Fidelity Compass

Is the Emerging Market Thesis Broken?

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Pamela Ritchie, Host

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Pamela Ritchie: Hello and welcome to Fidelity Compass. I'm Pamela Ritchie. Historically, emerging markets have presented strong opportunities to capture high returns in fast-growing regions. But with ever present challenges facing the global economy, including growing geopolitical risk, inflationary pressures and a bit of a slowdown in China, many are wondering if this thesis still holds true. Given that different regions have varying investment risk, what is the best way for institutional investors to invest in the emerging markets? How will consumers in emerging markets be affected by higher inflation and rising rates? To share his insights and to discuss the path forward for emerging markets, we're very happy to be joined by portfolio manager, Amit Goel. Amit is based in Singapore and has over 15 years of experience covering emerging market equities. He is a member of the Global Emerging Markets' team and he manages several emerging markets strategies. I had a chance to speak with him just a little while ago. Amit, hello. Welcome. Great to see you. Thanks for joining us.

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Amit Goel: Hi, Pamela. I'm glad to be here and thanks for having me here.

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Pamela Ritchie: We're absolutely delighted. The time change is just going to make for an ever... we'll all wake up and sort of go to sleep at different times, but that is the nature of being across the world while we discuss this. Tell us a little bit about traditionally, and I mentioned it a bit there in the intro, what was, what is the thesis for those in developed markets who need exposure outside? What is sort of the EM thesis? How would you describe that?

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Amit Goel: First and the foremost, I would say when we speak is what EM, EM is not a homogenous market. It's not a single market called emerging market. It's a combination of various markets, various degree of evolutions, various segments and sectors. If you look at the map of the world, you can put a diagonal line from South Korea on the right-hand side top to Chile, on the bottom on the left-hand side, and you will come across so many countries at different level of evolution in their history, socially, economically, demographically. I would say EM, it's not just a homogenous emerging market. It's a combination of countries. It's like a salad with different colours, different vegetables, different foods.

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As a developed market investor, we should look at EM as an opportunity ground of choosing between different countries, different sector, different companies. I think that's what makes EM a very interesting space.

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Pamela Ritchie: It is very interesting. If we were to crunch it into something, it's the idea that there's potential for massively growing middle classes that will become wealthier over, what timeline, what are we talking about, over the next 15 to 20 years? That's one of the main growth pieces of the story, right?

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Amit Goel: Absolutely. Even if you go one layer down when you talk about a growing middle class, this middle class is very different across different emerging markets. China, where we talk about middle class, it's actually not middle class, it's upper middle class. I'm talking about people who are earning more than 25,000 U.S. dollar disposable income every year. The number is 100 million in China. This 100 million number is going to grow to 300 million people in 10 to 15 years' time, so you're going to have a U.S. within China in terms of consumption. If you come to India, it's a very different middle class. It's a middle class which is really shifting at the middle or bottom of the pyramid. These are people who are earning 2,000 to 3,000 disposable income per year and you have 300, 400 million of these people and they're going to grow their earnings from 2,500 to 5,000 over the next 10 years. So, it's a very different middle class. These are very different people in terms of their evolution. They will use different products and services.

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For example, in China, we are very much focused on what these wealthy Chinese consumers are going to use products and services, what are their aspirational brands, how are they going to spend? In India, when a consumer is now going from lower middle to upper middle, they will get financially included, what kind of financial products they will buy, how they will leverage, they will buy more houses. So, it's a very large middle class. I've just spoken about two large countries, but this is the same situation across countries like Indonesia, Brazil, South Africa. Varying degrees of middle class, different people, different cultures. I would say, again, it's a large middle class, more than a billion people, but very different in their evolution across this whole middle-class spectrum.

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Pamela Ritchie: On that evolution, tell us a little bit more about what … I don't know if catch-up is the right term, but it does seem like India, also one of the most populous of the two most populous countries in the world, is going to somewhat catch-up to what China has done in terms of developing its own markets and creating wealth. What sort of catch-up do you think there will be in the years to come?

