Emerging Markets - A foreground of differences & a background of similarities

This weekly comment is being written from Brazil, an emerging market that we have previously owned in our private client portfolios through the Findlay Park Latin American Fund (now part of the recently established Brown Advisory Latin American Fund) but not one we currently hold.

My last visit in 2018 was shortly before the October elections, at the time investors were nervous of the outcome and, as with most clients in emerging markets, were caught somewhere between optimism and despair. Moreover, the “Car Wash Scandal” that saw former president Lula put behind bars, accompanied by domestic strikes over pension reforms, were weighing heavily on the local economy and an already weak currency.

Wind forward a few months, post President Jair Bolsanaro’s appointment (known somewhat stereotypically as the Tropical Trump), the Bovespa (equity market) Index is up 12.80% year to date and the Real has strengthened to BRL 3.81 versus USD from a pre-election low of BRL 4.20 (still someway short of the 3.25 levels from Q1 2018).

Primarily my time in Brazil is spent updating clients on their portfolios. We’ve been looking after clients here for a few years now and have started to learn that, as they have to tolerate high levels of volatility domestically, they seek from us stability, capital preservation and importantly diversification across non-Latam markets.

My time spent here has also afforded an opportunity to see some impressive businesses, that, were they domiciled in a developed market, would be contenders as top 100 companies. Take Natura (Brazil’s number one beauty brand) as a case in point; their premises are state of the art, their approach to ESG throughout their business is exemplary and they have recently acquired and started to revolutionise the Bodyshop (Emerging Markets investing in Developed Markets – a recent theme, discussed later in a Chinese context). Yet, despite that, they face significant headwinds domestically with counterfeit goods and supply chain disruption having a material impact on profits.

In preparation for the 30 client meetings scheduled for this week, one topic of conversation is likely to be prevalent here - not the dreaded B word, which is somewhat inconsequential for non-GBP thinking clients that have maybe a maximum of 5% exposure to UK markets. That subject is Trade Wars. Brazil has been a net beneficiary from the Chinese tariffs on US soybeans in particular, with predicted at 75.5 million tonnes in 2018-19 according to USDA estimates. The USDA also forecasts that soybean planted area will rise 3% to 36 million hectares and production to reach a record 123 tonnes .

As our Chief Investment Strategist, Joanne Baynham, constantly reminds our Investment Management Committee, however, the battleground in the Trade Wars is most materially being played out in the fight for dominance of global technology markets.

On a call last week with a German expat client (working in a senior position for a large MNC), who has been living in Brazil and has recently moved to China, I took the opportunity to ask how the Chinese perceive the Trade War. His comments were illuminating.

“China is monitoring absolutely everything domestically and wishes to do so globally”

“China has a super long-term game plan for a 1000-year dynasty and is quite content to see out the next 2 years of short-term tariffs under Trumpism, their near term goal as part of Xi Jinping’s Belt and Road initiative is to build out their global infrastructure both through technological dominance and investment (both through equity markets and debt dependence).”

The more long-term lateral thinking readers may also wish to follow closely the developing story around Italy seeking loans from the China-led Asian Infrastructure Investment Bank - a sure signal of long-term intent and a further notch in the Belt and Road initiative.

China A-shares and Variable Interest Entities

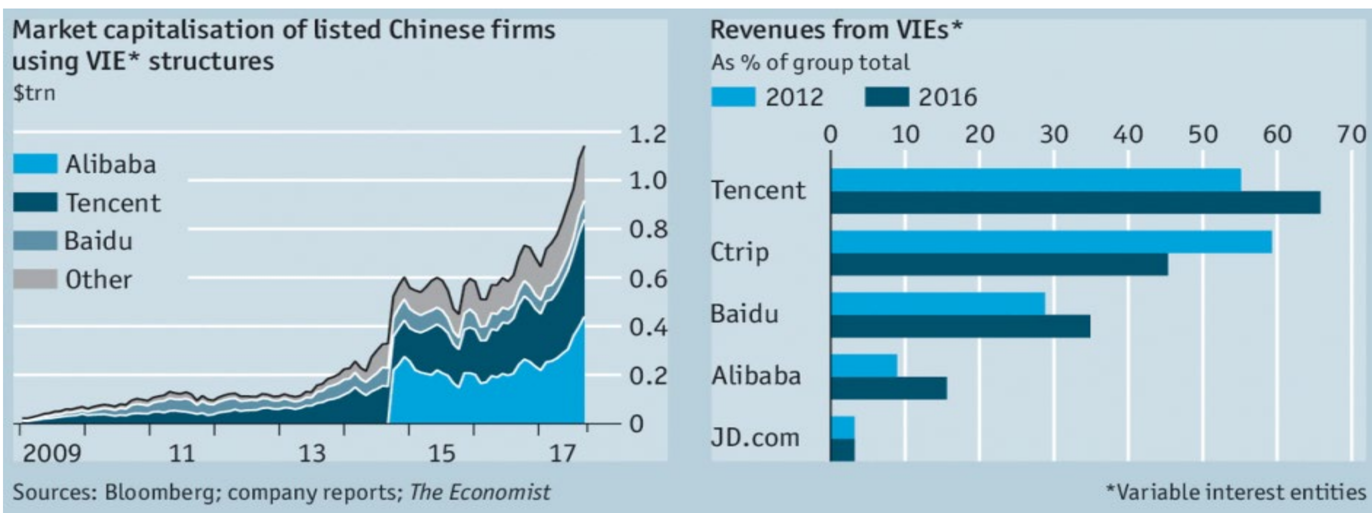
FT readers may have noted the article 'MSCI/China A-shares: weighty matters' on page 24 of this past weekend's publication. Without repeating it ad verbatim, it highlights that 'Foreign net inflows this year to mainland listed A shares, at $22Bn, are already half 2018's total' and that consequentially MSCI has decided to increase the weighting of Chinese equities in its emerging markets index than it expected.

