NEDGROUP INVESTMENTS

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# NEDGROUP INVESTMENTS GLOBAL EMERGING MARKETS EQUITY FUND

Quarter Four, 2019

For the period ended 31 December 2019

## NEDGROUP INVESTMENTS GLOBAL EMERGING MARKETS EQUITY FUND

Commentary produced in conjunction with Sub-Investment Manager, NS Partners Ltd

**Executive Summary**

Global emerging markets ended 2019 strongly helped by the hope of a 'phase one' US/China trade deal and the introduction of liquidity by the US Federal Reserve to ease conditions in the repo market. The MSCI Emerging Markets Index rose 9.63% in local currency terms and 11.93% in US dollars as the greenback was weaker after the Fed cut rates for a third time during the year. IT was the best performing sector gaining 19.04% while consumer staples was the worst up 2.64%. The tech heavy Taiwanese market was the best performing market rising 18.01% while Chile fell 8.76% because of the civil unrest which began in September.

Our analysis of money trends suggests that global economic momentum will remain weak in Q1 2020 but revive in Q2. We would hope to see a further acceleration in global narrow money growth to confirm this recovery scenario. US narrow money growth has accelerated but the missing link is China where credit conditions are still tight and money growth is losing momentum suggesting a GDP slowdown. Global December business surveys were disappointing and hopes that the US/China trade deal will give a boost to confidence and activity could be misplaced. Our view is that economic weakness has been driven by monetary policies that were too tight a year ago. Markets have been helped by the Fed expanding its balance sheet in response to a spike in repo market rates in mid-September due to unusually high Treasury issuance, heavy corporate tax payments and seasonal quarter end demand. Chairman Powell has hinted that the operations are temporary and equity markets will have to navigate the removal of this support. Also, stronger US money growth suggests the US economy will re-accelerate in H2 2020 putting upward pressure on US interest rates and the dollar although a rise in official rates is unlikely ahead of November's presidential election.

Chinese consumers have been squeezed by higher inflation with the CPI rising to 4.5% in November. The main driver is pork prices which jumped 110% in November as African Swine Fever swept through the country's hog herds. This is weighing on real money growth. Policy makers are reluctant to flood the market with liquidity fearing inflating asset price bubbles and continue to pursue a cautious approach, reflecting concern about excessive credit and possible exchange rate weakness. Moreover, PBoC easing has been partly offset by a tightening of credit conditions resulting from a rise in bank funding costs following the failure of several regional institutions. Chinese real money trends remain weak and we suspect that the recent improvement in PMIs represents a false dawn and will be reversed. The unrest in Hong Kong has created volatility but the market only underperformed slightly. Elsewhere in Asia, elections in Taiwan returned the pro-independence party candidate Tsai Ing-wen as president. Events in Hong Kong changed the terms of the election debate with the 'one country, two systems' approach, favoured by China, being discredited. In India the economy is experiencing a sharp slowdown after a severe credit crunch reduced commercial lending significantly. The government needs investment to revive and has announced a major infrastructure initiative after injecting more capital into banks to relieve stress.

In Latin America the Chilean economy has been impacted by a month of violent clashes which began as a protest against a metro fare increase. The country will now vote in April on whether to adopt a new constitution meeting a key demand of the protesters. The upheaval has come as a surprise to many given Chile's relative economic success in a region that has suffered from populist regimes implementing poor policy. However, there is a disconnect in Chile between its political system and citizens with low voter turnout and weak stakeholder engagement in developing regulations compared with other OECD and regional countries. Elsewhere the Brazilian economy is recovering with household consumption and consumer confidence reviving. Retail sales grew at 4.2% in October as credit and lending accelerated. Lower inflation and a slow improvement in the labour market are driving an improvement in consumer spending which accounts for about two-thirds of GDP.

There has been much attention given to the Saudi Aramco IPO, as the sale of a 1.5% stake in the energy giant raised a record $25.6bn through its long-awaited flotation on the Riyadh stock exchange. An additional tranche of shares has been sold in early January raising $3.8bn and the company's market capitalisation of $1.86tn makes it the world's biggest company. The IPO was supported by family offices in Saudi Arabia and other funds in the region after international investors baulked at the valuation placed on the business by the country's authorities. The stock has only been given a 15-basis point weighting in the index reflecting the low free float.