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Amit Goel: It's a very interesting question and a question which I always discuss with my clients or colleagues. India is exactly where China was roughly 20 years back. We have a playbook of China when we look at India, whether in turns of property market, whether in terms of how consumers will grow, what products and services they will use. But I believe that while we will go towards that thought, it is not going to be a very similar part as we have seen in China, given the political system is different, given the economic system is different. I would say India will be actually a more stable, more structured growth versus the risk that we have seen in China in terms of regulation, in terms of risk on growth driven by government activities, etc., risk on private businesses. India will be a more private sector structural growth. It might be slower than what China has done in last 20 years, but it is a more stable structure private growth that we will see in India.

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India, in my sense, Indian consumer present us the best kind of growth, structural growth, long-term opportunity in emerging markets. These are consumers, which are still, as I said, sitting at the bottom of the pyramid. If you see categories like car ownership, credit card ownership, air conditioning penetration in the country, we are talking about low single digit.

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Pamela Ritchie: Let's just hold on that for a second. Air conditioning, can we just talk about that for a second? That's massive, right, the growth potential. Can you just talk about that?

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Amit Goel: India has [indecipherable] million households. Last year, we sold 7 million air conditioners in a country which is very hot. By that context, China is selling 80 to 100 million air conditioners every year. India's disposable income per capita is only $2,000, so not many people can afford air conditioners. But it is not going to be a luxury product for most of the Indians given what climate conditions do we see. It will become a very hygiene and a staple product. As the country grow from $2,500 to $5,000, $6,000 GDP per capita, you will see a massive [indecipherable] in air condition penetration. So, again, that's the one segment where we can easily see the 7 million air conditioners sold last year to go to 40, 50 million air conditioners every year in 10 to 15 years' time. As investors, we are very much focused on which brand consumers are going to use. Are there companies which can be as large as some of the companies in Chinese electronic space, which we have seen, we have owned, we know how these businesses can grow. What are the similar opportunities in India?

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More importantly, India doesn't even have an ecosystem and a supply chain who manufactures so many air conditioners and they are developing one. Any good company in the component side, in the OEM side, which can manufacture air conditioners for brands, I think this is a massive opportunity. Air conditioner is one but you can look at autos, you can look at other consumer appliances; the story could be very similar.

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Pamela Ritchie: It's very, very interesting. A concern for most investors has always been a set of standards of reporting, of understanding governance, of understanding how companies can report and perhaps in a lot of cases, companies to invest in that do not have a lot of government involvement in them. Where do you begin? How do you manage things and how, ultimately, do you look at companies for quality reporting and governance?

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Amit Goel: I spoke to you about this structural growth in emerging markets, in parts of emerging market. Every and any business I look at and I want to own in my portfolio, you start with governance, because you can make any model on companies with long-term structural growth, 10 to 15% compounding for the next 10 to 15 years, which means business can be four or five times bigger than what they are. But if they are not managed by trustworthy people who you can trust with your own capital or your client's capital, I think as shareholders, we are not going to get that benefit. So, governance becomes a very important part of our investment thesis on each and every company that we invest into and more important in emerging markets because as you rightly said, reporting standards can be very different. Most of the companies might use local auditors where we are not able to verify or trust numbers.

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As investors, we try to go and meet them in their premises to see company [indecipherable] but we can still see a lot of governance issues. I think for us, governance becomes very important. When we talk about governance, we put a lot of focus on what has happened in the past. We don't try to predict the future. See what are the past actions of these management teams? Have they been aligned to minority shareholders?

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Pamela Ritchie: How far past do you go? I'm just curious. It depends how old the company is, but do you look at the company over a period of years before you invest?

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Amit Goel: It's a mixture. There are companies in the portfolios that I have been looking at for 15 years, throughout my investment career and I still learn new things about them every quarter. Typically, I would say, we spend a lot of time in understanding their business, their governance, we look at the last 10, 15, 20 years of history as much as available to start investing. We are not the kind of investors where we will meet a company, we like it and really jump into the stock. There is a lot of groundwork which is being done on each and every company. Again, when we buy businesses, it's not that we buy them in large acquisition size at once. Each of us as analysts or portfolio managers, we are limited in our knowledge. There are so many things about businesses that we don't know or understand at the first go. So, it's all about getting experience with those businesses, talk to the supply chain, talk to their competitors, talk to their consumers. Where are the red flags? As you gain conviction in these businesses over years, that drives your larger position size and conviction to own them for longer duration.

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Pamela Ritchie: Very interesting. Do all companies have to be, or are they, or do they happen to be within the benchmark or is that not necessarily the case?