However, all is not what it seems on the surface. Why might this be troubling to a bearishly pre-disposed thinker? For one, my favourite soundbite from the US this year so far is not from President Trump, but rather Treasury Secretary Steve Mnuchin, who has stated that the extradition of Huawei CFO and the Trade Wars are unrelated 'those are separate issues…'. To update those following the story, Huawei have pleaded not guilty to the 13 count inditement on Thursday 13th March and a court process for the case is to be set at the next hearing on the 4th April.

More worrying though is the abject lack of understanding by western market participants that when they are buying a Chinese stock (Alibaba or Tencent for example) they are not buying A shares in that company. Rather, they are acquiring interest in a Variable Interest Entity (VIE), which is usually domiciled in the Cayman Islands and is not recognised by Chinese authorities. Essentially it is the mechanism by which Chinese companies raise funding without ceding ownership rights to participants. To quote an Economist article from 16th September 2017 entitled 'A legal vulnerability at the heart of China's big internet firms – variable interest entities are their weakest link':

'…..occasionally it is worth pinching yourself and paying attention. Take VIEs, a kind of corporate architecture used mainly by China's tech firms… they go largely unremarked but have become incredibly important. Investors outside China have about $1trn invested in firms that use them (and that was in 2017!)….like scientist appalled by their monstrous creations, even the lawyers who designed VIEs worry. They are ''CHINA'S VERSION OF TOO-BIG TO FAIL…'

China's strangest export



Source: Bloomberg; company reports; The Economist

Could VIEs cause a potential black swan event if the technological trade war escalates beyond attacks on individual companies such as Huawei broadens across a landscape of Chinese Unicorns backed in a legally derivative fashion by western, largely retail, market participants?

On a practical note, having visited Cayman half a dozen times in the past few years and knowing the legal and corporate services industry there, I am yet to find either a lawyer or service provider who has established or administers these structures (akin to special purpose vehicles). My expectation is that they would fall foul of the new 2019 Cayman Islands Economic Substance Requirements.

Interestingly, this has become the most controversial aspect of the legislation that China is introducing to regulate foreign investment. According to a Bloomberg article published on 13th March, China's New Investment Laws Puts Foreign Firms on Notice, in the latest draft of China's Foreign Investment Law the language that may have invalidated VIE structures has been dropped to assuage concerns about a corporate structure that circumvented foreign-ownership restrictions.

‘However, it may be a matter of time before Beijing revisits the matter of VIEs, argued Adrian Lv and He Huanhao at Han Kun Law Offices, one of the country’s more prolific tech deal advisers. “The current legislation temporarily sets aside issues that still remain controversial but are relatively less urgent,” they wrote. The latest draft allows for future rules to address such issues, they said.’

It appears then that the Chinese are also prone to a ‘kick the can down the road’ mentality. That doesn’t alter the fact that foreign investors in any Chinese company with a VIE structure do not have any ownership rights.
How do we braid this narrative? As international managers with offices and clients in emerging markets, we have an experienced understanding that no two emerging markets are the same, however they do share common ‘mechanisms’ that developed market investors are, perhaps, under-prepared to handle should volatility spike or bear market conditions prevail.

If you would like MitonOptimal to review your exposure to emerging markets and guide you through the areas that we see as offering good value for considered risk, you are welcome to contact your direct link to our Investment Management Committee. For those of you who read only out of interest, hopefully this has helped to shine some light on darker areas of Emerging Markets and if you find yourself with an acquired taste for more of the same, I can highly recommend watching ‘El Mechanismo’ on Netflix.

Hopefully all readers will now have some awareness of VIEs. If, and when they do cause disruption you’ll at least be able to say, ‘ah I think read something about that from MitonOptimal a few days, weeks, months ago…’.

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