Perspective

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Fidelity Global Emerging Markets

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Fidelity Global Emerging Markets

Q1 2020 Review

Market Review

In Q1 2020, emerging market equities recorded worst quarter since global financial crisis. Global markets sold-off on the initial outbreak of coronavirus in China. As the virus spread beyond China to a multitude of countries stock markets throughout the world descended into a steep decline. By the end of the quarter MSCI Emerging Markets index recorded a loss of -23.6%, whilst MSCI World declined -21.1% (in dollar terms)*.

During the latter part of the period, fears were further exacerbated by a breakdown of discussions between OPEC and Russia which culminated in failure to extend production cuts in the wake of falling demand. For oil producing nations in the emerging world, the fallout in financial markets was significant. Chinese equities declined during the quarter but outperformed all major indices around the world as the country resumed economic activities in March after a stringent and prolonged lockdown. Latin American securities suffered as currencies tumbled during the quarter as the virus started to spread to the region and fears of a slowdown in the global economy mounted. Risk-off sentiment weighed on metal prices as well; copper prices tumbled to their lowest level in more than three years which hampered the Chilean market. With all emerging market regions and sectors posting negative returns, the emerging Europe, Middle East and Africa (EMEA) region did not fare better. At a sector level, defensive sectors were the best performing sectors on a relative basis (although no sector posted positive returns), while cyclicals trended downwards. Quality and growth outstripped value stocks on a relative basis.

The actions of policymakers have been watched fervently by market participants: Across the developing world monetary policy and fresh stimulus measures were announced. The People's Bank of China issued 1.2 trillion renminbi (US$170 billion) via reverse repurchase agreements and cut the repo rate by 0.1 percentage points. The Reserve Bank of India cut the benchmark rate by 75 basis point to 4.40% to boost liquidity in the system to counter the economic impact of coronavirus outbreak. In Latin America, Brazil's central bank lowered its benchmark interest rate for the sixth consecutive time by 0.50 percentage points to 3.75%. Mexico also announced the biggest rate cut in six years to provide liquidity in the system. It slashed its interest rate to 6.50% from 7.00%. Worthy of mention is the US - The Federal Reserve (Fed) cut interest rates by 150 bps, the fastest rate cut in the history of the Fed. It has also committed to unlimited purchases of government bonds, mortgage-backed securities (QE infinity) and for the first time ever - corporate.

*Source: Fidelity International, as at 31 March 2020. Based on the returns of MSCI Emerging Markets Index (Net) and MSCI World (Net), in US Dollar terms.

Performance

In Q1 2020, the Fund posted -13.4% against the benchmark, which returned -12.3%. Chinese holdings within the portfolio recorded a mixed performance throughout the quarter. This reflected the trajectory followed by the broader Chinese market which, first, sold off sharply in January as the virus took hold; and then, staged a recovery once it gave indications of an apparent success in containing the virus. Similarly, many of our holdings posted weaker returns during the early stages of the pandemic, but then emerged as outperformers as the quarter ended. In this context, many Consumer names feature as key contributors for the period, these are **Foshan Haitian** (soy sauce), **Li Ning** (sportswear), **Zhejiang Supor** (cookware), **China Mengniu** (dairy), **Zhongsheng Group** (autos) and **Midea Group** (white goods). Elsewhere in China, **Lonking Holdings**, a leading construction equipment manufacturer which had been added to the portfolio in Q4 2019, also aided returns; it was supported by discussions surrounding government stimulus measures aimed at boosting infrastructure and investment. Despite the strong performance of these holdings, China emerged as a detractor for the quarter at the country level. This can be primarily attributed to the Fund's limited exposure to **Tencent** and **Alibaba**. The two large internet players, operating the country's largest gaming and social networking, and e-commerce platforms, respectively, saw significant share price strength throughout the quarter, as limited mobility on the back of lockdown measures translated in soaring demand for online services. It is important to reiterate that the Fund adopts a truly benchmark agnostic approach, whereby the position size is determined on absolute basis with a minimum position of 1% and maximum 5%, reflecting the five key investment criteria of: Corporate Governance, Balance Sheet Strength, Sustainability of Core Return Profile, Reinvestment Opportunity, and Valuation. As such, the underweight position in these names is purely residual of their scoring again these criteria.

