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Closer to the truth

A tidal turn for emerging markets

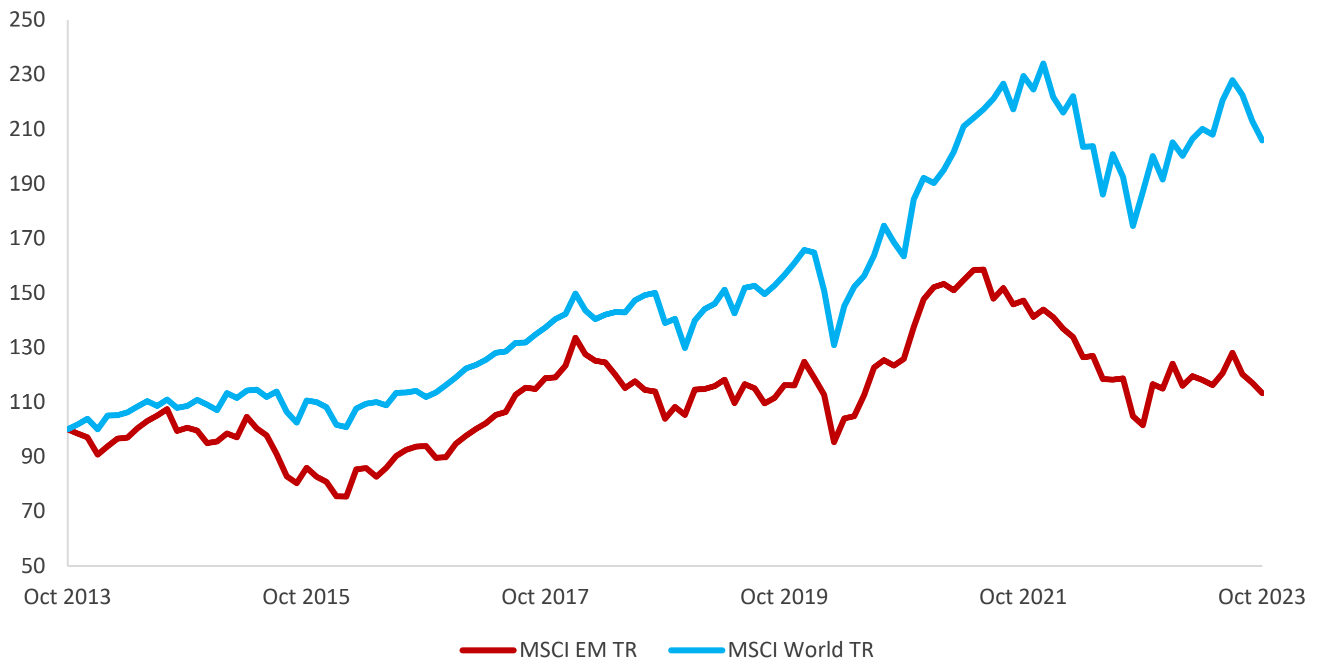
Adrian Clayton, CIO

In this article, I raise the unthinkable: emerging market indices could be on the verge of outperforming developed markets.

The MSCI Emerging Market index (MSCI EM) outperformed the MSCI World index (effectively a developed markets index) from 2000 but underperformed over 20 years and has been awful for the past decade, returning a paltry 10% versus over 100% for the MSCI World index.

Severe EM underperformance started after these stock markets hit their zenith in November 2007, one month before the official onset of the Great Financial Crisis (GFC), and they have never fully recovered, albeit flirting with new highs in 2021 before subsequently wilting.