Emerging market equities are highly sensitive to shifts in global growth. We are cautious on global economic prospects for H1 2020 though see potential for a pick-up in H2 so expect better relative performance from EM as the year progresses. We use a seven-factor checklist to assess the relative attraction of EM equities. As well as global growth prospects, this includes relative monetary growth rates, earnings revisions and the trend in the US dollar. The checklist suggested a cautious view a year ago but has improved recently, though is not yet giving a positive signal. Corporate earnings continue to be revised lower, but profit growth estimates remain in double digits for the next 12 months, much higher than in developed markets.

Transactions over the period have added to internet names in China where the regulatory and competitive environment has improved. We have also upgraded our assessment of Chinese A shares relative to Hong Kong listed names based on liquidity flows. We have reduced the underweight in communications significantly, funded from consumer discretionary and financials. Sector selection was the main positive as we favoured companies in IT and consumer discretionary. Stock selection was strong in Taiwan, Korea and Poland.

**Performance Attribution**

| 3 Months to December 31, 2019 | Allocation (%) | Stock Selection (%) | Net Impact (%) |
|---|---|---|---|
| **Total** | **-0.61** | **1.69** | **1.08** |
| Emerging Market Asia | -0.34 | 1.72 | **1.38** |
| China | -0.01 | 0.01 | **-0.00** |
| Korea, Republic of | 0.01 | 0.33 | **0.34** |
| Taiwan | -0.02 | 0.56 | **0.55** |
| India | -0.15 | 0.83 | **0.68** |
| Malaysia | 0.01 | 0.22 | **0.23** |
| Thailand | -0.01 | 0.02 | **0.01** |
| Emerging Markets Europe, Middle East and Africa | 0.32 | 0.23 | **0.55** |
| South Africa | -0.03 | -0.19 | **-0.22** |
| Russian Federation | 0.02 | 0.18 | **0.20** |
| GCC (Saudi Arabia, Qatar, UAE) | 0.42 | 0.00 | **0.42** |
| Emerging Market Latin America | -0.09 | -0.25 | **-0.34** |
| Brazil | -0.05 | -0.05 | **-0.10** |
| Mexico | 0.05 | -0.05 | **-0.00** |
| Frontier Markets | -0.13 | 0.00 | **-0.13** |
| Cash | -0.37 | 0.00 | **-0.37** |

Emerging Markets had a strong finish to 2019 with a gain of 9.63% in local currencies and a US dollar gain of 11.93% in Q4 as hopes for a resolution or at least a de-escalation in trade tensions between China and the US lifted investor sentiment. Security selection was the main contributor to relative performance in Q4 with strong contributions in India, Taiwan, Korea, Malaysia, Poland and Russia. Sector selection was also positive. All sectors in the benchmark posted positive returns in Q4. IT was the best performing sector with a US$ gain of 19% and our overweight in the sector was positive. Consumer staples (+2.6%) struggled to keep pace with the broader marker as did utilities (+4.3%) and modest underweights in both also added value. At a country level the best performing markets included Taiwan (+18%) and Russia (+17.1%) where modest overweights were positive but offset by positioning in India (+6.25%) and Vietnam (+1.2%). Underweights in the Gulf region where returns lagged the broader index were also positive for relative performance. The small overweight in Chile (-9.5%) which was the weakest market in Q4 also had a modest negative impact.

In Asia, India was the biggest contributor to relative performance as strong stock selection more than offset the country overweight as the broader market lagged. Our overweight in financials, which had been a drag in prior quarters, boosted performance. High quality financials were differentiated from the rest of the sector following a liquidity crisis centred on non-bank housing finance businesses earlier in the year. HDFC gained



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21.2% and ICICI Bank rose 23.9% in Q4. HDFC is the largest housing finance company in India and has always been prudently managed with strong margins and very low levels of non-performing loans. Sentiment had been badly hit as new smaller housing finance companies encountered a liquidity crisis during the year but HDFC has always maintained prudent lending and funding practices and its latest results were well ahead of market expectations in Q4 with no deterioration in loan losses or provisions. ICICI Bank has similarly recovered in Q4 as results delivered better operating and asset quality metrics than anticipated.

The silver lining of the credit crunch is a better competitive environment as less well-run businesses are forced to rein in lending due to an absence of strong deposit bases as enjoyed by both HDFC and ICICI. In consumer staples Varun Beverages gained 12.7% as results were ahead of expectations following the acquisition of further territories from Pepsi Inc in South and West India. Sales grew 60% YOY and excluding the acquisition were up a very healthy 18%. Investors are looking forward to an improvement in operating metrics in the new territories towards the impressive level which Varun has consistently delivered elsewhere.

