ROTHKO

MONDRIAN INVESTMENT PARTNERS LIMITED

Global Equities Watch Out, Inflation is (Definitely) Back

May 2017

US inflation, having bottomed out in February 2015, continues to threaten resurgence (see chart). This is directly important for global stock markets because valuations have ridden high on loose US dollar monetary conditions and low long rates, a situation that could turn. We believe that developed equity markets are more exposed to this risk than a portfolio of carefully selected emerging market equities and we believe Rothko is well positioned to exploit this dynamic.

In this piece we review our long held and, up until now, contrarian thesis on US inflation and explain why this view is now being evidentially borne out. We then review where the specific reflationary risks lie in the Emerging Market equities universe.

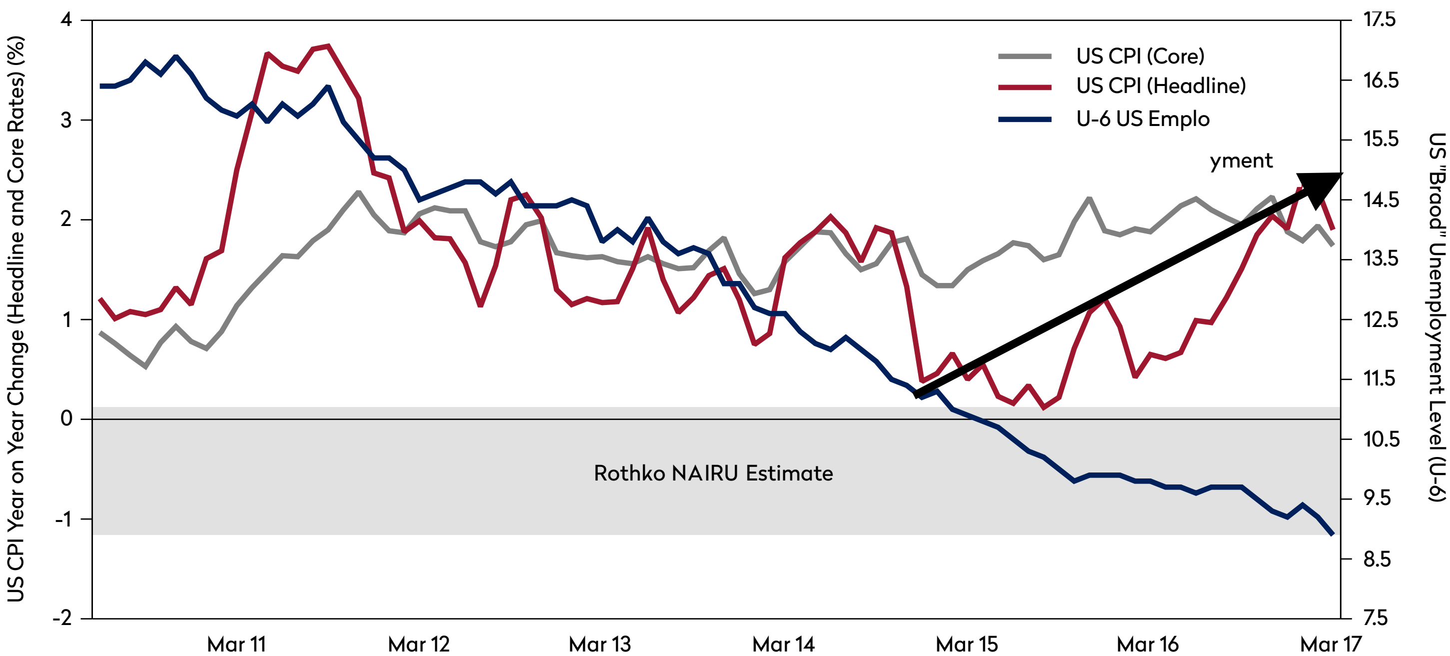
A Core Reality

Underlying CPI has crept up since 2013 (see the grey line in chart), while headline inflation in the US has increased dramatically in the past year (see red line in chart). Volatile items are mainly to blame but what makes this a more ominous sign is that broad unemployment (U-6) has now fallen through a critical inflationary level (the NAIRU[1]). The risk for investors is that sharply tighter monetary and liquidity conditions could follow a continued increase in inflation. The question is how to identify and avoid the most exposed stocks?