Chart 1: MSCI EM vs MSCI World (10 years to 30 Sep 2023)



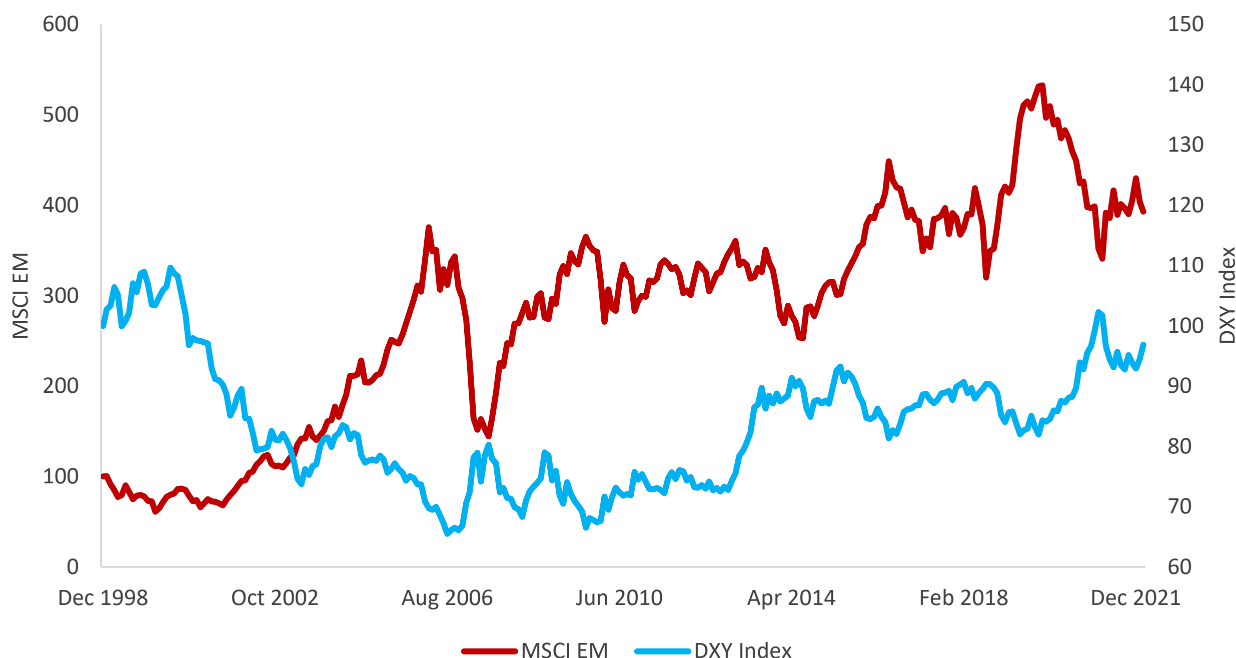
Source: Northstar and Bloomberg

But every dog has its day, so what will it take for emerging markets to rebound? The answer lies in dollar weakness and earnings growth.

Dollar weakness

With respect to EM performance, since 1998 there are really two distinct periods to consider. 1998-2008 was a decade of supercharged gains, and this was followed by more than a decade of underperformance. Both periods, not by coincidence, correspond perfectly with dollar movements (DXY index) – weakness in the first period, followed by a long and bumpy run of extreme dollar strength in the second. See the chart below.

Chart 2: MSCI EM vs DXY Index (to 31 March 2022)



