October 2021

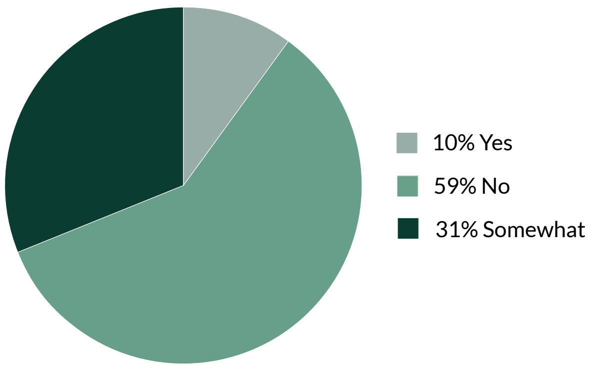
Global emerging markets update

We wrote at the end of 2020 that: "Towards the end of Edinburgh's summer, a single Chinese internet stock was "worth" more than the entirety of corporate India to the compilers of the most used global emerging markets index".

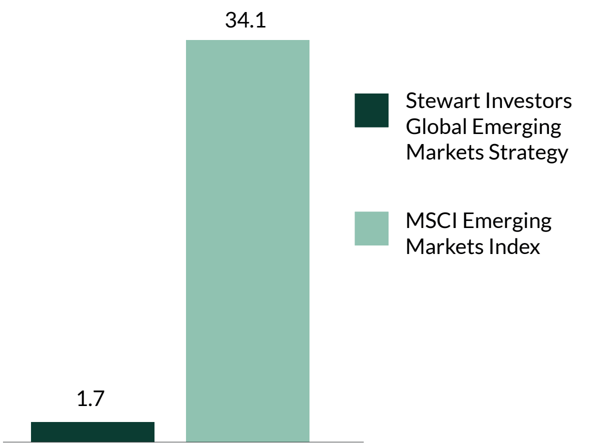
This situation quickly changed. We know we can't predict how dictatorships will make decisions and have carried the slide below in our client presentations for a couple of years now - the point being, how much of your clients' money do you feel comfortable investing in something so unpredictable? We have made the point many times that democracies are unpredictable but usually incremental in their decisions, whereas autocracies are merely unpredictable – save for an unusually high interest in self-preservation.

"Does corporate governance in China make sense?"

Foreign investor understanding of the system of corporate governance in mainland China[1]



% allocation to China[1]



We only really have two brief points on China.

The first is a reminder that "the commentariat" is not your friend in China. There is barely a corporation anywhere, still less a financial institution, which is not already making an extremely good living from China. The PRC has demonstrated its attitude to criticism several times – Xinjiang-sourced cotton and Western fashion brands for example. Western investment banks complain that they are not allowed full access to China. In practice, this often means they scoop up plenty of the fees, yet with little or no balance sheet risk – an amazing deal given the propensity of some (mostly European) investment banks to lose the same shirt twice. Such conflicts of interest probably explain why we are assured the debt crisis will be "contained". Those making the assurances might be right of course, but they have little choice but to say it.

The second point concerns the idea that investors should pivot to follow those industries in favour with the CCP government. This is a wonderful idea for those who are nimble and gifted in reading tea leaves. It was not long ago that the Chinese IT sector was "favoured"; or that the Chinese education sector was "favoured"; or that, by virtue of its ability to borrow over a trillion dollars largely from the government, the Chinese property sector was "favoured".

Our solution, albeit one that today still can't cross the high valuation hurdles, would be to find sectors in which the government will hopefully never have much interest. That way, tailwinds can't turn into headwinds. This explains our preference all across emerging markets for steadily growing but politically unexciting consumer companies – tins of beans, stock cubes, tubes of toothpaste and so on.

Our watch list of Chinese companies is mostly these sorts of businesses, not a short list of the General Secretary's latest implied preferences. It is not long ago that football was Mr Xi's assumed obsession, until the multi-million dollar transfer fees and absurd wages for imported Premier League has-beens didn't pass muster with socialist characteristics.

