
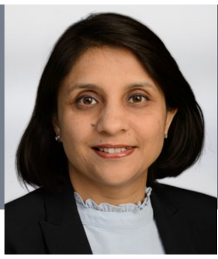

From the desk of

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Fidelity Global Emerging Markets Fund

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Further deepening our corporate engagements

In this 'From the desk of' we provide an update on our macro and market views and look at some of the headwinds facing emerging markets. We also discuss how we've ingrained our approach to sustainability into our investment process and examine how further deepening our corporate engagement has helped focus the portfolio even more to withstand a challenging macro environment.

What are your general views on the current market environment and the changes you have noticed over time?

Amit Goel: We are going through a tough operating environment as recent geopolitical events have led to a surge in commodity prices, inflation has come back and central banks across the world have raised interest rates. Equity markets saw a sharp rotation – value stocks substantially outperformed growth stocks with economic environment becoming more uncertain and cost of capital rising.

We believe this style rotation has already played out. The valuation differential between growth and value stocks has corrected and commodity prices, that added to the performance of value stocks earlier this year, have started to decline.

However, the growth environment across the world remains fragile. Inflation remains a concern, but at current levels, a large part of it is discounted in the price. Going forward, we believe the focus will shift to growth expectations and the risk to earnings over the next 12 to 18 months, which may keep the markets volatile. The key from here will be to deepen our focus and get even closer to companies we invest in to understand their earnings trajectory and make sure we make some sense of the near- term recession risk and growth expectations of every business we own.

How has the Fund performed this year in the face of multiple headwinds?

Amit Goel: After a strong performance in 2021, the Fund's performance fell behind the index this year. This was essentially due to the following headwinds:

- **Style headwind** – Value stocks did better than growth last year too, but the outperformance was not as significant and our positive stock selection more than made up for it. This year, however, the margin of outperformance was significant, and this hurt the Fund's relative performance. We were able to navigate it reasonably well given our focus on value within our quality growth framework that kept us away from loss-making and hypergrowth companies, which derated severely.
- **Underperformance of technology stocks** – the concerns of a slowdown in global growth led to the derating of our holdings in the IT sector, such as **SK Hynix, MediaTek** and **ASML**, even though they continue to report good numbers. The businesses we own in this segment, including semiconductor and memory companies in Korea and Taiwan and IT services companies in India, are the most competitive in their space.
- **Correction in copper prices** – the fall in copper prices in recent months impacted our holdings in copper producers **First Quantum Minerals** and **Southern Copper**. We should have reduced our exposure to these names after the strong run earlier this year, but did not because of our overall underweight in commodities and our view that copper usage will track the growth in EVs and renewable energy.

Conversely, the **key contributors** to the Fund's performance included our under-exposure to Russia, even before the start of the war. Our financials holdings, including strong quality banks in India (like **HDFC Bank**) and Indonesia (like **Bank Central Asia**) and pan-regional insurance major **AIA** proved rewarding, as they continued to benefit from long-term structural increase in penetration and near-term benefit from interest rate increases.

Select industrials businesses, such as car rental services company **Localiza** in Brazil and thermal control components maker **Zhejiang Sanhua,** also enhanced the Fund's performance. The former procures cars in bulk at a low cost and is able to generate consistently high returns. The latter was driven by growth prospects in its energy storage business for electric vehicles owing to strong order flow from Tesla.

China seems to be going through a perfect storm – tensions with Taiwan are on a rise and zero-COVID policy and property market slowdown is hurting growth. How do you see the economy and where are you finding investment opportunities?

Amit Goel: It is correct that China is facing a perfect storm of sorts with external geopolitical concerns and internal economic woes.

Geopolitical concerns – The China-Taiwan conflict escalated after the US House of Representatives speaker Nancy Pelosi visited Taiwan in August. We see this as one more event in the larger US-China conflict as both countries emphasise their political and economic primacy at a global stage. China has toughened its stance on Taiwan, increasing the possibility of a larger armed conflict, while the US is looking to protect Taiwan, seeing this as a big risk to the world's existing economic and technological order.

While we are not experts on geopolitics, in our view, the probability of any larger armed conflict in the next few years remains low. The world has already underestimated the impact of the Russia-Ukraine war. North Asia, and more importantly China, is a major player in the global supply chain across industries such as technology, manufacturing, alternate energy, chemicals, autos, etc, and it will be highly disruptive and inflationary if these supply chains (which are hard, expensive and time-consuming to replicate) are affected. The enormity of this impact should be enough to keep the probability of any large-scale conflict low.

China's domestic economic issues, such as the property sector meltdown and demand slowdown (due to sporadic lockdowns given zero-COVID tolerance and frequent resurgence of the virus) is making the fundamentals volatile at a time of geopolitical uncertainties.

We believe these domestic issues should be resolved over the next six to twelve months. China is not willing to go through the Covid-related mortality curve of any size and may not yield on its zero-Covid policy, but its impact on consumption has already been felt in H1 2022, making the base already quite low. The property sector sentiment can improve with targeted policy measures as sales volume is already down 30% to 40% from its peak.

Meanwhile, the Chinese equity market has fallen to attractive levels. We think China's risk premium may remain high in the near term, keeping the market volatile, but a lot of these factors are now discounted in the price. We remain selective and maintain a neutral position in China.