Source: Northstar and Bloomberg

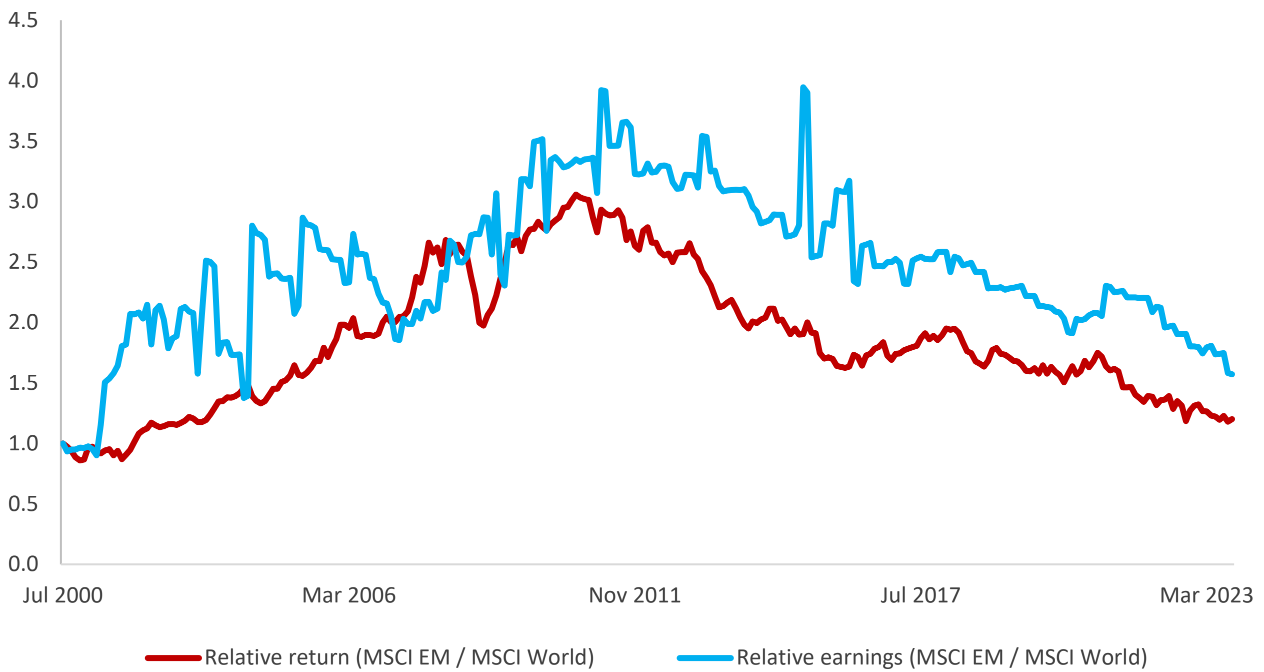
There are numerous reasons why a weaker dollar propels emerging markets, this article demands brevity, so we will cover the two main ones. Emerging markets, with dollar debt, benefit when the dollar weakens due to lower interest and capital repayments. Manufacturing based emerging markets have many of their input costs priced in dollars, so dollar weakness allows them to buy more of the same product per unit of dollar, which allows them to leverage their scale advantages profitably.

The dollar's strength over the past couple of years is ascribable to the US's exceptional growth story, a 'flight to safety', and aggressive interest rate increases from the Fed. We believe that many of these vectors are tired. A future world with a 'relatively weaker' dollar should surprise few.

Earnings growth

The other key to emerging markets outperforming is relative corporate profitability versus developed markets. The chart that follows illustrates this beautifully. From 2000 to early 2010, emerging market earnings growth was higher than that of developed markets, and emerging markets responded with a huge run-up that ended in late 2007, only to experience another leg up, which failed in mid-2010.

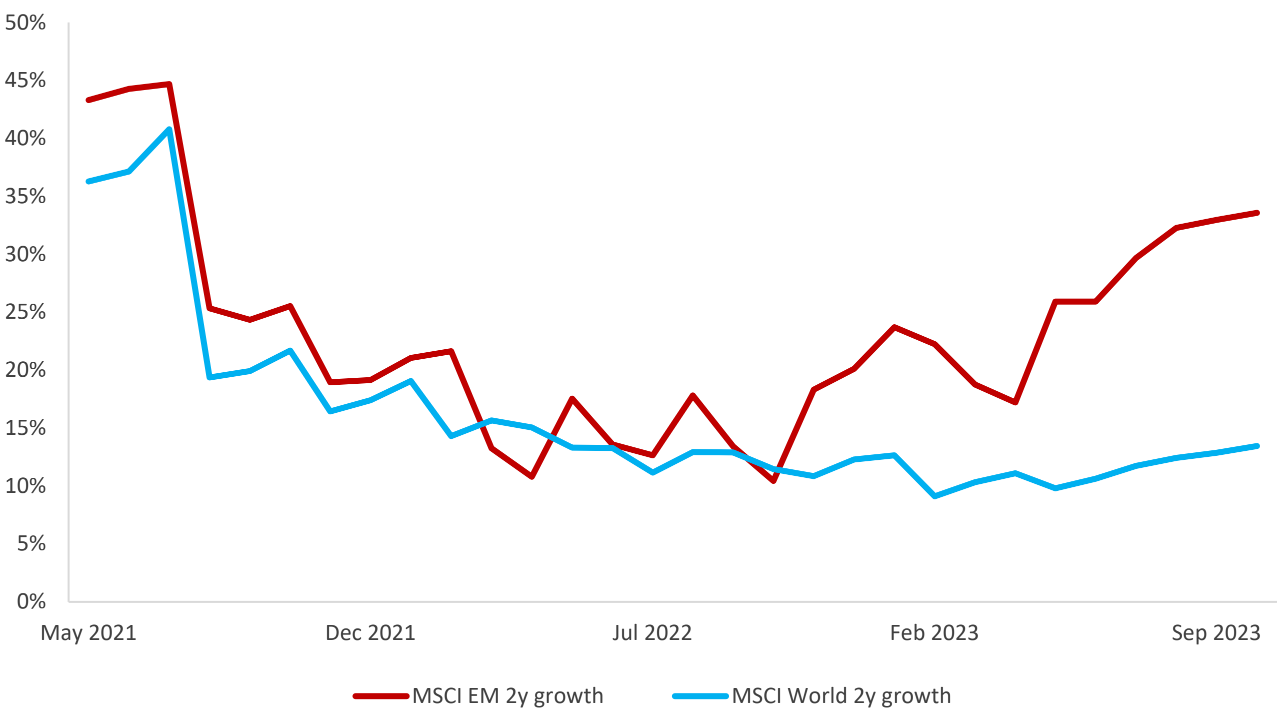
Chart 3: MSCI EM relative to MSCI World (to 30 September 2023)



