Fidelity INTERNATIONAL

From the desk of

Amit Goel

Portfolio Manager, Fidelity Global Emerging Markets strategies

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Recently, I've often been asked the questions, 'Are emerging markets (EM) rebounding? or 'What's the current investment case for emerging markets? To answer, I look to the same three key factors that I always do, no matter where we are in the cycle. When looking at any asset class it's important to understand; the quality of the underlying asset, its growth fundamentals and the price you pay for that asset class.

Let's start with quality. The medium-to-long term fundamentals in global emerging markets are very reasonable today versus the past. At a time when high inflation and interest rates are contributing to a standard of living crisis in developed markets, EM economies have been ahead of the curve in raising rates. They're now carrying positive real rates while inflation is plateauing. Whenever the US Federal Reserve (Fed) pivots, EM should have room to cut rates. In addition, EM economies have learnt from the past and strengthened external balances and foreign reserves. They're expected to now be in a better position to absorb external shocks.

Similarly, the growth profile of the EM appears to be strong. With China reopening this year, growth is accelerating. In India, consumption is slowing down at the margin after last year's reopening, but the ongoing investment into infrastructure and manufacturing appears to be supporting the country's rate of growth. Technology companies in Korea and Taiwan have already gone through a deep inventory destocking cycle which is expected to normalise going forward.

Thirdly, valuations seem much more reasonable with EM trading at a discount of 30% versus developed markets which is close to the highest in 20 years.

Current positioning and areas of opportunity

Financials

Over a quarter of the Fund is currently invested in financials, which is about five per cent overweight the Fund's benchmark, the MSCI Emerging Markets Index.

This is because we think EM financials are in better shape and don't face the same liability-side problems that we're seeing in some developed markets. Silicon Valley Bank (SVB) mistakenly thought they were a retail-funded bank when rates were close to zero only to realise that they were more like a wholesale funded bank when rates went to five per cent. Their small and very similar types of deposit customers moved out in bulk when rates increased, leading to asset-liability mismatch.

SVB's deposit book was principally composed of large, uninsured depositors who were quite similar in nature - private equity funds, venture capital funds, and tech start-ups. As the Fed increased rates, capital dried up, hitting these sectors particularly hard. Customers began withdrawing their money amidst concerns regarding SVB and rising interest rate markets.

In EM, most countries, have banks with strong liability franchises and a well-diversified depositor base which is stickier in nature. In addition, their funding costs are low due to a higher proportion of funds coming from both current accounts (predominately business accounts) and savings accounts. This means banks can be much choosier when deciding who to lend to and focus on quality customers who are less likely to default.

We own some of the biggest private sector banks in India and Indonesia and have recently initiated positions in both Brazil and Mexico. All these banks are considered to have a very granular and sticky customer base. Bank Central Asia (BCA), which is the largest private sector bank in Indonesia, has 27 million liability customers, against the country's total population of 250 million.

HDFC Bank in India has 70 million mid-to-high end liability customers versus the country's total population (1.4 billion of which are middle class or above). The average account balance of BCA and HDFC Bank is about US$1200 and US1000, respectively. Money sits in these banks not because depositors want interest income but because of the everyday convenience of having a bank account. These banks do not have large exposure to bonds or treasuries - their retail-funded balance sheet is invested into real loans which are shorter in duration, soundly priced and provisioned.

In terms of risks, we might see some pull-back in net interest margins. Banks have benefited from interest rates as their lending rates rose faster than deposit rates, but now funding costs have the potential to increase due to tighter liquidity conditions. That said, we still think many EM banks are very reasonably priced and we remain positive on them from a medium to long-term view.

Consumer

Our positioning in the consumer sector is quite differentiated versus the Index. We own some very specific businesses where we're seeing long term benefits from structural growth. A large part of our holdings in the sector sit in China where we see opportunities from the growth of the class.

China's upper-middle class is about 100 million strong, earning US$30,000-50,000 per year and have similar aspirations to their counterparts living in Germany, the UK or the US. As this segment expands to 250 million in the next ten years, it will boost the demand for premium products. We're interested in changes in their consumption patterns and look for businesses on a bottom-up basis that are aligned to this trend.

For instance, we own one of the largest domestic sportswear brands, a dairy company, and a luxury car dealer in China. We're also finding opportunities in some of Chinese healthcare businesses which will benefit from an aging population with a greater disposable income. Importantly, these are all domestic focused opportunities which aren't as impacted by geopolitical issues and are in areas that are less prone to regulatory risks.

In India, we also focus on businesses that benefit from the country's expanding middle class. As the country's per capita income grows from US$2,500 to US$5000, people will be move from buying essentials (like food, low-end housing and education) to more non-essential products and services (like automobiles, consumer electronics, mortgages, and credit cards).

Despite being a hot country, India sold seven million air-conditioners last year compared to China which sold 100 million. As income levels grow, consumers will leverage up and sales in some of these categories should grow exponentially.

Technology

Technology is our largest absolute and relative position versus the Index, but again our positioning is differentiated. We have a large underweight position in Chinese internet names as we think these companies are more susceptible to regulatory risks.

Instead, our focus is on hardware industry leaders such as TSMC, SK Hynix and MediaTek. Concerns around a global slowdown has meant that many of these names are trading at multi-year lows, but we believe we're now at the end of demand weakening and will likely see a recovery in the second half of the year.

The pace of this recovery is still uncertain, but any sort of recovery is yet to be priced in, which translates to attractive pricing for investors. Importantly, these companies are both critical and well ingrained in global technology supply chains and should therefore continue to benefit from the long-term structural shift towards high-end computing products, electric vehicles, and artificial intelligence.

Better value today

Given today's volatile environment, most of the potential risks such as a US recession, higher rates and inflation, and geopolitics, are well understood and largely priced into valuations. This also means our expectations for cost of capital, risk and growth are considered to be very reasonable today compared to a few years back when we were in a low interest rate and higher growth environment. So, while the environment remains unsettling, I think we're building in the right risk profile of the market.

Overall, if you consider the fundamentals, quality of underlying assets and valuations, global emerging markets are considered to be in better shape, more resilient, and more attractively valued than in the past.