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Emerging Markets Confront Political Hurdles in the Near Term

Adam Sparkman
Welcome to another episode of Away from the Noise. Thornburg Investment Management's Podcast on key investment topics, economics and market developments. I'm Adam Sparkman, client portfolio manager at Thornburg, and I'm joined today by Josh Rubin, portfolio manager of the firm's emerging market equity strategies. Welcome, Josh.

Josh Rubin: Glad to be with you today, Adam.

Adam Sparkman
So, Josh politics often have wide ranging implications on equity markets. But in many ways, 2022 has especially felt like a headline filled year. With a lot percolating right now, I thought it would be interesting to get your perspective on the current political landscape around emerging markets. Let's start with Brazil. It's the largest economy in Latin America and the fifth largest country level constituent in the EM index. It's also been one of the most volatile equity markets across EM over the last couple of years. What role, if any, has politics played in the elevated levels of volatility that we've seen since 2020?

Josh Rubin
Adam, that's a good question and I think it's important to break it into a couple of pieces which are both key to looking at the past but also understanding the future. The Brazilian economy really has two parts. One is the private economy that's domestically oriented and the second is the export related economy, which is much more about natural resources.

The export-oriented economy naturally tends to be more cyclical because it relates to oil prices, iron ore prices, the trajectory of the Chinese economy and so forth. Over the last several years, we have seen a lot of volatility in share prices in that area, because of COVID and because of the stop and start nature of the Chinese reopening.

That's something we have to deal with, and which is outside of the control of the general Brazilian population or the Brazilian government. On the domestic side, that is a very vibrant economy. It's consumption oriented. It has also had the ups and downs of COVID, COVID reopening and so forth. But right now, we're seeing one additional factor, which is political uncertainty. Historically, the playbook for equity investors has been to be highly involved in Brazil during good times. But to step back, particularly going into elections. Usually, three to six months before a Brazilian election, you would want to deemphasize Brazilian investments in your portfolio because the political discourse would lead to a lot of uncertainty and create volatility in equity prices.

The current Brazilian president, like many politicians around the world, has seen his approval ratings decline over the last year or so because of the slow economic recovery from COVID.

In this election, politics got uglier about a year ago rather than the normal three to six months in advance. And that meant that equity investors have gotten frightened far earlier than in normal political cycles. I think we can add on to that. Inflation in Brazil has been rising similar to most of the rest of the world and just like in the rest of the world, there's been investor uncertainty about whether politicians would focus on inflation or focus on being reelected. So the result of that is the domestic side of the Brazilian economy has also seen unusual volatility in share prices because of this election that's coming in October.

Adam Sparkman
What impact do you think a regime change may have on Brazilian markets? Over the shorter to medium term?

Josh Rubin
It's funny because on one hand, we have this heightened investor fear about the election, but actually we have two very well-known candidates who are running, and both of them have a long history in politics and a lot of clarity about what they have done compared to what they have said they would do in the past.

The two candidates on the left is Lula, he was president from 2003 to 2010 and historically he'd always been known as a pretty leftist candidate. But when he governed last time, he was a left center president and had very pragmatic policies. Bolsonaro often called the Trump of South America. He campaigns from the right, but his policies have also been modestly right of center, as opposed to as extreme as some of his campaigning.

So, in either case, we would expect that the government operations remain pretty steady state that the regulatory environment or other elements where the government gets involved in the economy probably has high visibility. But the nature of the way they campaign has spooked investors so getting past the election will be important because that's when the true governing platforms will be announced.

Adam Sparkman
Given some of the economic and political overhang of the past couple of years, the MSCI Brazil Index is currently trading at more than a 50% discount to where it was pre-COVID. As we're getting more clarity around the upcoming election and feeling pretty comfortable with really either of the candidates from a policy standpoint, should investors be looking at Brazil, and if so, what sectors or segments look particularly attractive?

Josh Rubin
We do think Brazil is a very interesting market to invest in right now. And the reason is, as you said, number one, there should be a clearing event when we have the final election, and the winner is known. The second reason is Brazilian equity valuations do tend to be highly

correlated with local interest rates. And just like the rest of the world, inflation has been high, interest rates have been rising, and that has led to depressed equity prices.