Source: Northstar and Bloomberg

But can emerging markets produce elevated profitability again? Sentiment is overwhelmingly negative against this investment class: news flow is dominated by geopolitical tensions, trade wrestles with the West, and fears of hyper indebtedness by governments and consumers. None of this can be disputed, yet analysts are upgrading 1, 2 and 3 year earnings forecasts for emerging markets relative to their larger developed market peers as is evident from the chart 4 below.

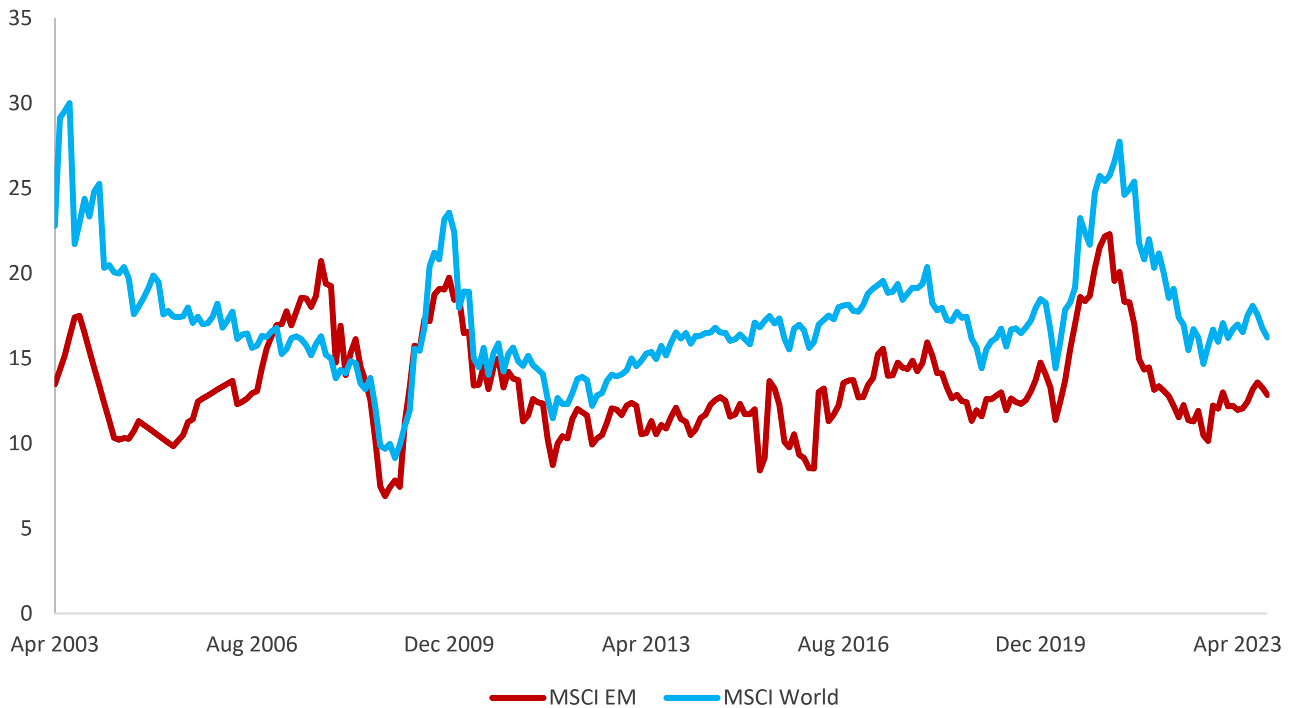
Chart 4: Earnings growth estimates (2 year) (to 30 September 2023)