Elsewhere, the Brazilian market sold off sharply on the back of the twin-shock of the coronavirus pandemic and lower pricing environment for commodities, of which it is a key exporter. Pronounced currency weakness and lack of valuation support, following a period of extended market strength post the 2018 election, also left Brazil vulnerable. In this context, limited exposure to domestic banks of the likes of **Banco Bradesco** supported performance. No exposure to the energy company **Petrobras** also boosted returns, as oil prices slumped on the back of the OPEC+ breakdown and lower demand. However, exposure to selected holdings in the Consumer space offset this positive contribution. The fashion retailer **Lojas Renner** emerged as a key detractor as it sold off sharply. We maintain long-term conviction in the business, which we believe can survive even with no store openings thanks to a healthy balance sheet. This, combined with a leading market position, will enable it to gain market share when it comes through this period of downturn. **Petrobras Distribuidora**, the largest fuel distributor in the country, also traded lower over this period. The company is not facing liquidity issues and we expect it to benefit from demand elasticity from lower oil prices, despite the more challenging macroeconomic backdrop in Brazil.

Throughout the quarter, and most markedly in March, the Indian market saw a big decline along with other South Asian countries versus the North Asian counterparts. Having been a long-standing overweight market for global investors, the outflows have been pronounced. With this decline, financials have taken a big hit. In this context, some of the Fund's long-term, high quality names such as **HDFC Bank** and **Housing Development Finance** came under pressure.

At the sector level, lack of exposure to Real Estate and Utilities supported returns. Elsewhere, selected Materials names traded lower, as demand-related concerns weighed on commodities prices globally. In this context, **African Rainbow Minerals** (South Africa, diversified miner), **Southern Copper** (Peru, copper) and **Severstal** (Russia, steel) weighed on relative performance. Whilst the near-term pricing environment for commodities remains weak, stimulus measures, particularly in China, should drive demand pick-up later in the year. Within Industrials, travel-related names came under pressure as lockdown measures were imposed to prevent the spread of the virus - both the largest Asian aircraft lessor **BOC Aviation** and the Panamanian airline **Copa Holdings** sold off.

Standard Returns:

	1M	3M	6M	1Y	3Y (ann.)
Fund	-11.3%	-13.4%	-6.1%	3.5%	10.9%
Index	-10.9%	-12.3%	-5.8%	-4.5%	5.9%

Source: Fidelity International. Portfolio = Fidelity Global Emerging Markets (ISIN Code – AU60FID00318). Performance is shown net of fees, with gross income reinvested, excluding any initial charge, in AUD terms, as at 31 March 2020. Comparative index is the MSCI Emerging Markets Index (net, total return). Past performance is not a reliable indicator of future performance.

It is worth reiterating that the sell-off was broad and indiscriminate; many of the high-quality names we focus on did not escape this period of drawdown. It is key to reiterate that we maintain a long-term view and focus on ensuring that the businesses we invest in continue to exhibit strong corporate governance and balance sheet structures: these are the feature that will enable them to weather this period of volatility and come out more strongly than peers from the downcycle.

Positioning

Throughout Q1, we initiated positions in two Taiwanese names in the I.T. space, namely **Advantech** and **Media Tek**: the former is a market leader in industrial PCs, whilst the latter is a fabless semiconductor manufacturer. Whilst these have been of interest to us for some time, the sell-off provided a good opportunity to acquire them at an attractive valuation. Looking forward, we expect them to benefit from the acceleration in 5G rollout. Elsewhere in the I.T. sector we exited the position in the tech case manufacturer **Catcher Technology,** as overcapacity increased pressure on its ability to sustain margins.

Another area of change with regards to positioning has been the gradual reduction of our exposure to Financials, which, since the portfolio's inception, had represented one of the largest positions at the sector level. This move reflected our view that global lower interest rates, combined with lukewarm credit demand, will continue putting pressure on Net Interest Margins in certain pockets of the market. In this context, we sold out of the position in the Brazilian **Itau Unibanco**: fee generation represents a large portion of this business' revenues, and we maintained the view that these would have come under significant pressure, without room to manoeuvre due to its large and inflexible cost base. Where we choose to maintain exposure to the sector, we do so via high quality names, which exhibit long-term structural growth drivers. Examples are **Bank Central Asia** and **HDFC Bank**.

In the Consumer space, we added two new holdings to the Fund, namely **Lojas Americanas** and repurchased **Naspers**. **Lojas Americanas** is a Brazilian retailer, which corrected significantly in this sell-off, presenting us with an attractive entry point to this high quality name. The business is divided an online and a brick-and-mortar side. The e-commerce will do well in this period of limited mobility, and part of the physical stores will be able to stay open, as they operate a combination of pharmacy and convenience stores.

