abrdn Sustainable Emerging Opportunities Fund

31 August 2022

Market review

Global emerging market equities rose in Australian dollar terms in August, sharply outperforming developed markets. The pace of monetary tightening by major central banks and macro headwinds remained key focus areas for investors.

The month started with data that showed US consumer prices rising slower than expected in July, in part due to falling energy prices, amid the aggressive pace of tightening from the US Federal Reserve (Fed) this year. While investors initially reacted positively, market sentiment turned negative towards the month-end after Fed chair Jerome Powell reiterated the central bank's firm stance to bring down inflation at the annual Jackson Hole summit. Powell's hawkish comments deepened concerns over the impact of tighter monetary policy on US economic growth and corporate profits. Meanwhile, oil and commodity prices softened as demand worries overshadowed supply risks.

Developments in China also dominated market sentiment. Investors grappled with heightened geopolitical tension between the US and China over Taiwan. Compounding worries around China's growth outlook were domestic Covid-19 flare-ups, a brewing crisis in the property sector as well as power cuts and power rationing in provinces hit by severe weather conditions. Policymakers responded with extensive fiscal and monetary support to bolster consumption, infrastructure and the property sector. At the same time, the People's Bank of China reduced key lending rates to pump liquidity into the system.

Meanwhile, several emerging market central banks continued on the monetary tightening path to curb inflation, with rate hikes seen in Brazil (50 basis points [bps]), Hungary (100 bps), India (50 bps), Indonesia (25 bps), Kuwait (25 bps), Mexico (75 bps), Peru (50 bps), the Philippines (50 bps), South Korea (25 bps) and Thailand (25 bps). In contrast, Turkey cut interest rates despite a weakening currency and surging prices.

Against this backdrop, Latin America was the best-performing region, largely due to robust gains in Brazil. In emerging Asia, Chinese equities lagged, while India, Indonesia and Thailand advanced strongly. Europe, the Middle East and Africa trailed amid losses in the Czech Republic, Poland and South Africa.

In matters related to environment, social and corporate governance (ESG), China Tourism Group Duty Free highlighted to us the importance it attaches to ESG and is working with brands to promote sustainability and awareness. It is also focusing on customer and stakeholder engagement. The company's MSCI ESG rating was recently upgraded from BB to BBB.

Separately, we met with B3's Head of Sustainability to discuss the Brazilian stock exchange operator's internal and external initiatives. We emphasised our views regarding diversity and inclusion within the board of directors, executive remuneration and disclosure on executive pay.

We also wrote to Mexican bottler and retailer FEMSA's board of directors regarding the company's recent round of capital allocation which resulted in increased business complexity. We urged the board to improve alignment between controlling and minority shareholders, revisit its strategy and reconsider its capital allocation, improve transparency and communication with investors and simplify its business structure to unlock value for all shareholders.

Portfolio review

The Fund gained 0.66% (gross), underperforming the benchmark's return of 2.25%.

Stock selection in China weighed on relative performance. Among our renewables holdings, LONGi Green Energy was the biggest single-stock detractor. Despite reporting second-quarter results that were in line with market expectations, the company's shares fell partly due to higher prices for polysilicon, a key material in the production of solar modules. NARI

Investment strategy

The Fund invests primarily in a concentrated portfolio of around 40-70 emerging market listed securities with the potential for capital growth and increased earning potential.
Our emerging markets equities managers, located in Sao Paulo, London, Singapore, Bangkok, Hong Kong, Jakarta and Kuala Lumpur, seek to identify and invest in good quality emerging markets equities through first hand company visits.

Investment objective

To provide investors with high capital growth over the medium to long term (3-5 years) by seeking exposure to emerging stock markets worldwide or companies with significant activities in emerging markets, adjusted to take into account certain ESG (Environmental, Social and Governance) considerations.

Technology, a critical components and technology supplier to China's national grid, also sold off after the company posted results that missed market expectations as its revenue growth failed to outperform industry growth. That said, company fundamentals for our renewables names remain strong alongside the long-term sector outlook as countries increasingly consider their energy supply resilience.

