the excesses built in the last five to seven years. There will be a consolidation in the industry as the bad-quality developers, especially on the private side, go out of business.

Despite these challenges, China still offers opportunities for the bottom-up stock picker. For instance, there are opportunities relating to environmental innovation, such as in EV supply chain and renewable energy, which have corrected to attractive levels now.

We are also finding more opportunities in areas that are likely to benefit from the government's stimulus, as well as high-quality technology companies that have fallen sharply during the correction.

You mentioned emerging markets are better placed than developed markets now, than in the past, for the next 10 years. Why do you believe so?

A better index: the developed market index has performed better than the emerging markets index over the past 10 years because of a growth in new economy and technology-led businesses, while emerging markets have been more oriented towards commodities, energy, as well as large government-owned financials.

However, we think the emerging market universe is now more competitive and better placed for the next 10 years because:

- We are starting to see the emergence of strong domestic emerging market companies in areas of consumption taking market share from global companies in their local markets.
- Strong tech-enabled companies from emerging markets are making their mark on a global scale in areas such as semiconductor foundry, tech components and IT services. These companies are an integral part of globally supply chains in leaders in their segments.

Cheaper valuation: The global emerging markets index is at its largest discount to developed market index versus history, trading at a 40% to 50% discount.

How are you thinking about portfolio positioning and are there any changes you have made recently? Any areas that help protect/insulate the portfolio from risks?

As mentioned earlier, our country and sector positioning reflect our bottom-up stock selection or our ability to find companies that fit our high quality and sustainability framework. With this approach, technology, financials, and consumer sectors are the areas where we find most of our investment opportunities. However, our positions are very differentiated versus the index in all these areas.

In **technology**, we remain wary of large Chinese digital businesses impacted by regulations. Our exposure is to businesses such as the world's largest and most competitive foundry **TSMC**, the world's second-largest mobile chip manufacturer **MediaTek** and the second-largest memory chip manufacturer **SK Hynix**. On the other end of the spectrum, we own the two largest IT services companies from India, **Infosys** and **TCS**. These are highest return businesses in their respective sectors with 10% to 15% growth potential over the next five to seven years.

In **financials**, we own some of the highest-return-on-equity generators in emerging markets. Some have seen their valuations compress recently due to a value rally that has seen lower growth, government owned, dividend yielding financials play catch-up. We are ready to take the short-term pain and wait for our holdings to come back, based on their mid- to long-term double-digit compounding potential.

In **consumer and discretionary**, we are overweight in both staples and discretionary segments. The businesses that we own here are domestic companies in areas such as sportswear, consumer electronics, dairy or food services, who are leaders in their respective categories and gaining market share even from global players. Short term, some holdings are taking a hit from the slowdown in China or getting squeezed due the move towards value, but we stay focused on them for their medium- to long-term alpha generation capabilities.

In terms of **recent positioning changes**, we have been implementing these at the margin and they do not impact the core of the portfolio. We are aiming to mitigate risks from the rise in commodity prices by ensuring the companies we own have strong pricing power and can pass on input cost increases to their consumers. To this end, we've reduced our exposure to consumer electronics businesses in China and India where we don't believe they will be able to pass on increasing costs. In financials, we own high-quality companies, but we are being even more valuation conscious – using a very disciplined valuation framework for our position sizing.

In terms of new opportunities, we've recently invested in **LONGi Green Energy Technology**, the largest solar wafer manufacturer in the world, based in China. We expect it to benefit from an acceleration in deployment of solar panels with the rise in energy prices. We also believe wafers are the most competitive part of the solar value chain.

With increased market volatility and higher inflation expectations, we have also invested in a South African gold producer.

Fundamentally, there is no change to the core of the portfolio, where we continue to own high-quality businesses on competitiveness and earnings growth, with an eye on valuations. At the margin, we're reducing positions with lower pricing power and incrementally adding some more defensive positions.

Emerging markets are facing multiple challenges, but risks are peaking. The region is in a better shape to withstand inflationary headwinds than it was in the past. While China is slowing, its policies are favourable to promoting more sustainable growth in the world's second largest economy. Looking ahead, we have strong conviction that this is an opportune time to invest in emerging markets – its equity index is now a better and more competitive index and at a better starting point in terms of valuations versus developed markets. That said, we need to separate wheat from chaff and use active stock selection based on fundamental analysis to construct a portfolio of high-quality companies that can generate sustainable returns over the medium to longer term.

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