In the Energy space, we sold out of the position in the Hungarian oil and gas producer, **MOL**. We lost convinction in the name as its growth and shareholder return profile deteriorated, also vis-à-vis other players in the EM space. The pricing environment for oil is expected to remain challenging in the near term, and we could see oil decline further before stabilising. We maintain exposure to the sector solely via the position in Russia's **Lukoil**. This is a high dividend payer with a strong balance sheet, with Ruble denominated costs and USD denominated earnings. This company is thus set to benefit from cost deflation thanks to sharp FX devaluation, similarly to what happened in 2014.

In general, the focus remains on owning well-managed businesses with attractive return profiles, an accretive reinvestment opportunity and a valuation that offers an adequate margin of safety on a free-cash-flow basis.

Rolling Returns:

	31/03/2016	31/03/2017	31/03/2018	31/03/2019	31/03/2020
Fund	-11.3%	15.9%	24.7%	5.6%	3.5%
Index	-12.6%	18.2%	24.2%	0.0%	-4.5%

Source: Fidelity International. Portfolio = Fidelity Global Emerging Markets (ISIN Code – AU60FID00318). Performance is shown net of fees, with gross income reinvested, excluding any initial charge, in AUD terms, as at 31 March 2020. Comparative index is the MSCI Emerging Markets Index (net, total return). Past performance is not a reliable indicator of future performance.

Outlook

In the near term, the spread of the coronavirus pandemic will continue being at the forefront of investor minds, giving rise to material concerns about the economic health of countries across the developed and developing world alike. However, the recent market dislocations have also created pockets of opportunity for the selective investor; importantly, the long-term investment case for EM equities remains strong, supported by structural growth drivers such as urbanisation and lifestyle changes. These should drive demand for different goods and services in underpenetrated markets.

Breaking down the universe, China thus far appears to have had success in containing and stabilising the virus, which has been reflected in a fairly resilient Chinese equity market, in aggregate. Here, factories have started to re-open, supporting investor sentiment. However, a note of caution must be warranted: as China's trading counterparts in the developed world are getting impacted by the spread of the virus, China will now have to deal with the consequences of the respective demand shock from the countries it exports to. In this context, fiscal and monetary stimulus measures will be key in supporting the domestic economy, with infrastructure spend being an obvious area, hence we are seeing some opportunities in adding to our industrial exposure.

Looking elsewhere in Asia, the situation appears more mixed. South Asia is behind the curve in controlling the outbreak when compared to China and the rest of North Asia. Moreover, economically speaking, government capacity in Indian and ASEAN countries is limited to compensate for the near-term economic impact. South Asian countries also run the risk of higher capital flows during risk-off periods - an example is India, whose market sold off massively because of its high foreign ownership levels.

In Latin America, the key area to look for is the government's response to the pandemic crisis. Failure to take appropriate measures may reflect in limited traffic to and from the US, which will further weigh on the local economies. A case in point is Mexico, where remittances are an important component of the economy and are set to fall sharply. In EMEA, markets sold off aggressively and, in countries like South Africa, there are some attractive valuations, but not necessarily equally attractive long-term prospects. Being both regions also home to many of the world's resources, the weaker pricing environment for commodities is also set to exert some pressure on local assets in the near-term.

Another area of concern with some EM economies is their ability to further cut down interest rates to stimulate their economies. The energy price slump that we have seen, especially in March following the OPEC+ breakdown, has an impact on the dollar cost of capital in emerging markets. The dollar cost of capital is rising, despite everything that the Fed is doing to try and offset that, and this creates challenges in emerging markets which are importers of foreign capital. In the near-term the immediate deflationary consequences of the demand shock and oil price collapse enable Central Banks to maintain a low interest rate environment. On a medium-term base however, they are likely to raise under inflationary pressures.

In an environment characterised by heightened volatility levels, our focus remains on identifying high quality businesses characterised by strong corporate governance and balance sheet structures. We believe that these are companies that can weather a more challenging economic environment and add significant value for investors over the long-term. Importantly, EM equities continue to trade at attractive valuations, trading on price-to-book levels comparable to the Global Financial Crisis, with even traditionally more expensive markets, such as India, seeing their premium to the wider EM Asia region collapse.

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