Equity Duration – Hot Spots in EM

Equity duration seeks to explain stock price sensitivity to (US) interest rates (see Schroder and Esterer, 2011[2]). We reviewed the equity duration of all stocks in the MSCI EM Index over the past 5 years (March 2012 – March 2017) and found several areas of the market that were particularly exposed to shifts in US long rates (see table on page 3), specifically the South Korean and Indian stock markets. (A description of our methodology is in the Appendix).

US Inflation – Upward Pressure



Sources: US Bureau of Labor Statistics, Rothko Investment Strategies.

[1]NAIRU is an acronym for non-accelerating inflation rate of unemployment, and refers to a level of unemployment below which inflation rises.

[2]Schroder and Esterer, 2011. "A New Measure of Equity Duration: The Duration-Based Explanation of the Value Premium Revisited" EDHEC, 2011.

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Interest rate risk is governed more by a stock's "country of risk" than by the sector it inhabits, although the "Real Estate" sector is somewhat exposed across a number of geographies. The most exposed countries are South Korea and India, both home to a material number of stocks that have a high sensitivity to rates. In these markets the most sensitive stocks have equity durations that range between between 5 and 12 years, a very high sensitivity, implying that a 1% rise in US 10 year rates alone would slam returns of these stocks by over -10%. Taiwan on the other hand has a negative sensitivity to US long rates with negative equity durations, implying that Taiwanese stocks would benefit from reflation in the US.

Equity Duration Hot Spots: High Sensitivity Stocks by Country and Sector

	Hong Kong	Taiwan	South Korea	South Africa	Brazil	India	Indonesia	Thailand	China	Russia	Israel
Financials			6.08			8.66					4.90
Information Technology		-8.86	10.74								
Consumer Discretionary	-15.06	-5.89	8.87			10.48					
Industrials		-7.36	10.65	6.14		11.24	8.08				
Consumer Staples			7.92								
Materials		-4.34	7.59		-6.85	10.00					
Health Care			10.10								
Real Estate	10.39					10.97		11.22	9.66		
Utilities											
Telecommunication Services											
Energy										-8.22	2.34

Source: MSCI, Rothko Investment Strategies.

Note: Statistically significant factor loadings of the 84th percentile stock (mean+1 standard deviation) in each country/sector bucket

These results are owing to a number of complex dynamics but it is also notable that of the three markets broadly sensitive to long rates (Taiwan, South Korea and India), financial leverage is likely to play a part. Indian and South Korean stocks have far higher debt to equity ratios than Taiwanese. Taking the 84th percentile debt-to-equity stock in each market (i.e. the stock that represented the mean debt to equity, + 1 standard deviation), Taiwanese debt to equity was around 115% whereas South Korea was 175% and India 280%. We remain underweight to South Korea and India on account of our model's implicit valuations.

Rothko: Moderating Leverage and Duration

Rothko's strategy is diversified across country, sector and single stock and we believe we are underweight the potential impact of reflation and rising long rates. We remain underweight to India and South Korea and overweight to Taiwan on the basis of the relative values our models identify in these markets. We believe this orientation will allow the Rothko Emerging Markets All Cap Equity Fund, L.P. to continue to extract value from EM Equities in a volatile market environment, while preserving client capital in what will be an unpredictable medium term.

Appendix

We ran non-linear, multivariate regressions, monthly over 5 years ending Mar 2017 on all stock total returns (Y) versus the factors: MKT and RATES (X). MKT was simply the MSCI EM Index and RATES represented the total return on the 10year US Treasury. Only stocks with statistically significant non-linear factor loadings to RATES, at the 10% level or better, were considered. That written, we believe that equity duration is a "tail risk" and so to account for this, we took the mean + 1 standard deviation factor loading in each sector/country "cell". This factor loading was translated into an equity duration number analogous with a bond's modified duration, assuming that the 10year US Treasury had a constant modified duration of 7yrs. More details can be provided on request.

Disclosure

Views expressed were current as of the date indicated, are subject to change, and may not reflect current views.

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