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Emerging Markets Q3 investment update

October 2024

Investment manager Will Sutcliffe and investment specialist John Rae give an update on the Emerging Markets Leading Companies and Emerging Markets All Cap strategies covering Q3 2024.

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John Rae (JR): Hello, my name is John Rae. I'm part of the Emerging Markets client team here at Baillie Gifford, and I'm joined today by Will Sutcliffe. He's head of the Emerging Markets Investment Strategy. He's also a partner of the firm. The plan today is to give you a brief update on the Emerging Markets backdrop alongside portfolio performance, positioning and also a bit of an outlook.

So Will, I know China has been certainly in the news the past couple of weeks. I think it was the best performing weekly return since 2008. So yeah, what's your views on this? Is there anything meaningful here?

Will Sutcliffe (WS): Yeah, thanks, John. Yes, sentiment on China seems to have been transformed. So I heard somebody talking about the ABC mantra and two weeks ago, ABC stood for anywhere but China. But now it stands for all in by China. Is it meaningful? Well, yes and no. The measures announced so far have been relatively incremental. We've had rate cuts, we've had a Politburo meeting at which the prospect of fiscal stimulus was raised, and we've had a few well-timed media leaks hinting at the likely size of any fiscal stimulus. But what we've not had is much detail, and we've certainly not had anything that's remotely analogous to the 2009 fiscal bazooka, 25 per cent of GDP that was mobilized at the trough of the financial crisis. And so a lot of commentators are dismissing the recent stimulus as a bit of a storm in a teacup. It's a temporary boost of sentiment, but it doesn't really move the macro dial. However, I would suggest that the degree of coordination of these announcements hints that something has shifted at the top of the policymaking apparatus. And that's why you've seen animal spirits being reignited in the equity markets. And remember the role of liquidity and momentum in Chinese stock markets in particular. And when you've got trillions of renminbi in savings sitting on the sidelines and waiting for a signal from on high that it's safe to get back into the water, then it doesn't take much for that rally to become self-fulfilling and self-reinforcing.

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JR: Okay. And so from what you've seen, does that give you cause to think about changes to any positioning in China?

WS: Well, I'll start with my customary reminder that our job isn't to predict the future or second-guess policy, it's to maximize our clients' exposure to parts of the market where we think we might have a differentiated view. And where we do have that differentiated view, it usually comes from looking a little bit beyond the time horizon of most other market participants. And China in recent years has been, we found it's been a bit of a conundrum in this respect, because of course, in the short term, everyone hates it. We keep hearing that the economy is a busted flush, and we keep hearing that there's no space for the private sector in Xi's China. But in the medium term, we have not believed that those issues are nearly as bad as they're portrayed. For sure, the Chinese economy has its problems, but it's also a walled garden economy where the normal rules don't apply and where policymakers do have greater space to address those problems. And while we think it is correct to worry about policy risk in segments of the economy, and it's increasingly clear that the finance industry is in the firing line, by the way, there are other sectors where we're more sanguine. So certainly when it comes to big tech and the platforms, SAMR, which is the state administrator for market regulation, they've made it clear that a line has been drawn in the sand and to use their terminology, the rectification phase is over and we're now in the supervision phase. So short term, sentiment's been very bearish. Medium term, muddle through a likely outcome. And that's why China has become so interesting from a contrarian investment perspective, if nothing else. But the problem you have is that the longer you extend that time horizon, the more challenging geopolitics becomes, regardless of who's in the White House. And I don't think we have any great insights there. So what all of that means is that we have been unashamedly index aware when it comes to our China position. We were underweight. We've been closing that underweight over the last year or so as sentiment appears to become increasingly disconnected from fundamentals. And we're now much closer to neutral. We still think there are large chunks of the Chinese market, particularly in the platform space, where valuations just look stupidly cheap, even after the rally, which, after all, has only taken us back to where we were at the start of 2023. But what's stopping us from going all in China? Well, it comes back to that long-term view and the fact that there are other parts of emerging markets where we simply feel our longer-term views are more differentiated.

JR: Okay, that's helpful. So if I zoom out to, I guess, the whole portfolio performance over the last three months, now I know it's very short term and how much this has changed over the past week or so, maybe highlights that fact. If I was to briefly summarize performance, clearly we've seen China perform well and our stock selection there has worked. We've seen just general global growth outlook has been a bit weaker. So energy and commodity names have been a bit softer. I think the biggest component of performance has been a pullback in semiconductor estimations, particularly in the memory space. And then just finally, India has continued to perform well, and we

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still have an underweight there. So to summarize all of that, the portfolio has performed well in absolute terms, but has lagged the benchmarks slightly. I know it's short term, but how are you thinking about all of that? And how does that influence positioning?

WS: Yeah, I think that's a fair summary. And I'd emphasize your first point. What the last quarter has shown very clearly is that value of taking a longer-term perspective. Because when the quarter began, investors were obsessed with the risk that the world's two largest economies were heading into recession. And now it looks much more likely that both the US and China will be heading into 2025 in easing mode. And as I said, our job is not to anticipate fluctuations in policy, it's to identify how, if at all, those shifts in policy will meaningfully affect the longer-term fundamentals of the companies that we invest in. Now, an environment in which both China and the US are easing is probably not a bad one for the EM asset class. And it's certainly true that our appetite for stodgy value preservation stocks remains limited. But that appetite is predominantly driven by the number of attractive and, in our view, deeply mispriced secular growth drivers that we're finding rather than any overarching macro view. So absolutely, we have stocks that are exposed to global growth, that people have been nervous about, for example, in the semiconductor space and the commodity space, as you mentioned. But in each case, it's the secular drivers that excite us more than the cyclical ones, whether that's electrification or data or artificial intelligence. And it's our faith in those companies' ability to execute through the cycles that gives us confidence. So what I would say is it seems absurd to me that the market is worried about cyclical slowdowns in copper, for example, when prices of copper remains below the levels required to incentivise new production. And it seems absurd to me that the market is worried that AI could be over when it's only just starting to move out to the data centres and into the mainstream economy. And when the companies that we invest in with exposure to those themes are themselves mostly trading on single digit or low double digit earnings multiples, it seems even more absurd.