However, somewhat different from the U.S. the Brazilian central bank has been ahead of the curve from the beginning. They began raising interest rates over 12 months ago, and there's real interest rates. So, inflation is around eight to 9%, but interest rates are over 12%. We would expect that equity valuations should begin rising as interest rates begin coming down. And in general, it seems that interest rates are likely to begin declining in Brazil by the middle of 2023 maybe a little earlier, maybe a little bit later. But certainly during 2023. What the Brazilian economy has done is show it has the capacity to grow and for earnings to grow for the companies even in this high interest rate environment.

So, we think that in the nearer term you can own Brazilian equities for the underlying earnings growth and over the medium to longer term you can own Brazilian equities for the opportunity for valuations to rise.

Adam Sparkman
Staying within the region. Chile is another Latin American economy that's made a political pivot during their last presidential cycle. While it's a relatively small constituent within the EM index, it seems like their upcoming constitutional referendum may have further reaching effects than some investors realize. Could you walk us through some of the possible implications?

Josh Rubin
Absolutely. The first thing is, on one hand, we are having a constitutional referendum in 2022, but it's actually the result of a number of years of evolution in Chilean politics and really 40 plus years of evolution in the country. So, in 1980 Chile wrote a new constitution. At the time the country was still governed by a dictator, General Pinochet, and the idea was how could the country migrate from a military regime to a democracy.

On one hand the constitution has been very successful. It did allow the country to migrate to democracy and on the other hand it's outdated. In 2018 it's hard to remember pre-COVID days, but in 2018 there were actually protests in a number of countries around the world about the affordability of things like public transportation, health care and other services for the middle or lower classes. And Chile was not immune to that. The result was that in late 2018 the government decided to form a new constitutional convention that would take its time to rewrite the Chilean constitution to be modernized for the world of today. This included a number of elements both about civil rights, human rights and so forth. It also included the ways that the government will exercise oversight or earn royalties for mining companies in Chile.

So, the constitutional convention completed the final document in July and then we'll vote on that at the beginning of September.

There are a few implications from this. Certainly, in the domestic economy, there'll be long term implications for affordability of basic services and general consumption. But the mining side is probably more interesting to most investors. This is because Chile is about 20 million people, but it actually produces nearly one third of the world's copper and almost a quarter of the world's lithium.

Lithium, as in what's used for cell phone batteries, but also electric vehicle batteries and similar uses. So, we have this one tiny country where mining companies have been afraid to invest for nearly five years because they had political uncertainty about the new constitution along with COVID and now they're trying to make final decisions as the world needs more copper and lithium.

If we just step back for a minute, in 2022 alone, we have probably seen a meaningful acceleration in demand for copper and lithium. The reasons for this are twofold. Number one, if we think about Europe, they are now highly motivated and are willing to spend the money to transition away from Russian gas dependency toward other sources of energy and the main additional source of energy they have is renewables. This means they're going to need to build more wind farms, more solar farms, and to do that they need more copper.

Secondly, around the world, the situation with Russia has reminded a number of developed market governments and emerging governments that oil prices are uncertain and electric vehicles are a way to wean different economies off of oil. This requires more lithium.

So, we're at a point in time where demand for these key resources produced in Chile is accelerating. But the supply has been stagnant because companies have been totally uncertain about the political outcome and the economic reopening story. Consequently, whatever the price of copper is this year or next year, you should have Chile to thank for it. Because of Chile's importance in the global supply chain.

Adam Sparkman
So, turning to China, regulatory induced uncertainty, especially around segments like I.T, e-commerce and health care have been an overhang for markets really since last summer. Coupled with the ramifications of the zero COVID policy we've seen this year; some investors have begun to question the investor ability of the world's second largest economy. As far as political clarity, where do we stand today regarding China and how has your approach to investing within the country changed in light of the last couple of years?

Josh Rubin
Well, there's no doubt that on the economic front, Chinese growth has been disappointing for the last year. We do think that there are a couple important ways that the Chinese economy can re-accelerate as we get into 2023 and beyond. The first, which is not political, is simply the slow and somewhat painful process of reopening in China.

We have been surprised by the degree of the zero COVID policy creating two steps forward and one step back, or even sometimes two steps back for economic reopening in 2022. But slowly and surely, they do seem to be gaining clarity that they can reopen.

The second element is just like we talked about for some of these other countries and investors not liking uncertainty, domestic corporates in China also don't like uncertainty and they have faced some uncertainty because of the zero COVID policy. But they faced a lot of uncertainty because of these policy issues you just mentioned around regular regulations in the IT space and others.

