JOHCM Funds

James Syme
Senior Fund Manager

March 2023

Emerging Markets Spotlight

Misplaced Risk-Off Reaction: An Opportunity for Emerging Market Investors

KEY POINTS

- The collapse of Silicon Valley Bank & Signature Bank is a 'first world problem' with limited EM exposure. No JOEMX portfolio companies have been identified as having exposure.
- Every boom includes illusory wealth that is exposed when liquidity tightens, revealing frauds and bubbles.
- Tightening liquidity and financial malfeasance has been observed in EM, but the US banking stress isn't expected to impact EM.
- The current volatility in EM assets is a misplaced risk-off reaction without any fundamental basis, creating an opportunity for EM investors.

The collapses of Silicon Valley Bank and Signature Bank very much look like a 'first world problem'. There is limited EM exposure overall (so far, only one small Kuwaiti company identified as having exposure) and no JOEMX portfolio companies have been identified as having exposure. Given the banks' US locations and USD balance sheets, this shouldn't be a surprise.

Looking at the collapse in a wider context, these sorts of events are not uncommon when liquidity is tightening after a boom.

In 1955, JK Galbraith's The Great Crash gave what has become the definitive version of the Wall Street Crash of 1929 and its aftermath. In it, he coined the term "bezzle" to describe the stock of illusory wealth that exists "between the commission of the crime and its discovery", when "the embezzler has his gain and the man who has been embezzled feels no loss." Warren Buffett's business partner, Charlie Munger, extended this concept to include the "febezzle", the functionally equivalent bezzle, which he defined as the illusory wealth that exists during periods of over-optimism.

Every boom, fuelled by liquidity, includes bezzles and febezzles. Every boom comes to an end, normally when tightening liquidity causes redemptions and withdrawals, exposing the frauds and bubbles.

As Warren Buffett famously said, "Only when the tide goes out do you learn who has been swimming naked."

In EM, the last year has seen tightening liquidity and some suggestions of financial malfeasance. In Brazil, major retailer Americanas (not held in the portfolio) is in financial trouble after revealing USD 4bn of 'accounting irregularities', while the Adani group of companies in India (not held in the portfolio) have faced severe accusations of fraud and misgovernance that have forced the group into various restructuring steps.

Events like these are sometimes taken as evidence of poor governance in emerging markets. Still, the similar problems in developed markets show that this is more a cyclical phenomenon that can occur everywhere. Most emerging markets have weathered steep interest rate increases in the last year without signs of financial contagion, and we do not see the current US banking stress as having any material implications for emerging markets.

The current volatility and short-term weakness in emerging market assets is, we feel, a misplaced risk-off reaction without any fundamental basis, and we feel that EM investors (existing or contemplating) are being offered an opportunity here.

Source for all data JOHCM/Bloomberg (unless otherwise stated)