Source Northstar and Bloomberg

A blunt indicator of valuation is the price to earnings ratio (P/E), and whilst it certainly does not adequately deal with all the nuances on valuation, it does tell a story. The MSCI World index trades at a lofty premium of 26% to the MSCI EM, which is not far off the average premium that has existed since 2011. The earnings upgrades by EM market analysts should, given time, be reflected in a lower DM premium.

Chart 5: P/E ratio (to 31 October 2023)



Source: Northstar and Bloomberg

For beleaguered investors stuck in emerging market funds, your time for reprieve could be drawing near. This includes South African investors – it is true that our market has been a victim of its own goals due to our sociopolitical and economic failures, but the JSE has also been shunned through association with all emerging markets.

When this tide turns, it will do so for all small boats!

Investing for long-term outcomes: macro economic factors and the "chessboard problem"

Lo Giyose
Chief Investment Officer/Portfolio Manager (First Avenue)

Investment outcomes associated with short term returns (cyclical) and long-term returns (compounding) are nowhere near even. Despite alpha from compounding being higher, more enduring, and less volatile, investing in highly cyclical companies for mean reverting returns has great appeal for reasons of instant gratification (a strong psychological force). Since returns from compounding are non-linear, that is, do not go up in a straight line, investors surmise that a bird in hand (cyclical, mean reverting returns) is better than two in the bush (compounding). Investment markets always pose the following question to investors, "would you rather take $1m right upfront or a penny on day one doubled every day until day 30?". Doubling every day for 30 days would yield $10m while doubling every day would yield $1m in 27 days. So, taking $1m upfront would make you look like a hero for 27 days. However, you would rue your lack of patience to net you $10m in the last three days of the month. That's why temperament has an exponential impact on investment outcomes (relative to other sources of alpha generation, namely, analytical, and informational advantages). Temperament allows us to forgo upfront gains (quarterly and even annual gains) in favor of compounding outcomes that may only show up further out on the horizon of transient factors affecting the economy/industries.

2021 - The year that changed the world

2021 ushered in a rise in consumer price inflation (CPI). Demand rebounding from the lull in consumption during the COVID pandemic found supply chains short of capacity. Excess demand was exacerbated by government stimulus cheques to help supplement incomes of those whose livelihoods had been adversely affected by the pandemic.

Businesses that had taken precautions to limit production and inventory during the pandemic found themselves scrambling to turn on the taps again. This stoked inflation where consumers outbid each other to secure goods in short supply. Central Banks around the world responded by raising interest rates to stop prices from spiraling higher – effectively curtailing consumer demand.

The battle against inflation saw no respite as Russia invaded Ukraine in February 2022 and much of the Western world imposed sanctions on Russian oil and gas. Ukraine, the largest producer of wheat, also could not export the staple. These disruptions added to supply shortages relative to demand. CPI breached 7% in the US and crept closer to double digits in the UK.

Central Banks responded by continuing to raise interest rates. The bleak outlook on inflation and interest rates decimated the markets. The economically sensitive Nasdaq tumbled 33%. Who would have imagined though that in 2023, the same index would get off to a roaring start despite worsening inflation and interest rate figures? As I write this article, the Nasdaq is up 25% year to date.

2023 – the bounce back for certain market segments

This recovery is amazing given that the 10yr US Gov bond yields peaked at 5% in October, above the long-term median of 4% going back to 1871.

