Candriam Equities L Emerging Markets

Market Overview

October proved to be a challenging month for Emerging Market (EM) equities, with a 3.9% correction (in USD terms), slightly underperforming Developed Market (DM) equities (-3%). The primary cause for concern was the rising yields on the US 10-year treasury, reaching levels not seen since 2007. Even some of the more defensively positioned emerging markets saw corrections, with Mexico experiencing a 7% decline and India witnessing a 3% correction for the month.

In Asia, China's performance closely aligned with emerging market equity returns, experiencing a 4% correction for the month. This was noteworthy, given incrementally positive data points that suggested a potential bottoming of economic indicators. The prospects of further US-China dialogue also supported sentiment. However, these positive signs appeared to be overshadowed by the prevailing risk-off sentiment. Of particular significance in the Chinese context was the shift in fiscal policy stance, as the 3% cap on fiscal deficit was removed, creating room for increased fiscal support to the economy.

In North Asia, Korea experienced unexpected volatility, correcting by 7% in USD terms, especially in thematic and long-duration stocks. This volatility could possibly be attributed to the regulator's removal of the short selling ban in the previous month. On the other hand, Taiwan remained relatively resilient, with a 2% correction, as the tech giant TSMC indicated the possibility of a recovery in demand and pricing for its semiconductor products.

Among emerging markets, Poland was the top performer during the month, with a significant gain of 16%. Turkey was hit by UST yields and stronger USD. This was driven by anticipation of more reformist economic policies following a surprising election outcome. In Latin America, Brazilian equities performed in line with emerging market returns, even as rising US yields raised questions about the pace of policy easing by the central bank.

Emerging market currencies weakened during the month, with the dollar index gaining 0.5%. In the commodity complex, the most notable development was the strength observed in gold, which held above the $2,000 per ounce mark. This increase was driven by heightened demand for the safe haven asset due to geopolitical conflicts in the Middle East. EM Equity funds outflows worsened in October, following large outflows in September.

Portfolio Highlights & Strategy Review

Both the portfolio and the benchmark demonstrated negative returns for the month of October, with the portfolio slightly underperforming the benchmark in a challenging market environment. In terms of sectors, the top negative contributors were Industrials and Financials. However, this was partially offset by positive contributions from Consumer Discretionary and IT sectors. Weakness in the Industrials sector was primarily concentrated in Samsung Engineering, following disappointing results and investor concerns about the company's transition to clean energy taking longer than previously anticipated. Additionally, GAP's stock price declined substantially due to news of the Mexican government reviewing airport license fees. On the other hand, the strength in the IT sector was concentrated in the AI thematic, with major players like SK Hynix, Accton, and Taiwan Semiconductor Manufacturing experiencing a rerating, driven by expectations of strong demand growth for semiconductors and related equipment. From a country perspective, a weak performance in China had a negative contribution, primarily due to profit-taking in Petrochina. Similarly, a stronger performance in Brazil led to corrections in some of the portfolio's more expensive positions, such as WEG and Raia. In contrast, Korea and Taiwan showed positive contributions, largely driven by the strength of the AI thematic. Smaller markets like Turkey also made positive contributions to the portfolio, thanks to strong stock selection, particularly in BIM. The portfolio continued to reduce exposure to the electric vehicle thematic due to concerns about rising margin pressure, resulting in adjustments to positions in Samsung SDI and CATL. Additionally, the portfolio added new positions like Shandong Gold Mining (a large Chinese gold miner), Shenzhen Transsion (a Chinese consumer electronics company with a strong presence in Africa), and Garanti Bank (Turkey).

Fund Outlook

Despite our overall positive outlook for EM equities over the longer term, we have maintained a cautious near-term perspective. This caution has been primarily driven by the challenges posed by “high for longer” US Treasury yields, which have created headwinds for EM valuations. Additionally, geopolitical tensions have remained elevated, further contributing to our near-term caution. As a result, we have retained a slightly defensive and balanced position within our strategy to navigate this environment.

In October, we unfortunately witnessed the emergence of another geopolitical conflict in the Middle East, intensifying the risk-off sentiment in the market.

However, the current landscape is starting to change. We have begun to observe signs of softening in US economic activity, which suggests that the Fed may be nearing the end of the current rate-hiking process initiated in March of last year. This development has made us more optimistic about the near-term outlook.

The challenges around the potential for EM equities to outperform become more pronounced as long-term US interest rates rise. It appears that investors are waiting for a full cycle to play out in the US, which includes a GDP recession and subsequent rate cuts, before a robust and lasting demand for EM equities can take hold.

In terms of our positioning, we will continue to maintain a slightly defensive and balanced stance while awaiting further confirmation that the peak of interest rates is behind us and that China's economic recovery is gaining momentum, contributing to the differential growth of EM.