Investment Insight

ENRICH NOT EXPLOIT*

EMERGING MARKETS, SUSTAINABILITY, BRAZIL AND THE BODY SHOP

Beaming optimism among fixed income investors is giving way to a growing sense of dread. Where are we going after two years of spectacular returns in Emerging Markets debt? Are there still opportunities, are the current returns sustainable or is the next crisis just around the corner?

Risks worth taking

The global recovery since the 2008 financial crisis and improvement in commodity prices have provided favourable external conditions for many Emerging Markets. In an environment of zero-return for investment grade debt, we have often preferred to take high quality Emerging Markets risk over low quality high yield risk in developed markets. Corporates in Emerging Markets countries are often penalised by that country's credit rating ceiling, so high quality companies often offer generous yields. By contrast, developed market High Yield corporates that are highly leveraged and junk-rated often trade at similar levels. We know which risk we would rather take. With benchmark rates rising globally, we would rather be exposed to corporates with high quality businesses and low leverage over low quality businesses with high leverage and embedded structural risk. That is why we prefer Emerging Markets over High Yield in many cases.

The sensible increases in global interest rates we expect in line with our overall view of the global economy for the next five years leads to another important consideration. Currently our emerging market portfolio has an average swap spread of 300 basis points, which we consider to be a 'cushion' or pay back for the risk we take by investing in Emerging Markets credit rather than US treasuries. However, today most new issues are being launched with spreads of around 250 basis points, which we consider insufficient given that we expect benchmark rates to rise another 50 basis points or more.
This has important consequences for our portfolios. We remain highly selective with our bond exposure and maintain a significant allocation to cash to be able to take advantage of any future sell-off. We also continue to stick to our relatively short duration stance so that in a worst case scenario we have a shorter time to hold issues to maturity and have lower mark-to-market fluctuations. While we have been cautious for a while, we continue to have strong conviction that positioning in companies offering quality and value and a clear view of the future economic and market environment are factors which will insulate our portfolio from any defaults or strong markdowns.

A new era

Today many Emerging Markets countries have emancipated themselves from the troubles of the past. It has not been an easy journey. Many countries suffered from poor governance and weak institutions. Governments operated through deficit spending, high public debts and gaping current account deficits. Corporates exploited their position

* In 2016, The Body Shop celebrated its 40th anniversary with the creation of a new business and corporate social responsibility commitment: Enrich Not Exploit™.

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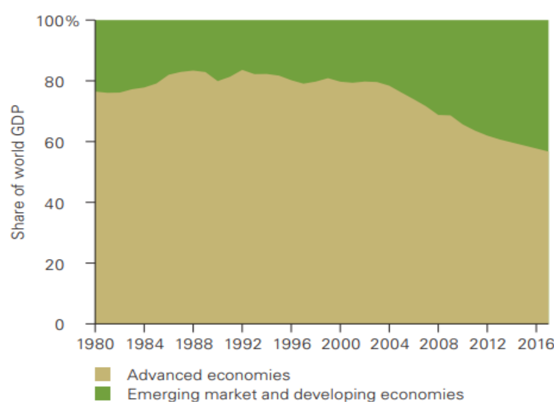
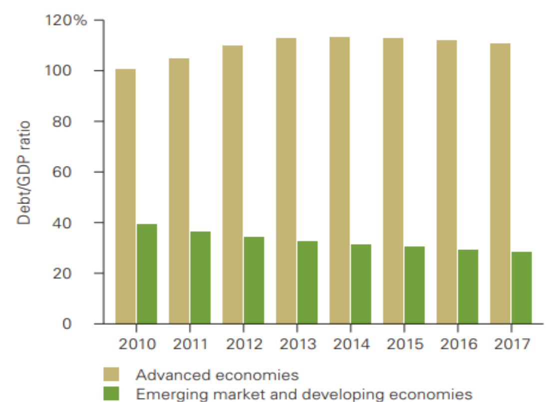
through flawed business practices. Corruption was widespread. As politicians and business leaders found out, this was a short term strategy. It may have allowed a few of them to make a quick buck, but it led to their countries lurching from one crisis to the next and resulted in an appalling dearth of long term growth.

We do not underestimate the political and social challenges to global growth. The challenges of globalization have had a profound effect on both Developed and Emerging markets, not least in the rise of populism we have witnessed in the US and in Europe in the past five years. However we have seen tremendous progress towards alleviating poverty and delivering prosperity across many Emerging Markets countries through better governance, structural reform and financial discipline. We think we are still at the beginning of a new era where political and business elites have realised that their long-term wellbeing is predicated on delivering durable long-term growth to their countries. Part of the motivation has been a realisation inside these countries that they cannot just rely upon raw commodities as their main export or on labour cost arbitrage for their competitive advantage. Both can be inputs but they can no longer be the sole foundations of their business models.

