Fidelity INTERNATIONAL

Perspective

The current case for emerging market equities

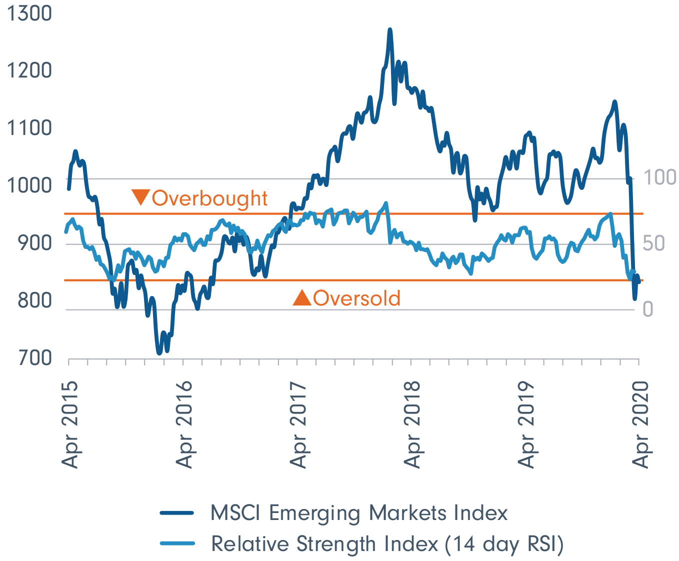
May 2020

The spread of COVID-19 took its toll on stock markets globally, and whilst we have much to learn about the eventual underlying economic impact of the virus, there are reasons to remain invested and opportunities to take advantage of across global emerging markets (EM).

Key observations

- The sell-off has provided a buying opportunity (incrementally and selectively).
- China's experience provides us with a path for recovery.
- EM countries will face different challenges and have varying levels of ability to cope with the crisis.
- The composition of the EM universe has improved markedly over time, with many of the largest companies favourably positioned both for the long-term and this period of disruption.
- A vast universe offers diversification benefits and affords investors the ability to navigate away from risks and toward opportunities.
- The long-term case for emerging markets remains intact.

Figure 1: Emerging markets equities move into oversold territory



Source: Fidelity International, Bloomberg at 3 April 2020. Weekly data for the last 5 years for MXEF (in US$) and 14 day RSI. Index data for MXEF – Price. Absolute.

*Valuation data sourced from Bloomberg as at 30 April 2020.

On balance, this is a buying opportunity

As the spread of COVID-19 took hold, emerging market stocks moved swiftly into oversold territory. The asset class now trades at a price-to-book multiple of 1.2x, on a par with the global financial crisis. This represents a 38% discount to MSCI World, and a 59% discount to the S&P 500.*

Of course, we must acknowledge that for many companies there will be a deterioration in profitability, but the sell-off has offered up an opportunity to acquire best-in-class companies at compelling valuations. The key is to understand balance sheet strength and ability to manage P&L in an environment where demand is severely affected. Some of these businesses will come out even stronger out of this crisis. These are businesses

Important information:

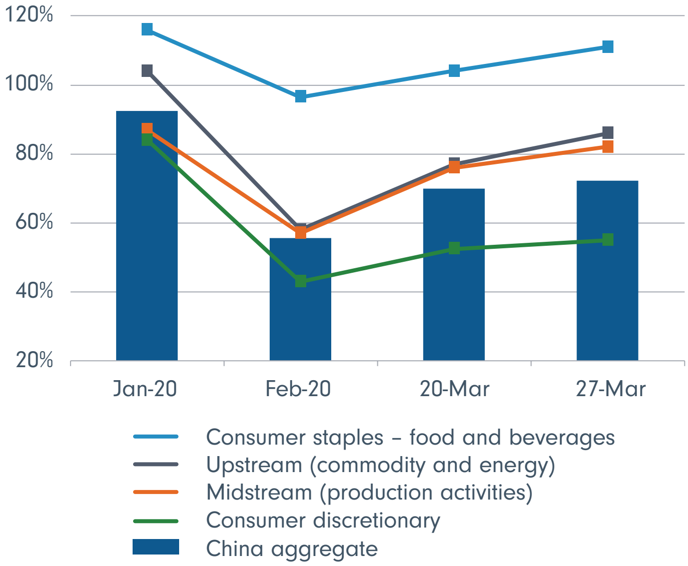
- The value of investments and the income from them can go down as well as up and investors may not get back the amount invested.
- This fund invests in overseas markets and The value of investments can be affected by changes in currency exchange rates.
- This fund invests in a relatively small number of companies and so may carry more risk than funds that are more diversified.
- This fund uses financial derivative instruments for investment purposes, which may expose the fund to a higher degree of risk and can cause investments to experience larger than average price fluctuations.
- This fund may make increased and more complicated use of derivatives and This may result in leverage. in such situations performance may rise or fall more than it would have done otherwise. This fund may be exposed to the risk of financial loss if a counterparty used for derivative instruments subsequently defaults.
- Investors should note that the views expressed may no longer be current and may have already been acted upon.
- Past performance is not a reliable indicator of future returns.