The surge in 10yr US Gov bond yields took off in earnest from the June quarter end, at which time the yield was 3.8%. The 10yr yield is what auto loans, credit cards, and other long-term debt is priced off. As yields rose, the

Nasdaq fell 11% from July 19 to October the 27th. It has since rebounded 8% from October to today, November 13th, in sympathy with US Gov bond yields that have retraced lower from a high of 5% to their current 4.6%.

But is short-term market behaviour really consequential?

Why are we regaling you with this story? Because investors waste their time trying to impute these movements into their valuations of businesses. They buy and sell shares based on the movements in inflation, interest rates, GDP growth and other macro-economic factors.

Competitive advantage can be assessed and valued

Against this, we believe that companies should be owned or disowned based on their relative competitive advantages and our valuation framework must account for differences in competitive advantage. We are obsessed with competitive advantages because they are solely responsible for compounding of shareholder value. It behooves us to identify and value competitive advantages in a business if we wish to arbitrage the cyclical nature of macro-economic factors. One should never forget that some of the best businesses the world has ever seen were listed at times when the US Gov 10yr bond was above 6%:

Apple	1980
Cisco	1990
Google	2004
Microsoft	1986

Great businesses demonstrate resilience through the toughest of times:

These businesses lived through a peak of 14% in the US Govt Bond yield to be what they are today. One may argue that they were disruptive, and their long-term prospects unknown due to significant risks to product penetration. You may even argue that it's less risk for incumbents to cede “first mover advantage” to a disrupter and be a “fast follower” instead. Please allow us to provide our retort by quoting Andrew McAfee, digital innovation research scientist at MIT Sloan School of Business:

“Opting to be a fast follower is a recipe for long term decline. Every risk that you can point to that prevents you from being a first mover is real. But if you are behind on learning about them, then you are behind on the learning curve. Then you are behind on the experience curve, and you are behind on the productivity curve. The risks are real but manageable. You can imagine how insulting the disrupter is going to make it for you to copy them. Your prize will simply be staying alive.”

Great businesses are often difficult to value

The reason we focus on companies that provide us with the best options to compound shareholder returns is that it is as hard for competition to beat them as it is for us to accurately compute their valuation. In fact, it is mathematically impossible to handicap the valuation of a moat that is widening. Think about it, an analyst would have to keep increasing her valuation as Coca Cola went from colouring and flavouring 0% of the world’s fresh water to 2%. We use the anecdote of the “Chessboard Problem” to illustrate the difficulties with accurately valuing a business with a flywheel of value creation well in motion.

The chessboard problem

Since returns from compounding are non-linear, that is, do not go up in a straight line, investors often surmise that a bird in hand (from mean reverting, macro-factor induced returns) is better than two in the bush. Psychologists use a story of an ancient Indian Minister, Sessa, who supposedly invented chess, to illustrate the power of compounding over time.

As a reward for inventing the game of chess, The Minister requested the ruler to give him grains of wheat according to the squares on a chessboard. He asked the ruler to double the wheat grains with every one of the 64 squares on the chess board. The ruler laughed it off as a meager prize for a brilliant invention, only to have court treasurers report the unexpectedly huge number of wheat grains – the sum of the grains on the chess board would be eighteen quintillion, four hundred forty six quadrillion, seven hundred forty four trillion, seventy three

billion, seven hundred nine million, five hundred fifty one thousand, six hundred fifteen, or over 1.4trillion metric tons which is over 2000 times annual wheat production today. Naturally, this would outstrip the ruler's resources.

A modern day example of compounding

Updated to modern times, the same hypothetical question is used to ask, “would you rather take $1m right upfront or a penny on day one, doubled every day until day 30?” Doubling every day for 30 days would yield $10m while doubling every day would yield $1m in 27 days. So, taking $1m upfront would make you look like a hero for 27 days! However, you would rue your lack of patience to net yourself $10m in the last three days of the month.

Lessons from this piece

Understanding a company’s competitive advantage (moat) and having the structures in place to value this advantage, is critical to generating market beating returns. We believe this is a more sustainable method of generating wealth for clients than attempting to guess economic cycles or responding to short-term economic noise.