Robotics automation provider Estun retreated as second-quarter results disappointed owing to Covid-led disruptions. Shares of luxury car distributor, Zhongsheng Group, remained weak on the back of concerns around further Covid-related lockdowns in provinces where the company operates. On the flip side, Chinese companies with US listings added to performance after US and Chinese regulators reached a deal to allow American accounting regulators to inspect audit papers of US-listed Chinese companies.

Stock selection in India was negative as the broader market extended its upward momentum in August, though our holdings Power Grid Corporation of India, Kotak Mahindra Bank and HDFC participated in the rally.

Technology stocks were under pressure amid market concerns around the risk of slowing end-demand for semiconductor chips and consumer electronics in the face of a potential global economic slowdown. As such, our positions in Samsung Electronics, ASML, ASM International and Taiwan Semiconductor Manufacturing Co hampered performance. Similarly, the Fund's exposure to Singapore-based internet firm Sea detracted as its share price declined following mixed results. Losses per order narrowed for South-East Asia and Taiwan but the company removed guidance for its e-commerce division. Separately, our holdings in South Africa were hurt by falling metal prices.

On a brighter note, the Latin American region was the top contributor to performance. In Brazil, Banco Bradesco's share price rose after the lender delivered results that were mostly in line with market expectations. Stock market operator B3, pharmacy retailer Raia Drogasil and railroad operator Rumo also outperformed.

Elsewhere, Indonesia's Bank Central Asia was the top stock contributor to performance after the central bank finally lifted rates by 25 bps. Thai equities also fared relatively well thanks to foreign inflows. As a result, the holding in Kasikornbank was additive. Finally, the Fund also benefited from the position in Samsung Engineering, which rallied on expectations of strong future orders.

Turning to key portfolio activity, we participated in China Tourism Group Duty Free's Hong Kong initial public offering and introduced Telkom Indonesia, the largest and strongest player in the country's key telecommunications growth areas.

In addition, the Fund's transition to a sustainable mandate saw the introductions of battery maker Contemporary Amperex Technology, industrial robot manufacturer Estun, wind turbine maker Goldwind and financial software company Hundsun Technologies in China; electrical equipment maker Crompton Greaves, renewable energy company ReNew Energy, contract research and manufacturing services company Syngene International in India; real estate firms CTP in the Netherlands and Multiplan in Brazil; Adecoagro, a leading agro-industrial company in South America; and Polish parcel delivery service provider InPost.

In a similar vein, we exited Anglo American Platinum, ASUR, Budweiser APAC, Grupo Mexico, Kweichow Moutai, PTT Exploration and Production and UltraTech Cement. We also divested Shenzhou International to fund better opportunities elsewhere.

Outlook

After a rough start to the year, dominated by Russia's invasion of Ukraine, and the subsequent supply shock in markets, emerging markets face risks from higher inflation and a tighter financial environment. While the Fed continues to unwind years of loose monetary policies to tackle inflation, with a series of aggressive rate hikes in recent months, emerging market central banks have been well ahead of the curve, having started their rate hiking much earlier. This cycle, emerging economies' currency reserves and current account positions are also in much better shape than before, and their central banks are closer to ending their tightening cycle.

Meanwhile, the potential for a counter-cyclical recovery in China remains, even as its zero-Covid approach had a material impact on growth in the second quarter while a brewing crisis in the real estate sector is raising concerns. Policymakers have room to stimulate the economy as inflation remains relatively low compared to the rest of emerging markets - and we have seen this materialise in August as China introduced a series of fiscal

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stimulus measures and eased monetary conditions. In addition, we expect ongoing relaxation of the zero-Covid policy over time, which should be hugely stimulative for the economy.

Heightened geopolitical risks have also brought the security of energy supply to the forefront, increasing investments into renewables. Emerging market companies are currently dominant in much of the renewable energy supply chain and should benefit from this trend.

The portfolio remains focused on businesses that have discernible quality characteristics, including sustainable free cash flow generation and earnings growth, pricing power and low levels of debt. Such characteristics should help businesses manage this period of supply disruption and cost pressure. We expect markets to focus on these fundamentals as we move through the rest of the year.

Specific share class performance is available on the relevant factsheet.

The opinions expressed are those of abrdn as of the date of publication and are subject to change at any time due to changes in market or economic conditions.

Companies selected for illustrative purposes only to demonstrate the investment management style described herein and not as an investment recommendation or indication of future performance.