In Taiwan the overweight in IT was helpful as semiconductor giant TSMC gained 26.7% in Q4. Results were ahead of consensus at a point when investors were uncertain regarding the impact of trade tensions on semiconductor demand. A confident results call and increased capex plans reinforced the message that the demand outlook looks healthy to management as 5G spending starts to pick up in 2020. Strong demand is also resulting from moves to disentangle the US/ China technology supply chains. TSMC is picking up strong demand from non US semiconductor players that are seeing accelerating orders from China. Mediatek (+24.2%) is one such company in the portfolio which also delivered strong gains in Q4. Mediatek has long provided its system on chip (SOC) semiconductor to Chinese companies as an alternative to US competitors like Qualcomm. Mediatek is seeing strong orders from customers like Huawei for both its 4G and 5G products.

In Korea our holdings in IT boosted relative returns with both SK Hynix (+18.4%) and Samsung Electronics (+17.7%) benefitting as sentiment towards the semiconductor space was boosted by the positive signals on a Phase 1 trade deal between the US and China. In financials we added to the position in KB Financial and the bank delivered a very helpful 15.4% gain in Q4 outpacing the rest of the sector in Korea. The bank's high market share and strong capital base allow it to grow loans ahead of competitors and results for Q3 were better than market expectations. In Malaysia our long-held position in Heineken Malaysia boosted returns with a gain of 15.7% over the quarter. The company is a brewer in an oligopolised Muslim market and a clampdown on illicit alcohol is lifting demand for Heineken and its premium portfolio of drinks, including non-alcoholic beers.

In Chile, unexpected civil unrest in a country long viewed as the most stable and developed in Latin America took the administration and investors by surprise. An increase in subway fares was the catalyst to unprecedented violent protests. An initial unhelpful bellicose response from the president encouraged more to join the movement to express discontent about social issues from healthcare and education access to inadequate pensions. At the time of writing the situation had de-escalated as the government had agreed to constitutional reforms and an increase in social spending. Our holding of Banco Santander de Chile (-17.6%) lagged the market as foreign investors sold the position. Santander is one of the top four banks in Chile with strong underlying divisions but the disruption to business for the bank and its SME customer base is unhelpful.

In South Africa relative performance was disappointing as the market staged a surprising 13.3% rally in Q4. We continue to hold an underweight position in the market where weak monetary data and an ongoing power shortage from national generation company Eskom leave us with little enthusiasm. The biggest impact in South Africa came from the zero weight in materials where gold and platinum miners rallied 34% in aggregate. Despite the Q4 rally our underweight was positive for the year as a whole and we do not see fundamental reasons to add at this point.

Polish security selection continued to boost relative returns in Q4 as our long favoured gaming software company CD Projekt delivered a 21.5% gain reflecting investors anticipating the launch of its eagerly awaited Cyberpunk 2077 title in April of this year. Security selection in Russia was positive as Yandex rose 24.4% and our energy names gained 25.6% in Q4. Yandex is Russia's leading internet search provider and concerns regarding restrictions on foreign ownership of a strategic business had led to sharp declines in Q3. The company has resolved the issue by agreeing to a "Golden Share" for the government which contributed to the strong recovery in Q4. We are modestly underweight energy stocks in the portfolio overall but favour the Russian names Lukoil and Tatneft which benefit from low Russian ruble costs and operational gearing as oil rallied 14.5% in US dollars.

## Portfolio Activity

### Top 10 Purchases

| Country | Security | Sector | % |
|---|---|---|---|
| China | Tencent Holdings Ltd | Communication Services | 1.85% |
| Thailand | Minor International Pcl | Consumer Discretionary | 1.27% |
| Thailand | Ptt Explor & Prod Public Co | Energy | 1.23% |
| China | Baidu Inc - Spon ADR | Communication Services | 1.16% |
| China | Joyoung Co Ltd -A | Consumer Discretionary | 1.07% |
| Hong Kong | Esr Cayman Ltd | Real Estate | 1.04% |
| China | JD.com Inc-Adr | Consumer Discretionary | 1.04% |
| Korea, Republic of | Amorepacific Corp | Consumer Staples | 1.01% |
| Taiwan | Win Semiconductors Corp | Information Technology | 0.97% |
| China | Momo Inc-Spon Adr | Communication Services | 0.95% |

Transactions over the period raised exposure to Asia slightly while reducing cash. The focus was on internet names in communication and consumer discretionary where the regulatory and competitive environment has improved. Also, we wanted to raise exposure to China A shares given the political unrest in Hong Kong. We have re-introduced JD.com, the online direct sales company which offers a wide selection of products through its website and mobile applications. The company's third quarter results were impressive with total revenues up 29% year on year and earnings before interest and tax ahead of estimates by 54%. JD is in a strong position to benefit from rising consumption in lower tier cities and margins have continued to improve with scale. We like the operating efficiency of the group and believe that the services revenue will continue to grow along with the greater penetration in lower-tier cities where the majority of new customers are coming from.