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Amit Goel: Absolutely not. First, I would say emerging market is a very wide benchmark. You have more than 500 companies in the benchmark. There are some large companies, they happen to be largely government-owned companies in countries like, for example, China. They happen to be large tech companies like Alibaba or Tencent. In general, we are quite averse to owning government companies and we see regulatory risk on some of these large tech companies, but if you go below that, it's a very fragmented benchmark. As investors, which are very much focused on governance, quality of businesses, long duration of growth, I think we have been narrowing down our universe of investments. We just want to choose 40, 50 great businesses that we trust. They might be part of benchmark, they might be completely outside benchmark, but even if they're part of benchmark, given it's a very fragmented benchmark and they are small part of benchmark, I think emerging market gives us a lot of opportunity to run active money. We've been running close to 80% active money for a very long duration in our portfolios. I think we could easily kind of run 75, 80% of active money. It's a market where you can run off benchmark and active money.

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Pamela Ritchie: I wanted to talk a little bit about China. We spent some time on India and there's a lot more to discuss about the Indian consumer and where it is and at what stage, but let's focus on China a little bit. China has been an extraordinary story. You've probably watched it closer than many. Its focus for investors, for savers was real estate. It really was. Other things were happening at the same time, their capital markets have been maturing for years, what's the direction from here, though? It's not real estate anymore. We're seeing that sort of slowly implode.

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Amit Goel: I think it's a very important time for China in this whole emerging market journey. First, I would again say I've spent a lot of time in China. I've been to more than 25 cities in the last seven, eight years. I've spent almost one week every quarter pre-COVID in China speaking to people. I started from India in my investment career, so going to China was very important as an emerging market investor to understand culture, to understand people. I would say it's a very real country contrary to what a lot of people believe. I've seen these large infrastructure projects being created in front of my eyes, large cities being created and I always think that China has done a very good job in alleviating a billion people out of poverty in 20, 30 years. That's a commendable job they have done. But, obviously, there are plus and minuses everywhere, and I think, in China, what has happened is that because the economy has been so tightly controlled and there has been so much investment on infrastructure on property side, which actually they needed, but what they have done is that they have surely created excesses in places where they found them as a very important tool of sustaining that growth target, which was driven by top-down. That has meant that they are heavily invested in manufacturing infrastructure, property, it's 60, 65% of the economy, so consumption continues to be lower part of the economy.

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But what China now wants is to change this mix from property infrastructure towards more consumption and services. Obviously, these are not two-year, five-year changes. These are multi-decade changes. But I firmly believe that China as a system wants to achieve this change. What would that mean? What they, I believe, want is that slow glide path to their property and infrastructure sector where they are happy with zero growth or low single digit growth, but they want consumption to grow high single digit, 8 to 10%, and that can drive this change over very long period of time.

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The problem with that is that what is their ability to manage both rates in tandem for a very long period of time and whether we will see a big slowdown or a cliff in sectors like property. Obviously, we saw a big slowdown in property late last year. Numbers were anywhere between -10 to -20 and they are continuing to be this weak. And there is all kind of presumptions from market that China will stimulate the economy to stabilize property market, to stabilize infrastructure side, but my view is that China would actually want property to be weak for medium to long term, but just control it so that it's not a systemic risk. But this shift is very inevitable.

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Pamela Ritchie: To what extent will the so-called green economy take over?

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Amit Goel: Green economy, I think is a very different aspect of Chinese economy as well. Obviously, China has given a very long net-zero target, but China is also in a way, as we say China's [indecipherable] to the word, China is also a major part of green economy supply chain across the world. Whether you talk about electric vehicles, whether you talk about solar energy, whether you talk about wind energy, whether you talk about the supply chain across these three alternative energy areas, 70, 80, 90% of global supply of components, of materials, of battery, of solar panels, comes from China. Chinese companies are competitive on scale, competitive on technology, so I think China will remain a very large part of this green economy, not just in China, but globally also. Again, this will throw opportunities for us as investors where we can buy good companies, which are scalable businesses, which are competitive on technology. Again, we need to make sure that we are at the right people in the right business segment, but I think green economy, not just for China, China will be a very important part of the global supply chain on green economy.

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Pamela Ritchie: Are you worried when you look at issues like the ADRs and other types of auditing that was demanded and actually given in, ultimately, for Chinese equities to trade overseas in the U.S.? Are some of the regulatory changes and regulatory risk ... how do you navigate that?