JR: Okay, maybe just sticking with valuation, we've been saying for a few quarters now that India looks expensive. It's got more expensive this quarter. So how are we thinking about our Indian underweight? Is that likely to persist in the coming quarters?

WS: Yeah, I mean, India is a well-loved market and there are good reasons for that. It's an economy that should be capable of growing at a double digit pace in nominal rupees for many, many years before it has to start worrying about middle income traps. It's an economy that is relatively insulated from the problems of the rest of the world in economic and geopolitical terms. And it's an economy where, or a market I should say, where there's plenty of scope for valuation, however lofty to remain underpinned by relatively low levels of domestic and foreign equity ownership. So the question for us though, it's a relative one. What is our appetite for Indian mid-caps on 50 times earnings when growth appears so egregiously mispriced in much of the rest of our universe. So that underweight you mentioned in our portfolios, it certainly doesn't reflect any particular hostility to Indian equities.

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It's simply that we think we can get idiosyncratic growth elsewhere, names like Luckin Coffee in China or Kaspi in Kazakhstan, both on low teens earnings multiples for growth that's approaching near 50 per cent.

JR: Okay, that's really helpful. If I zoom out to the outlook for the portfolio, I think probably the key concern for emerging markets investors who are maybe sitting on the sidelines is geopolitics, it's trade tensions. In the last few months, we've had more tariffs come in. Do you think that presents an issue for the emerging markets asset class for the longer term time horizon?

WS: Yeah, I mean, we're watching tariffs. And so far, they appear to be unfolding along relatively predictable geopolitical lines. So Ottawa, recently, we saw following Washington in imposing 100 per cent tariffs on Chinese EV imports. But I would lay very good odds that most of Asia and most other emerging markets will not follow suit. So yes, there are risks, but there are opportunities. And for example, China now exports more to Southeast Asia than it does to the US, which is a massive change from five years ago. While people tend to focus on the risks of China exporting over capacity, there are huge economic advantages associated with that, most of which will be focused on emerging markets rather than developed markets. So cheaper capital goods and cheaper consumer goods from China is good news for hundreds of millions of new buyers across Asia and across Latin America. More broadly, I do think this perception that deglobalization is a bad thing for emerging markets. I think that's simply wrong. Because countries on both sides of the geopolitical divide will still need a lot of stuff. They will need critical minerals to bridge the transition to a renewable age. And they will need semiconductors to power the digital age. And they'll need lots of steel and lots of cement to build the new supply chains. And where are the biggest and the best and the lowest cost producers of this stuff? you know, they tend to be in emerging markets. And to the extent that this trade is increasingly happening in currencies other than the dollar, it's a game changer for emerging markets, because it liberates those economies from that historical relationship that has always been between policy in the US and financial conditions in emerging markets. So you no longer need to hold dollars throughout your supply chain in this new world of intra-emerging markets trade. And you no longer need to reinvest the proceeds of that trade into dollar assets. And that is potentially where your positive feedback loops really kick in for emerging markets.

JR: But just to wrap up, we've been banging the drum for emerging markets for quite a few quarters now. And forgive me for asking this question, but I was asked it just last week. What do we see the catalyst for turning sentiment towards emerging markets around, if we see one at all? Maybe we saw it last week.

WS: Perhaps. I mean, but as we've often said, picking turning points is incredibly hard. But anticipating the longer-term direction of travel, I think is more straightforward. And look, we've now had more than a decade of underperformance of EM equities and we've now had more than a

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decade in which emerging markets have had to learn to become self-sufficient and have had to get by without access to plentiful foreign capital. So what that means is that we're now coming from a point of bombed-out valuations and bombed-out sentiment where macro resilience has never been better and the calibre of companies has never been higher. And at some point, this all has to matter.

JR: Brilliant. Thanks very much, Will. And thanks, everyone, for watching.

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Emerging Markets (including Emerging Markets All Cap and Emerging Markets Leading Companies strategies)

Annual past performance to 30 September each year (net%)

	2020	2021	2022	2023	2024
Emerging Markets All Cap Composite	16.3	17.9	-35.8	18.0	25.5
Emerging Markets Leading Companies Composite	22.6	18.7	-35.2	15.8	24.5
MSCI Emerging Markets Index	10.9	18.6	-27.8	12.2	26.5

Annualised returns to 30 September 2024 (net%)

	1 year	5 years	10 years
Emerging Markets All Cap Composite	25.5	5.5	5.6
Emerging Markets Leading Companies Composite	24.5	6.4	6.1
MSCI Emerging Markets Index	26.5	6.1	4.4

Source: Revolution, MSCI. US dollars. Returns have been calculated by reducing the gross return by the highest annual management fee for the composite. 1 year figures are not annualised.

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