Although China's stock market returning perhaps halfway back to Earth has, in a relative sense, been kind to us, we still have plenty to be worried about.

> Indian valuations

We believe some of the global emerging markets' best owners of businesses, and therefore, best businesses full stop, are listed in India. We have nearly 30% of client monies invested here. Roughly half are export focussed (outsourced IT, pharmaceutical), the other half domestic.

Valuations in India are getting extravagant. We have trimmed our holdings significantly. We are confident that in ten years the best businesses will grow into their valuations, but there are many that may not over the shorter term - there are any number of bumps along the road.

To us, the leadership of China increasingly resembles a personality cult, but it is in India where the newly built world's largest cricket stadium is named after the Prime Minister, with the two principal stands named after business groups with reputations as enthusiastic supporters of Modi and his party.

> National balance sheets

There is probably not a government in the world which borrows less today than pre-COVID 19, but over a longer term span, there are very few emerging market governments borrowing less now than in 2007 or 2008 - the last peak of global markets (the COVID crisis in stock market terms was a severe but short blip).

Brazil's government debt was around 55% of GDP when the (financial) world last ended in 2008. It now rounds up to 100% of GDP. For South Africa, the equivalent figures were approximately 30% of GDP in 2008 and perhaps 85% today. Many other emerging markets, especially those outside the North Asian technology-hardware belt are similar.[2]

Government debt to GDP is a blunt metric. And no doubt there are factors making headline numbers better or worse than they might at first seem, but they certainly have not spent the last decade or so heading in the right direction. Especially not those emerging market nations which have likely passed the rapid growth stage and are flirting with, or long since married to, the middle-income trap.

Highly indebted emerging market countries are not uninvestible per se, it just focusses the mind on which businesses may preserve and grow capital best, as higher debt levels increase both the number and size of economic wobbles. Banks are clearly vulnerable – even before their "warrant on an economy" status, they are the easiest to regulate and the easiest to tax. Some utilities and telecoms are also easy for governments to raid, as is the natural-resources sector. No government anywhere truly believes that signing a piece of paper gives sovereignty to a private-sector corporation over what can be dug up, pumped up, or cut down.

Not all our companies will be (or have been) unscathed. Corporate taxes will probably rise in many countries; if they don't, then income taxes or sales taxes may reduce the consumer's spending power. In the 20th century, rising emerging market government debt was accompanied by higher inflation and weaker currencies. We would hope many of our companies could price their way through this via strong brands or genuine intellectual property - but it will be tough.

> Well intentioned mal-investment

For the planet to survive the rest of the century it needs more solar panels, more wind turbines, probably more lithium, and so on. There will be companies out there which will make excellent returns from these investments and, if valuations and the governance side of things are acceptable, we might hope to own one or two for clients also.

What the world probably doesn't need is for companies which have spent a century honing their art in one specific field – say oil and gas exploration – suddenly investing billions of dollars into offshore wind. We believe they are unlikely to be the best at it, and in failing to be, shall make sub-par returns for their own shareholders whilst bidding up the cost of saving the planet for those who might have done a better job.

We try not to own companies for clients today which have highly unsustainable business models – we do not own any fossil-fuel producers. But we do own some companies producing what we believe are critical necessities – construction steel in poor countries for example – which would be in a grey area, certainly insofar as the single metric of carbon emissions. For businesses such as our steel company investment, we would welcome improved efficiency; we would welcome more diverse and greener sources of energy - but we are desperately keen to avoid diworsification. Businesses such as these should pay their taxes; pay their carbon taxes too where appropriate, but otherwise should probably concentrate on being the best they can at whatever they have already spent a century trying to excel at.

Tom Prew
October 2021

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[1] Source for pie chart: ACGA Foreign Institutional Investors Perceptions Survey 2017. Source for bar chart: Stewart Investors. Data shown is for a representative Stewart Investors Global Emerging Markets Strategy account and the MSCI Emerging Markets Index as at 30 September 2021.

[2] GDP statistics sourced from the International Monetary Fund

Investment terms

View our list of investment terms to help you understand the terminology within this document.

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