Share of World GDP for Emerging and Advanced Economies



Debt-to-GDP ratio for Emerging and Advanced Economies



Source: Vanguard using IMF data.

Our positive view on Emerging Markets countries has yet to change to investors' views of risk. Although many Emerging Markets countries have now reached fiscal deficits and debt-to-GDP ratios that are sounder than most developed countries, the Emerging Markets premium that has been required to holding such debt in many cases still reflects the political and corporate governance risk of the past, acting as the Achilles' heel of Emerging Markets countries.

This is the opportunity we see. Brazil, in particular, is a good example of this theme.

Brazil is coming back

In a previous insight we wrote in November 2016 titled *Commodities and Emerging Markets: The Stone Age did not End for Want of Stones*, we talked about how the winners will be those countries able to capitalise on their competitive advantage of access to cheap commodities and transition to more balanced diversified economies. We specifically looked at the energy and the agricultural sectors.

Fundamentals matter for countries and for companies. We need to get back to the basics and start with economic indicators and the political agenda. Brazil is coming out of one of

its deepest recessions. Growth is encouraging. In the third quarter of last year, GDP growth of +1.4% showed the strongest gain in nearly four years. Growth is expected to accelerate to almost 3% in 2018 and over 4% in 2019, assuming a supportive electoral outcome. More spectacular is the fact that the turnaround in the economy has been accompanied by a drop in inflation (from a peak of over 10% inflation in 2016 to less than 3% average in 2017), which has enabled the Brazilian central bank to cut rates, fuelling a consumption-led recovery.

As a result, Brazil has experienced a virtuous cycle. Brazilian businesses are in a position to boost investment. Meanwhile, external accounts have been supportive to the Real. Brazil's current account balance should post a deficit of about 1% of GDP in 2018 after 0.4% of GDP in 2017, a figure which is easily covered by foreign direct investment, which is seven times larger. Yet problems remain on the fiscal side, whereby the government would need to raise the primary surplus to 0.5% of GDP in order to stabilise the debt and maintain a primary fiscal deficit of 2%. The biggest culprit is the pension system and the government's failure to pass pension reforms, with the subsequent ballooning social security deficit the reason why the country's credit rating was recently downgraded by S&P to BB- (BB).

Brazilian politics have been troubled but are improving too. After years of stasis, positive reforms have helped to streamline the economy, the most distinctive ones being the revamping of the Labour Code, the implementation of spending limits, the removal of BNDES loan subsidies and the launch of a new privatisation program.

The next presidential elections are in October 2018 and the outcome is uncertain. A positive result would be if instead of the current front runners, who are exemplars of the polarization of Brazilian politics, a more moderate candidate would prevail. Former President Luiz Inácio Lula da Silva is facing legal challenges as a result of long-running allegations of corruption that means he would not be able to run in the elections. Although he is leading in the polls, it appears unlikely that he would be allowed to hold high public office again in Brazil, even though he will try to appeal any decision. Jair Bolsonaro, the outspoken right-wing congressman from Rio de Janeiro, is currently well behind in the polls in second. Both candidates have high rejection rates among their political opposition so it appears unlikely that they would pass the second round required of the Brazilian presidential electoral process. Instead, political analysts are focusing their attention on Sao Paulo Governor Geraldo Alckmin (a centre-right PSDB candidate) who is believed to have the political clout necessary to continue prudent economic policies, securing the passage of the much-needed pension reforms and tightening fiscal policy as mentioned above.

Why being green and sustainable is an example of better governance
Natura "Bem estar, estar bem"

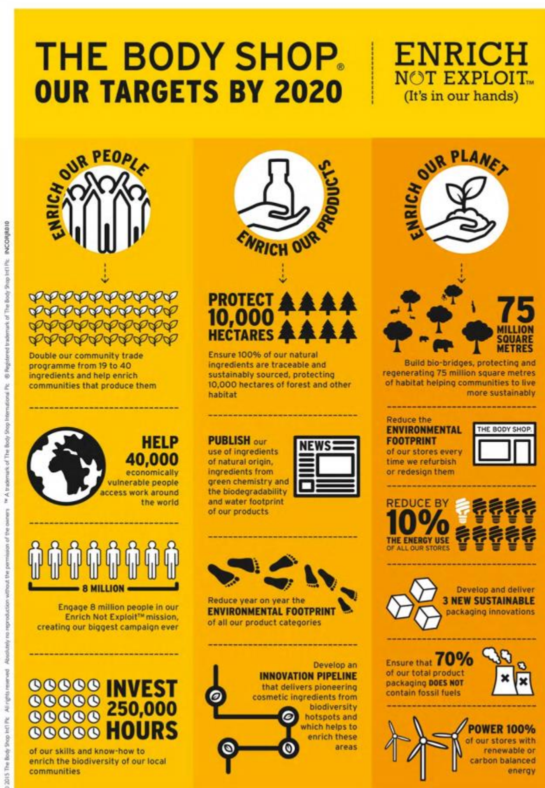
We believe strongly that the emancipation we are seeing in Emerging Markets countries is part of the wider global economic, ecological, social progress that is driving both Developed and Emerging Markets countries, and which could be a durable and permanent source of growth and prosperity.