Latin America has been a beneficiary of high energy and commodity prices. How has the commodity market correction impacted their economies?

Punam Sharma: Latin America has benefited from higher commodity prices, which has helped their fiscal and trade balances, thereby maintaining currency stability and better growth. The correction is making the equity and currency markets in the region increasingly volatile. A large part of the primary and trade surplus was a function of the high commodity prices, and we could see some deterioration in the same. It is important to emphasise that the region has a natural advantage and is the lowest-cost producer across commodities and there is a supply constraint for many of these commodities which is hard to bridge.

The region is diversified and has a higher per capita GDP than Asia – fundamentals which bode well for domestic consumption and services. The digital talent pool in Latin America is creating avenues for employment via outsourcing and growth of digital services from the region. The latest data suggests domestic demand remains resilient and unemployment has come down versus last year. GDP growth has held up well for CY22, but we are seeing a cut in next year's growth projections, in line with growing fears of a global recession.

Most countries in the region proactively tightened their monetary policies. Brazil's central bank ended its aggressive interest rate hiking cycle at its policy meeting in September, leaving its benchmark rate unchanged at 13.75% after twelve straight increases. The region is used to high inflation, with robust mechanisms of inflation transmission built into wages and other contracts that prevents a standard-of-living crisis that we are seeing in the West. In addition, the aggressive tightening is yielding results and inflation is lowering in some countries in the region.

We continue to analyse the region from a bottom-up perspective and have a diversified exposure to idiosyncratic structural growth stories in the region.

How is the Fund positioned in this environment, what changes have you made, and where are you finding investment opportunities?

Amit Goel: The Fund's positioning has not changed much. We maintain our overweight in consumer discretionary, industrials and IT sectors and underweight in energy, utilities, and commodities.

Increasing market volatility and macroeconomic changes are tough to predict. Since we do not have an edge in making macro calls, we had a choice of either diversifying the portfolio or to **deepen our focus and get even more closer to the businesses we invest in**. We chose the latter, staying with our focused approach and intensifying our engagements with company managements and other stakeholders. The idea is to make sure that we further understand their pricing power and ability to gain market share to navigate a tough period of higher cost pressures and slower growth. This deeper understanding of our investee companies also helps us value these risks even more accurately.

Based on our due diligence, we have stress-tested our portfolio and trimmed exposure to businesses that we view may be disproportionately impacted by slowdown in growth or by rising inflation and interest rates or where valuations were rich. For instance, we sold out of **Zhejiang Sanhua** and **SKSHU Paint** after a rebound in Q2 and weaker outlook for growth. Indian IT services major **Tata Consultancy Services** was sold on expensive valuation and prospects of a cut in global IT spending.

The research has also led us to areas of new opportunities. China is one place where we believe recent underperformance provides strong valuation support. However, as we allocate more capital in the country, we are also cognisant that the near-term environment remains volatile and challenging with various macro headwinds. With this in mind, we initiated a position in **Pinduoduo**, **Longi Green Energy** and **Laobaixing Pharmacy**. Pinduoduo is China's third-largest e-commerce platform that's announced strong growth and market share gains due to its focus on competitive pricing, even as market leader Alibaba shifts focus on consumption upgrade. The stock has been trading at an attractive price after last year's correction. Longi Green Energy is China's largest maker of solar wafer, cells, and modules. It is benefiting from the growth in alternative energy across the world. Laobaixing Pharmacy benefits from structural growth organised drug retailing in an ageing society.

Outside China, banking is one area where we are finding more opportunities to invest, given rising interest rates and long-term structural growth. Recently, we added **Bank Bradesco** in Brazil and **ICICI Bank** in India. Bradesco is Brazil's second-largest private-sector bank and one of the cheapest in the GEM space, despite high-teen through-cycle ROE. ICICI is also the second-largest private-sector bank in India that has successfully repaired its balance sheet and is set to gain market share for public-sector banks in the next capex cycle.

We are very happy with the businesses we own in the portfolio. Most of them are now trading at more reasonable valuations. While growth may disappoint next year, we still expect the portfolio to compound at double-digit rates over three to five years. Also, the portfolio's current valuation is the cheapest I have ever seen, which holds us in good stead even if we face a recessionary environment next year.

Can you talk a bit about your sustainability approach to investing and is it hard to find sustainable stocks in Global Emerging Markets?

Amit Goel: Philosophically, our sustainability approach originates from our belief that strong ESG practices will over time lead to lower cost of capital and higher returns for a company versus a competitor with weak ESG practices. Also, consumers are increasingly becoming conscious of a company's social and environmental practices and over time this will reflect in a company's brand leadership and market share.

Hence, we adopt a well-rounded ESG framework covering exclusions of 'proven harm' sectors (weapons, tobacco, gambling, etc.), and integration of sustainability criteria into the investment process alongside fundamental criteria and engagements.

We put a lot of emphasis on engagements, as it helps GEMs companies, which are on average behind their DM counterparts, improve their sustainability practices and disclosures and in the process create value for our clients.

Given we have a very focused portfolio of 30 to 50 holdings, it is not difficult to find companies in our universe that understand the importance of ESG, are willing to engage with us, and are receptive to our suggestions to improve their policies and disclosures.

We are conscious that these engagements are time consuming and need technical expertise and hence we are working closely with Marion O'Donnell, Director of Sustainable Investing on ESG engagements, for this strategy.

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