Great businesses compound returns and can create outsized returns for investors – the art is recognizing which businesses might do this.

Temperament has an exponential impact on investment outcomes (compared to other means of alpha generation, namely, analytical, and informational advantages). Temperament allows us to forgo upfront gains (quarterly and even annual gains) in favour of compounding outcomes that may only show up further out on the horizon of adverse macro-economic factors.

Is a rand hedge stock strategy viable?

Marco Barbieri
Director SA Equities

As South Africa's medium term outlook has deteriorated, many investors have become increasingly vocal about having higher exposure to rand hedges. But does the available pool of locally listed rand hedges allow for a consistent and successful rand protection strategy? Historical returns and correlations do not seem suggest so.

Background

The past decade has been particularly difficult for local equities, with many investors becoming skeptical of South Africa's medium term prospects. Locally sensitive sectors, such as retailers, financials and general industrials in particular, have borne the brunt of a deteriorating macro environment. Only a handful of "SA Inc" stocks have done well by taking advantage of regulations, innovating and exploiting opportunities that have emerged from government's failures to implement policy (e.g. energy, logistics, schooling).

Rand hedges, which are companies whose earnings are linked or denominated in hard currency and thus "protected" from adverse rand movements, have fared much better. As investors have become more bearish of South Africa's outlook and by implication the trajectory of the rand, many have become increasingly vocal about having higher exposure to rand hedges in their local funds.

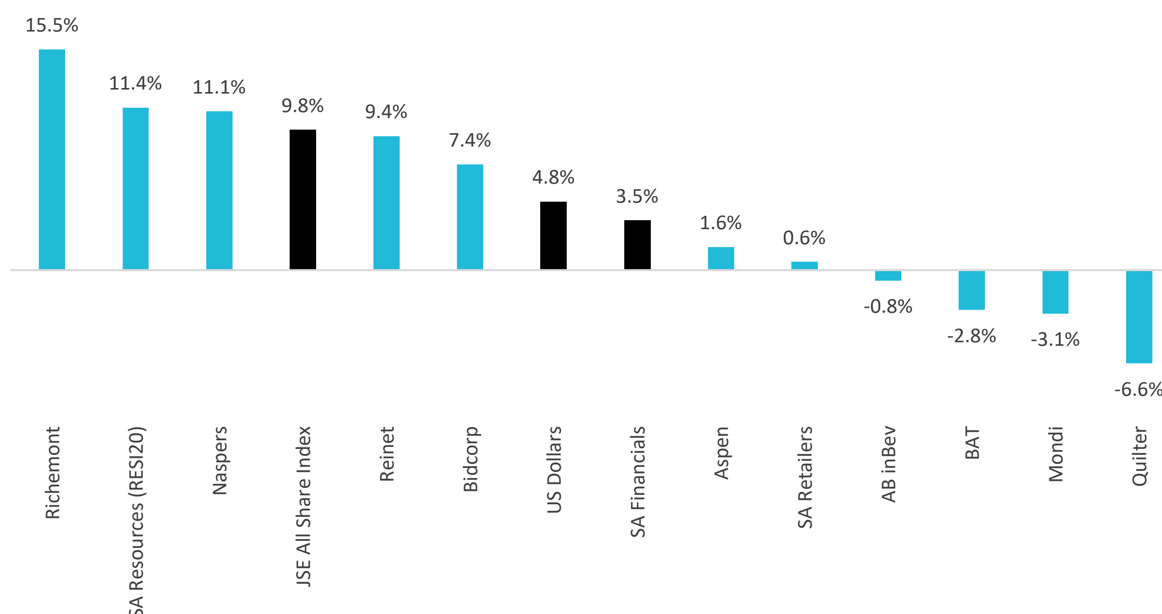
But does the available pool of locally listed rand hedges allow for a consistent and successful rand protection strategy? Historical returns and correlations do not seem suggest so.

Opportunity set and historical performance

The availability of rand hedges in the local market is limited and in the Top40 universe, excluding resources, there are less than ten stocks that are plausible candidates (highlighted in blue in Chart 6).