We have also re-introduced internet search engine Baidu as we believe revenue growth for search and feeds could be better than expected despite macro headwinds. The company has executed well in the cloud and the operating metrics of its mobile ecosystem show growth and momentum as daily active users rise. We have also purchased 58.com which offers a life service platform transferring a range of products and services between purchasers and sellers. We believe the company can maintain its leading position in housing and online recruitment while management is diversifying its products and services. The group is investing in technology and innovation cementing its dominant position while improving operational efficiency by reducing overall headcount.

We have moved overweight to internet media giant Tencent with a 1% active position. The share price made little progress over the course of the year but the company has announced a collaboration with NVIDIA to bring PC gaming in the cloud to China. Mobile gaming remains the key driver for Tencent and the shift to the underpenetrated cloud in China will improve margins in the long run. Recent results should dismiss fears of ad revenue decelerating and a deterioration in fintech and business margins. Earnings are set to grow around 30% per annum over the next two years and a multiple expansion is overdue.

Away from the internet in China, we have added Joyoung, which manufactures and distributes small electrical appliances. The company has launched a successful product series in 2019, which typically sustains growth for two years in the small appliance sector. Vacuum cleaners and blenders are two key growth areas and the company will benefit from premiumisation in these products. We expect the share price to re-rate as the improving earnings visibility is appreciated by the market. We have also re-introduced Jiangxi Copper where the shares had fallen since April but first half earnings were ahead of expectations. The outlook for copper is helped by disrupted supply, which could lead to mounting deficits and rising prices. The shares have been weak since April, as the smelting business has faced headwinds and capital management challenges have weighed on sentiment but would respond well to a pick-up in copper prices, which we judge likely over the medium term.

Elsewhere in Asia, we have introduced Korean cosmetics company Amorepacific where margins have improved in both domestic and overseas markets. Management has been restructuring its retail channels and pursuing prudent cost control while luxury brands have performed well online. We have also added to banking group KB Financial, the holding company for Kookmin Bank which provides financial services to over half of the Korean population. There is a lot of bad news discounted in bank share prices as the sector has faced a challenging environment with net interest margins contracting, rising operating expenses and some mis-selling issues. KB has solid sustainable earnings despite the tougher operating environment with profits of non-bank subsidiaries recovering. Regulatory pressures have eased, and the group has the strongest capital base in the sector. In Taiwan, we have purchased Win Semiconductors, which will benefit from infrastructure growth from the 5G build-out, an increase in foundry outsourcing within the RF industry and design changes for RF and 3D sensing features in future iPhones.

### Top 10 Sales

| Country | Security | Sector | % |
|---|---|---|---|
| **Taiwan** | Taiwan Semiconductor Manufac | Information Technology | 1.98% |
| **China** | China Mengniu Dairy Co | Consumer Staples | 1.40% |
| **Thailand** | Minor International Pcl-Foreign | Consumer Discretionary | 1.34% |
| **Hong Kong** | AIA Group Ltd | Financials | 1.22% |
| **China** | China Construction Bank | Financials | 1.22% |
| **China** | China Mobile Ltd | Communication Services | 0.93% |
| **China** | Li Ning Co Ltd | Consumer Discretionary | 0.93% |
| **China** | China Life Insurance Co. - HK | Financials | 0.92% |
| **China** | Midea Group Co Ltd-A | Consumer Discretionary | 0.87% |
| **Thailand** | Ptt Exploration & Prod-For | Energy | 0.80% |

On the sell side, we have taken some profits in Taiwan Semiconductor, reducing the high active weight. Sales elsewhere include China Mengniu Dairy, which has been making a number of acquisitions, and China Construction Bank where the announced loan prime rate (LPR) reform and potential involvement in the bad debt resolution of distressed small banks may hold back the share price. We have reduced the active weight in insurer AIA given the rising risks in Hong Kong and used utility Guangdong Investment and China Mobile as a funding source for new ideas. In consumer discretionary, we have exited home improvement company Midea because of its exposure to the mature large appliance market rather than the more dynamic small appliance sector but also partly reflecting the risk of a price war with troubled competitor Gree. In India, we have taken profits in IT services group HCL Technologies which had been a steady performer.