which will gain market share, which will improve their competitive position, whilst competitors fall foul of exogenous factors. Conditions remain volatile, but valuations suggest strong potential for attractive returns in the medium term. Furthermore, active managers have been afforded a great opportunity to high-grade a portfolio, accessing companies which previously traded on more demanding valuations.

Life after lockdown

Activity in China cratered as the country adopted stringent lockdown measures in January 2020. However, as restrictions have been lifted, activity is returning to more normal levels. China's 'story' thus far has shown us there is a path to recovery. Demand recovery spans a wide range of areas from consumer goods (including beverages, food and sportswear), services such as insurance, and manufacturing, production and commodities.

Figure 2: GS China aggregated tracker (demand as % of last year) as at 27 March 2020



Source: Company data, Goldman Sachs Global Investment Research, Gao Hua Securities Research
Reference to specific securities should not be construed as a recommendation to buy or sell these securities and is included for the purposes of illustration only.

Of course, we must acknowledge that COVID-19 has delivered both a supply and demand shock, which China is not immune from, but the thirst for certain goods and services is not permanently eradicated by the pandemic. Key long-term growth drivers include evolving consumer habits, urbanisation, the development of financial services and the continued upsurge of next generation technology (5G, artificial intelligence, digitalisation) which remain firmly intact.

The benefits of a diverse universe

Global emerging market investors can pick from an array of companies with strong growth credentials. In the short term, individual markets can be alluring for investors; however, in this volatile asset class, global managers can hold stocks across a range of industries and countries to ensure diversification and reduce the risk of being impacted by a single event. Single events can encapsulate anything from corporate governance failings at the company level to the more exogenous such as geopolitical risks that can weigh on sentiment toward an entire market. When such risks arise, they can be assessed for individual companies or industries, but the ability to navigate away from those threats and toward opportunity is enhanced by a broader mandate. Similarly, taking profits where pockets of the market become too rich and redeploying where there is value, or adopting exposure to more cyclical areas of the market given the prevailing environment, can be achieved more effectively. For investors, a global mandate can be implemented with greater ease, and can avoid the pitfalls of trying to time the market.

Disruptive forces accelerate growth

The rise of the internet and persistent technological advancement have been increasingly important drivers of emerging markets in recent years – evidenced by the evolution of the index. Today, some of the largest e-commerce, gaming, social media and hardware manufacturers reside in the developing world.

Lockdown has accelerated demand for a variety of services – the China experience demonstrates this: working from home boosted the need for cloud services (in its infancy and ripe for expansion), mobile phone time surged to over five hours per day, and time spent gaming on Tencent titles – Honour of Kings and Game for Peace – surged to two or three times the prior monthly run rate.