We've seen a deceleration in activity or news flow around additional regulatory issues for these sectors over the last several months that that's a positive. But you never you never know until it's really clear. But we think what's happening is in October of this year, the Chinese Communist Party will hold its election where the strong expectation is that President Xi will be reappointed for another term. Once that has happened, we think the government will be ready to create a lot more clarity and longer-term visibility about a variety of policies impacting many parts of the economy, the sectors that you mentioned, as well as property development, banking services, et cetera.

As long as corporates and consumers have visibility, we think that should allow animal spirits to return within China. It may still be two steps forward, one step back because of COVID, but we think we just need to get through October, and that will allow the general political administration, along with the announcement of policies that do help re-accelerate the economy.

Adam Sparkman
Given Russia's invasion of Ukraine, implications surrounding the China-Taiwan relationship have certainly gained attention. The US diplomatically acknowledges a one-China policy, but Speaker Pelosi's recent visit to Taiwan seems to have fueled additional tension. From an investment perspective, how do you navigate this situation when considering companies either domiciled in or doing business with Taiwan?

Josh Rubin
There's no doubt that Speaker Pelosi's decision to go to Taiwan created a lot of political complexity. But although we've just been talking a lot about politics and markets intertwining, Taiwan is a market where it's important to think of the actual fundamentals of the businesses more than just the politics.

Most companies that are based in Taiwan are not driven by the local economy. Their global businesses or part of global supply chains. So as we look at Taiwan, of course, we do want to make sure there's stability in the political backdrop. But what's more important for us in thinking about Taiwan is what the global backdrop looks like for the relevant supply chains.

We view this year's selloff in Taiwanese listed stocks as being much more related to investor fears about a downturn in semiconductors or the global industrial sector than investor worries about U.S./Chinese political tensions.

When we think about investing in companies in the Taiwanese market, we do think about the security of the supply chain and the risks to both their customers or their upstream suppliers. So as we think about some of the issues being highlighted in the news, we're considering whether Taiwanese companies are choosing to build new capacity off the island, whether it's some of the discussions about semiconductor plants being built in the United States, but owned by a company domiciled in Taiwan, or whether these companies are doing business in China. There's actually very vibrant trade between Taiwan and China, and those companies are likely to still do OK, even if U.S. and China tensions over the island are heightened.

Adam Sparkman
Shifting gears for a second to a truly global political issue. Despite the U.S. pulling out of the Iran nuclear deal in 2018, there's recently been some momentum to revive it. What impact, if any, do you think a deal may have on emerging market equities?

Josh Rubin
Another complicated question, Adam, but I'll do my best to keep it simple. Iran, as a country or as an economy has a very negligible impact on emerging market equities.

But what's important is before the original nuclear deal was signed, Iran was producing about 3.3 million barrels per day of oil. And after it went into effect, it was producing about four and a half million barrels per day of oil. Today, it's back to about 3.3 million. So, if a new agreement is signed, the world should very quickly see additional supply of a million or so barrels a day. In a world of $90-$100 oil prices that could be beneficial to American consumers, emerging market consumers and so on.

One thing to consider is it's also coming at the time that the U.S. has been selling oil out of our Strategic Petroleum Reserve to the tune of about 1 million barrels a day. So, we might have something of a net neutral supply demand balance because sales from the SPR will end while the new Iranian supply will come back on.

But overall, our view would be that an Iran nuclear deal helps protect U.S. and other global consumers against even higher oil prices. But it doesn't really change the economic dynamics or other political dynamics in various parts of the emerging markets.

Adam Sparkman
And what's your outlook for the Middle East more broadly?

Josh Rubin

When we think of the Middle East more broadly, we've seen two major changes this year. The first is within emerging markets the Middle East has grown from roughly 4% of the index to about 8% or 9% of our investable universe.

This has two causes: one is that Russia was removed from our index. And the second is as oil producing countries, most of the Middle East has a currency pegged to the U.S. dollar. So, while the dollar has strengthened this year, so have Middle Eastern currencies. When we look forward, we think these economies are pretty stable. They obviously have good trade surpluses. Domestically, they're trying to improve their vibrancy in the consumer economy or in parts of their infrastructure or industrial economies. So, we think that the Middle East is increasingly a more interesting place to invest overall.