**Portfolio Strategy**

Global emerging markets ended 2019 strongly helped by the hope of a ‘phase one’ US/China trade deal and the introduction of liquidity by the US Federal Reserve to ease conditions in the repo market. The MSCI emerging markets index rose 9.63% in local currency terms and 11.93% in US dollars as the greenback was weaker after the Fed cut rates for a third time during the year. IT was the best performing sector gaining 19.04% while consumer staples was the worst up 2.64%. The tech heavy Taiwanese market was the best performing market rising 18.01% while Chile fell 8.76% because of the civil unrest, which began in September.

We expect global economic momentum to remain weak into Q1 2020 with labour markets the next indicator likely to deteriorate. Chinese credit conditions remain tight with the PBoC still behind the curve. Policy loosening is also needed and likely in Brazil, Mexico and Russia. We continue to focus on ROIC/WACC winners with an emphasis on beneficiaries of structural change and expect a rising consumer wealth effect to reassert a positive influence on relative stock performance. Our EM checklist is less negative but not yet positive with relative narrow money growth between EM and DM the main cautionary factor.

At our last country meeting in December we upgraded UAE to a 2 rating on better money growth and downgraded Thailand to a 3 and Malaysia to 4 both based on a deterioration of our political assessment. The Chinese market has discounted the consistently bad news of 2019 but real money growth has fallen due to a slowdown in nominal money and a food-driven inflation surge. This has coincided with a tightening of credit conditions following the failure of several regional banks and an associated rise in funding costs with the ease of obtaining external finance falling. The labour market is softening and cuts in the reserve requirement ratios are not solving the credit problem due to risk aversion and solvency concerns rather than a lack of banking system liquidity. Food inflation was slightly lower in December and should fall from February, as an early lunar new year will likely boost January. Auto sales are stabilising but an industry body is forecasting a 2% fall in 2020. Consequently, we have held the rating at 4 but are close to benchmark weighting on the portfolio given our increased optimism for China A shares and internet related names. Elsewhere in Asia real narrow money growth is strong in the Philippines where we have a 2 rating and weak in Malaysia. In Latin America money numbers are similarly soft in Brazil and Mexico but strong in Chile suggesting the market may be oversold. Elsewhere there has been a rebound in Turkish real narrow money growth while Russia and Poland are strong and South Africa is weak. We are looking to add to Russia and Turkey on any pull back but reduce India while Indonesia is subject to a review.

In terms of sectors we continue to favour consumer discretionary and IT against underweights in the cyclical sectors of energy, materials and industrials as well as healthcare and utilities. We still like education stocks in China such as China Education which is a private higher education provider. The company operates universities and a vocational college and enrolls students across all provinces in mainland China. It provides bachelor's degree, junior college diploma and vocational education programs. Another significant active position in consumer discretionary is Lemon Tree Hotels which is a mid-end hotel owner and operator. We like the former Tata group management who are looking to develop a large capital light portfolio of managed hotels for the growing middle classes. In Brazil we own Lojas Renner which is one of Brazil's three largest apparel retailers, which together command an estimated market share of about 12%. The company operates stores selling clothing, shoes, and accessories, as well as leading housewares retailer Camicado. Purchases made using its credit card represent nearly 50% of sales. Renner also provides personal loans, annuities and insurance, so financial services represents 20% of net income. The group has a very strong balance sheet and should benefit from better consumer confidence and spending.

In communications we continue to like CD Projekt in Poland which is a distributor of games and multimedia software directly supplying all major retail chains and independents. The company develops and publishes games and is currently focused on The Witcher and Cyberpunk, which are action role-playing games that we believe have strong growth potential. We also like internet related names such as Baidu, 58.com and Tencent. In IT we prefer chipmakers such as Taiwan Semiconductor, Samsung and Win as we anticipate a recovery in memory and logic pricing as spending improves from 2019. In financials, we like the growth story in Asian insurance played through Ping An which provides a variety of insurance services in China. The company writes property, casualty and life insurance as well as financial services, and is the leader in private sector insurance in China. In India we are overweight Housing Development Finance which is a company lending to the housing segment at very attractive margins. The group has a low level of non-performing loans as it typically advances to borrowers with at least a 40% deposit. We prefer banks in Latin America and South Africa as ways to play increased consumption and spending power with decent management and reliable business models.

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