Improved corporate governance and sustainable sourcing of goods/inputs are both examples of this new longer term mentality. They may cost more money in the short run, but the pay off with consumers, voters and investors in the long run is undeniable. In the same way that many Emerging Markets countries are fighting off corruption, corporates are grasping with the necessity to make environmentally conscious investments, communicate and engage with customers.

The acquisition of The Body Shop from L'Oréal by Brazilian company Natura last autumn highlights the long-term benefits of sustainability. Natura is a large company by any standard. It is the second largest cosmetics company in Brazil with 10.8% market share, behind Unilever (12.8%), and ahead of L'Oréal (7.2%). As of 2016, the global cosmetics, fragrances and toiletries (CFT) segment totalled USD 444 billion, of which Latin American accounted for 7.3%. The top five countries in terms of market size were the United States, China, Japan, Brazil and Germany. Brazil was the only Latin American country in the top 10, with a global market share of 6.6%.

In our commodity insight already mentioned, we highlighted Brazil's diversification of its energy matrix to the extent that renewable energy sources represent 42% of domestic energy supply compared to an average of 10-15% in the OECD. Natura is a good example at the ground level of a company benefitting from this strategy. Since 2007, it has been carbon neutral: all emissions related to their manufacturing, transportation and storage of products are compensated for via reforestations. There is also a commitment to use river and maritime transportation because it generates less carbon emissions.

Natura has a manifesto commitment to triple bottom line accounting: valuing social and environmental progress as well as financial metrics.



Source: The Body Shop International PLC, 2015

It also commits to disclose environmental and social footprints of all of its brands: from the diversification of renewable energy sources used, to the packaging made of recyclable material and the subsequent boost in development and income for families in the Amazon region. The company wants to ensure that 30% of all inputs used by Natura Brazil come from the Amazon region by 2020. As a result, Natura ranks 14th in Corporate Knights' 2018 Global 100 sustainability rankings (well ahead of L'Oréal at 84th).

By buying The Body Shop, Natura has increased its relevance and exposure to the global beauty market. International operations are now half of its total revenue.

The Body Shop has a global sustainability strategy, 'Enrich not Exploit' that comprises 14 targets for 2020 and reflects "the brand's belief that business can be a force for good, which means enriching people as well as the planet, its biodiversity and resources, while also developing sustainable and ethical products." The Body Shop products are not tested on animals, and since 1989 the company has conducted campaigns around the world to eliminate this practice.

Natura emphasised the fit of The Body Shop's ethical approach with its existing brands. Both companies share the same culture focused on sustainability and with an environmentally friendly approach in the production and distribution of beauty products - "Bem estar, estar bem."

All three companies that now comprise Natura's portfolio of brands, Natura, Aesop, and The Body Shop, are committed to generating positive economic, social and environmental impacts through such actions as developing vegetable-based products, using traceable and sustainably-sourced ingredients, promoting fair trade with suppliers and rejecting animal testing.

Natura's strategy has paid off since it managed to come to the Eurobond market as a first time issuer with a very well accepted issue. We invest in quality and value: although we like Natura as a business, we chose not to participate as the maturity, terms and yield (five year maturity, callable after three years, coupon of 5.375% and yield-to-maturity of 5.18%) were not sufficient for us in the current environment. We are watching it closely and are ready to buy if we get an opportunity.

Core Emerging Markets bonds portfolio values

At J. Stern & Co. we invest on a long term and fundamental basis, we seek to take the right risks and not the wrong ones, we do not chase jumps in prices or quick capital appreciation and we are not unduly worried about market volatility and mark-to-market fluctuations. We like differentiation and value at the right price, which is why we much prefer emerging market bonds over high yield debt in this environment.

In our approach to investing, we are constantly identifying companies in developed and emerging markets that can adapt to the challenges, contribute to innovation, growth and sustainable development of their economies.

We believe that it is not necessary to compromise on our standards of quality to invest in companies that follow the older, obsolete Emerging Markets paradigms. Among those for example, is Venezuela and its state owned companies. The country is amongst the top ten world oil producers yet whatever the historical, political and social reasons it is a failing state that is blatantly incapable of feeding its population, with a government and civil service that appear to push the limits of corruption to ever further extremes.

Natura is an example of the types of companies we own in our portfolios. There are many other names that follow a similar approach and have an attractive total return potential. They are at the core of our conviction in investing with quality and value as a central principle and give us the confidence that they will allow us to generate significant value over time.

Catherine Blanc-Adams

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