Adam Sparkman
So, we've talked a lot about areas of political uncertainty around emerging markets, but I thought it may also be helpful to highlight some areas where you're currently seeing more stability from a political perspective. Are there any markets where you feel especially good about the level of political certainty?

Josh Rubin
There are. Both the challenging element of investing in emerging markets, but also an important thing to recognize is there are over 20 countries in emerging markets. We've only talked about a few of them, but most of them are in fact pretty stable. Sometimes that's because elections happened recently, and we do have visibility. Sometimes that's just because the uncertainty during COVID or in this higher oil price environment still really hasn't challenged the status quo in those countries.

I think Southeast Asia overall remains fairly stable and predictable, and those economies seem to have weathered the rise in energy prices or some of these currency dynamics pretty successfully. Other parts of Latin America, like Mexico or even surprisingly, Peru, have done well. Peru does have an uncertain political situation, but the good news for them is they always have an uncertain political situation. So, it's sort of status quo for them as well. And when we look at Eastern Europe, although it's right on the border of the Russia / Ukraine war and it's dealing with Western Europe's challenges, Eastern Europe appears to be pretty predictable also. So, Adam, if we step back to the whole emerging markets, both political situation as well as economic or capital market situation today, what's interesting is, yes, there are areas of uncertainty, but this is how emerging markets go.

What we're used to is that developed markets have high predictability and high certainty. And that's what's been very confusing to global investors in 2022. But in emerging markets, there's always one or two or three countries that are really surprisingly either to the downside and others that are surprising to the upside. And a year of discombobulation like 2022 is very normal for emerging markets.

That's why we actually think corporates are able to be nimble and adjust to the current situation as well as countries are because there's always something going on in emerging markets. And even with uncertainty or unpredictability, emerging markets tend to be able to continue growing and the best companies tend to continue to be winning even in times of uncertainty or when it feels scary to develop market investors.

Adam Sparkman
Really, to your point, emerging markets almost by definition carry a higher level of political uncertainty than developed markets. On a global level, though, Russia, Ukraine, inflation, tightening economic conditions, et cetera, have driven an elevated level of uncertainty broadly across both developed and emerging markets in 2022. Given everything going on right now, how do you feel about the current political risks across emerging markets relative to those in more developed markets?

Josh Rubin
I'm biased in answering this, Adam, but often we talk about the promise of emerging markets as being the ways in which they will evolve toward developed markets. Something we don't often talk about is the risks for developed markets moving toward emerging market issues.

Something the world is seeing today is that there were a set of developed markets, primarily Western Europe, that had a dependency on low energy prices, and they thought the status quo could hold. Emerging markets have had those same issues in the past, and that's led to huge uncertainty and volatility for emerging markets. So that's what we're seeing instead for developed markets this year.

When we look forward, we actually think this is the norm for emerging markets. There's always a surprise happening and good emerging markets or good emerging markets companies or good emerging market political leaders understand the need to adapt and be nimble while marching forward. But it's not as clear that some developed market countries or companies are able to be as nimble. So that's something we need to figure out as global investors inn the coming years.

Something that we see in emerging markets, and I'm not sure that it's as evident in developed markets, is emerging markets still have a lot of relief valves. Let me just give you one example. Indonesian consumers absolutely suffer from high energy prices, but Indonesia also exports a lot of coal and palm oil and other commodities that have been positively impacted by rising oil prices.

So, the Indonesian government is using those excess royalties to subsidize energy prices for the consumer. This is keeping the consumer economy strong. It's tamping down on inflation and it's allowing the Indonesian economy to continue growing even to this tough spot. A lot of emerging markets have these types of, as I said, relief valves or ways to mitigate the uncertainty.

So, when we look forward, we thought 2020 was going to be a year where emerging market economies accelerated, COVID got in the way of that 2021 began the acceleration and then the invasion of Ukraine also decelerated it. But in the 2023 we do expect that emerging economies around the world still have the chance to be accelerating.

Not all of them are negatively impacted in the same way as developed markets by some of the current issues we've been talking about. So--, we remain very positive on the outlook for emerging markets, even in an uncertain world.

Adam Sparkman
Well, thanks, Josh. It truly sounds like the case for emerging markets is delayed but not canceled.

Josh Rubin
Adam, I really appreciate the chance to talk about these subjects. None are easy, but they're important and they are key factors for investing in emerging markets today.

Adam Sparkman
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