Over the past 5 years, the rand has depreciated annually against the US dollar by 4.8% and against the euro by 3.3%. This should have been a significant tailwind for these stocks, particularly when we consider that the JSE All Share Index, over the same period, has returned 9.8% per annum. However, with the exception of the resource index, Richemont and Naspers, which have fared well over this period, returns in rands have been mixed and not particularly impressive for half of the non-resource set of stocks, which also come short of beating a US dollar cash index and thus "hedging" the rand.

Chart 6: 5-Year returns, annualised (rands) (to 31 October 2023)



Source: Bloomberg, Northstar AM – Rand hedges are highlighted in Blue

Furthermore, when we consider the performance of these stocks against global indices, the outcome is also not particularly different with only Richemont outperforming the MSCI World Index in US dollar terms. Whilst we are not debating whether rand hedges should be competitive against their global indices, it is also worth noting that all charted stocks in chart 6 have underperformed their respective MSCI global peers groups in US dollars over 5 years.

Rand correlation - Do rand hedges do their job?

While rand hedges benefit, in rand terms, from a depreciation of the currency, this effect does not appear to be the main driver of share price return for local investors.

A correlation analysis of share price movements and the USDZAR reveals that while the SA financial and retail indices exhibit a statistically significant positive relationship with the rand, interestingly, the return profile of all above mentioned rand hedges is not explained by rand movements. The implication is that, while the currency has been a tailwind over the period under consideration, it has been a smaller driver and component of share return.

Finally, as resources make up the bulk of JSE's rand hedge universe and a potential integral part to a rand hedge strategy, it is also worth noting that the correlation of the rand with SA resources tends to be complex and non-stationary. Although the JSE Mining Index return performance over the past 5 years is broadly uncorrelated to the USDZAR, over time the rand tends to exhibit positive correlation to commodity prices and thus not always ideal for rand protection strategies.

Why own rand hedges?

In our opinion, whilst it is hard to construct a currency protection strategy from the current available pool of stocks, we believe that there is a strong case to be made for many of these investments on a stand-alone basis. Based on our work, we note that the uncorrelated nature of many rand hedges to locally sensitive stocks is an attractive characteristic from a diversification perspective. And finally, although our work suggests that many resources are offering a better medium term entry point, particularly after a difficult year for many commodities, we think the opportunity remains more attractive for higher quality non-resource rand hedges such Reinet, BAT, ABinBev and Bidcorp.

Meet the team

Jorge Haynes
Chief Operations Officer, First Avenue

When did your interest in financial markets start?
During high school, seeing television programs and movies about Wall Street and watching the financial indicators being read on the news I developed a curiosity around what all this meant and how it worked. This piqued my interest to learn about it and I realised that people make a living investing, which was different to normal jobs, like lawyers, doctors etc one is told about at school. What further interested me later, was learning about human behaviours that drive the markets and world around us.

What did you study and why?
I started with a B.Com degree in Economics, as I felt Economics would provide the broadest understanding of financial markets and it is also a study of human patterns on a holistic scale. To further deepen my knowledge in the financial markets I enrolled for a postgraduate degree in investment management. After gaining work experience for a couple of years, the logical next step in my personal development was to complete an MBA.

What do you think equips you to do this job properly?
Having technical knowledge is a requirement to not only fulfil job responsibilities but also drive the business to the next level. On a personal level, having a good dose of curiosity and being a lifelong learner have been invaluable as markets, systems, and the regulatory environment are all very dynamic, complex and rapidly evolving, driven by technology.

What do you love about investing?
Investing has indirectly exposed me to multiple industries rather than being in a single job and industry: for example, you get a look into the world of resource companies, hospitals, retailers, luxury goods, car manufactures and very few jobs provide that breadth and depth of knowledge gathering. To add to this, markets are constantly changing, removing monotony. Investing successfully can lead to financial independence for ordinary people.

What do you find the most challenging part of your role to be?
Many factors in the world influence markets so there is constant change, the industry itself is highly competitive with both local and global players competing for the same clients across the globe.

Why do you think clients will do well at Northstar and First Avenue?
I believe the integrity and honesty with which the team engages amongst themselves, is the same ethos adopted when it comes to managing our clients' lifesavings – everything we do aims to deliver best results for our clients.

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