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Amit Goel: First and foremost, I would say regulation is a part of each and every Chinese business. It's a country which is driven by a particular economic system and every large business in China that you see needs to be governed by the government. This is not something new. We have seen this in sectors like property, financials, telecom. Any company which becomes too large, socially, economically, touches millions of people, I think you will see more and more regulation and oversight on these companies. As investors, we were always telling our clients to be cautious on some of these large tech businesses as well like Tencent, Alibaba and what we have seen the last two years. I think this was completely inevitable. These companies are too large and they touch millions of Chinese people. Everybody's kind of transacting or working with 700, 800, 900 million Chinese people and I think they have to be regulated. I would believe that this regulation will continue. Whenever, as investors, I look at China, regulation is a very important part where I judge businesses on and I want to make sure that we take as less regulated risk as possible in our investing.

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Pamela Ritchie: The first question when we used to speak about emerging markets, even a year or two ago, and the only question in some ... to be cynical ... would be, but what about the dollar? How fragile, versus maybe a few years ago, are the emerging markets to the strength of the U.S. dollar? Is it still the sort of red light?

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Amit Goel: There's no perfect answer to this question. What I would say is that we have all been discussing the fragility of emerging markets. They were called Fragile Five, Brazil, Russia, India, China, Tunisia, South Africa — actually not China but South Africa. What I would say is that if I compare the fragility of some of the large emerging market economies, they are less fragile than they have been in history.

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Pamela Ritchie: Why is that?

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Amit Goel: This fragility comes from two things. First, what are the level of inflation and interest rates these economies are carrying versus the developed market, for example, U.S.? And then you were speaking about dollars. If you think, inflation in this time is more of a developed world problem. You have seen inflation in U.S. at high single digit, developed Europe at high single digit, but inflation in different parts of emerging markets are different levels. North Asia is low single digit, 2, 3%. So, you continue to [indecipherable] monetary conditions there. South Asia, India, Indonesia is 5, 6, 7, but also the real rate differential is much, much lower than what it has been historically. U.S. is talking about five rates of 3%, but inflation of high single digit and inflation expectations coming down. Who knows what happens?

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But at this point in time, the negative real rate differential actually is the other way around. U.S. is carrying a bigger negative real rate, developed world is carrying a bigger real negative rate versus emerging markets. That's what you clearly see in currencies performance. Historically, taper tantrums, dollar strength, you will see emerging market currencies weakening a lot but in this round of taper tantrum we have seen, whether you are talking about Chinese yuan, whether you are talking about Indian rupee, Brazilian real, they have all been much stronger currencies than what they have been in the past. I am not saying that inflation is not a problem. Inflation is a problem and declining global growth is a problem. But I think the situation in emerging markets is much better versus what is has been in history.

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Pamela Ritchie: It's fascinating to see, as you say, there's an evolution of a number of different things. That's one piece of it. So, if you have to answer the question, is the EM thesis broken, your answer is?

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Amit Goel: I don't think EM thesis is broken and I think it never was because as I said at the start, you are looking at EM benchmark, which is not a homogenous benchmark. It's a very kind of heterogeneous benchmark. You can create a fund within EM which is very different to what the benchmark looks like. So, I think EM, I would say, would still remain a faster growth economy. EM, I think they have better competitive companies than what it had in the past. EM today are trading at the deepest discount to developed market versus their historical valuations. Your starting point in EM, actually better than what it has been in history, though you still carry a short-term risk of inflation and declining global growth. That said, finally, I would say, you still continue to see a very strong opportunity of running active money and active sharing EM that gives you an opportunity to create long-term alpha or where benchmark delivers. I think if you combine all these things, I would say EM is still a very good place for active managers to be in.

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Pamela Ritchie: Fascinating. It's great to have some time with you. Thank you for joining us, Amit Goel. Thanks for sharing your time and your insights.

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Amit Goel: That's perfect and glad to be here and good evening.

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Pamela Ritchie: Thank you very much. That's Amit Goel. And thank you for tuning in today. If you have any suggestions for future topics or guests that you'd like to see here on Fidelity Compass, please do share your ideas with us, we're always welcome to get those. Stay tuned for more Fidelity Compass webcasts in the weeks and months ahead. I'm Pamela Ritchie.

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