Figure 3: EM composition: The evolution of the index

December 2009

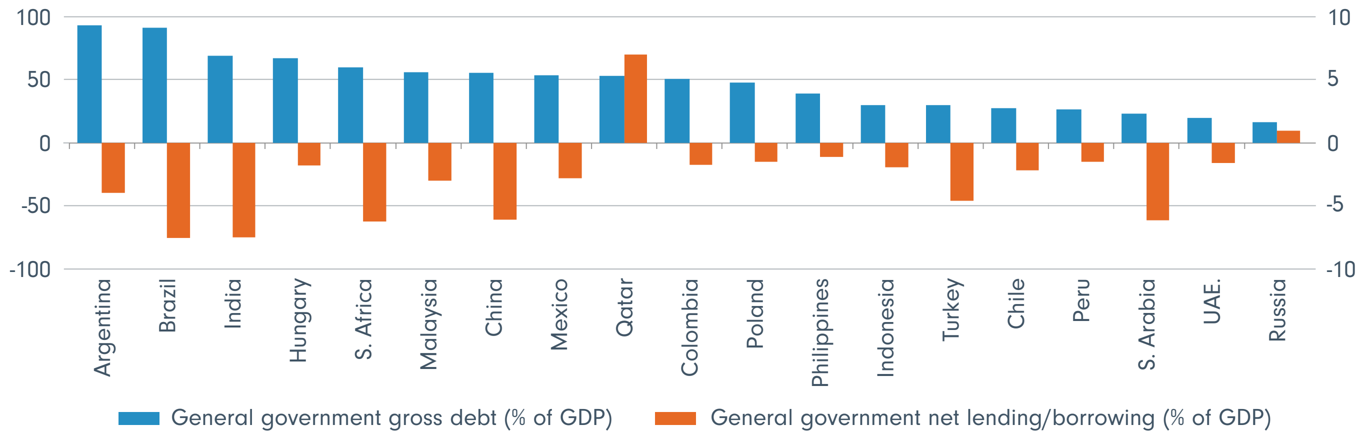
Name	Sector	% Index weight
BR PETROBRAS	Energy	3.72
VALE	Materials	2.83
SAMSUNG ELECTRONICS	Information technology	2.62
GAZPROM	Energy	1.82
中国移动 China Mobile	Communication services	1.74

December 2019

Name	Sector	% Index weight
Alibaba Group	Consumer discretionary	5.77
Tencent 腾讯	Communication services	4.44
tsmc	Information technology	4.37
SAMSUNG ELECTRONICS	Information technology	3.70
中国建设银行 China Construction Bank	Financials	1.34

Source: MSCI as at 31 December 2009 and 31 December 2019.
Reference to specific securities should not be construed as a recommendation to buy or sell these securities and is included for the purposes of illustration only.

Figure 4: Government debt/GDP and fiscal position



Source: Fidelity International, International Monetary Fund, World Economic Outlook Database, October 2019.

Whilst these examples focus on China, more broadly, companies with a solid online proposition of sorts have fared better through recent months. It is appropriate to assume that social distancing measures will be enforced in many countries for some time to come, albeit varied and phased in nature. In the short term, this can lend further support to demand for certain services. Beyond this, some semi-permanent or permanent changes in society and consumer habits will emerge: Health and lifestyle choices and financial planning are areas worthy of consideration. With such a large consumer base across the developing world, successful companies can benefit from rapid growth which can drive higher-than-average returns for investors.

Source: Fidelity International, Research Notes, 19 March 2020, App Annie data to 19 March 2020.

When you think about the significance of policy, think global!

Countries with balance sheets equipped to support their economies will inevitably exit impending recessions faster.

Across global emerging markets, we've seen governments commit to supporting their domestic economies. These measures have been coupled with decisive moves by central banks, where higher real rates have afforded policymakers head room to lower rates. For emerging markets domestic policy is just one part of the puzzle; China and US monetary policy and stimulus measures will influence these economies. Infrastructure investment will drive demand for commodities, and weaker currencies will improve the competitiveness of exporters, meaning that some of the region's largest economies have a high beta to recovery in the US and China.

Concluding remarks

Volatility has been high and stock price displacement has been very sharp and very wide. As we look ahead, in this new era, an active, fundamental bottom-up stance has become even more crucial.

The key features of our emerging markets capability:

- Portfolio managers draw on the expertise of Fidelity's in-house emerging market equity analysts.
- An unwavering focus on bottom-up stock selection is underpinned by good corporate access, local presence and language skills.
- The search for quality is core to our investment philosophy, seeking to reduce the risks of permanent loss of capital.
- Co-location of emerging market equity and debt team members further underpins the rigorous investment approach.
- Truly active management is supported by independent risk controls.