QUARTERLY COMMENTARY

June 30, 2023

China stimulus?

Last quarter, we wrote an optimistic comment on China's economy driven by encouraging Q1 economic data. Nevertheless, 2Q posted a slowdown in most relevant metrics that was harsher than expected. The official manufacturing PMI dropped below 50 in both April and May, inflation has lowered to almost 0% and 2Q GDP growth came out much lower than expected. Consumption is still weak, with the youth unemployment rate at over 20% and the property market has worsened again.

This data comes amid a lack of confidence in the Chinese economy driven by lack of policy support. As the slowdown has been stronger than expected, we've seen weak consumption and increasing savings among locals. The latter needs to change, and the tipping point comes solely from government stimulus.

The PBOC governor reinstated in June the necessity of counter-cyclical adjustment after eliminating it from its statements in April. Authorities have implemented some policy supports, such as lowering focalized interest rates, targeted easing on property and some subsidies for NEVs and home appliances. This is far from enough; new measures are needed on all fronts, particularly in fostering credit and in the property sector.

Historically, in China, various policy measures tend to move in the same direction at the same time. Thus, it's reasonable to expect more easing in different areas as data continues to be weak. It is possible, but difficult to foresee, that Chinese policymakers will not achieve their growth target of around 5% and fail for a second consecutive year. This has never happened in history and China has the tools to prevent it if it wants. Policymakers have control over commercial banks and can set up policies for property and infrastructure through their control of local governments. It's key for the government to resume a credit upcycle. Economy recovery in 2009, 2012 and 2016 was preceded by a credit impulse, driven by policy easing in infrastructure and property.

The Politburo meeting held during the last weekend of July had a change of tone with a more constructive bias, although we are still missing concrete measures.

India's market had a very good quarter, reverting its 1Q underperformance. Despite well-known expensive valuations, small-cap companies have shown impressive resilience and strong growth momentum likely to be maintained. India is currently the most important market in our index, and we continue to expect strong growth in our companies for the mid-long term. For example, companies like **Phoenix Mills** (PHNX IN) are likely to post +20% CAGR EPS growth for the next five years, driven by solid execution and margin expansion.

Latin America reported a strong 2Q, maintaining the trend of previous quarters. The region is experiencing positive tailwinds, such as nearshoring in Mexico and the starting of the rates easing process during 2H. Brazil's market performed extremely well due to positive results expectations for 2H, amid discounted valuations, normalization of local dynamics together with rate cut expectations for 2H. The Latin America region is also favoured by commodities prices, which, despite a global slowdown, have maintained elevated levels, especially copper, with the expectation of supply mismatches to continue. We are overweight in Latin America, driven by our bottom-up selection of companies that we expect to continue delivering strong results in the following quarters.

Our Global Alpha EM portfolio is also overweight in China, Mexico, Indonesia and Poland, although selectively. In China, we focus mainly on the consumer front and manufacturing, on local brands and companies that serve the Chinese population and industrial automation. In Indonesia, our invested companies are in the consumer and healthcare sectors. In Mexico, our focus is on companies that can benefit directly from nearshoring but also leverage their strong domestic operations. In Poland, we have recently initiated positions in the materials and industrial sectors. In all cases, we favour companies with good balance sheets, strong free cash flows and market leadership and our portfolio continues to be well diversified.

BACK TO EMERGING MARKETS SMALL CAP

During the second quarter, the MSCI Emerging Markets Small Cap Index outperformed the MSCI EAFE Small Cap Index and the MSCI Emerging Markets Index.

Within the MSCI Emerging Markets Small Cap Index, financials, which represents 9.9% of the index, was the strongest-performing sector, delivering a return of 10.3%. At the opposite end of the spectrum, energy was the worst-performing sector, returning -2.4% for the quarter, with an index weight of 1.8%.

PERFORMANCE HIGHLIGHTS

For the second quarter, our Emerging Markets Small Cap composite delivered a return of 10.2% gross (9.9% net), outperforming the MSCI Emerging Markets Small Cap Index by 3.8% gross (3.5% net).

Our top performer for the quarter was **JSL** (JSLG3 BZ). The company has the largest portfolio of logistics services in Brazil and extensive expertise operating across various sectors with a nationwide scale of operations. JSL has forged long-lasting and strong business relationships with clients in diverse economic sectors, including pulp and paper, steel, mining, agribusiness, automotive, food, chemical and consumer goods, among others. Remarkably, it has maintained its leadership for 19 years and it significantly surpasses its closest competitor in size and scope.

So, what drove the stock up?

The main reason for the strong performance is the company's consistent delivery, not only in 1Q23 but also for eight quarters in a row. Organic growth has consistently been close to 20% since its IPO and JSL has also demonstrated a favourable M&A track record that has contributed to EPS expansion. Among the top 10 logistic companies in Brazil, JSL holds close to a 2% market share. JSL's market share is approximately 1%, nearly five times larger than the second-largest player), positioning it well to continue consolidating the industry. Additionally, JSL's stock continues to trade at discounted valuations.

Another top contributor in 2Q was **Va Tech Wabag** (VATW IN). The company is a global player in the water treatment industry with a market presence in India and several other geographies. VATW offers comprehensive life cycle solutions, including conceptualization, design, engineering, procurement, supply, installation, construction and O&M services for sewage treatment, processed and drinking water treatment, effluent treatment, sludge treatment, desalination and reuse for institutional clients.

What drove the stock up?

The main catalyst for the stock was the company's confirmation of the long-awaited project for the desalinization water treatment plant in Chennai, which increased the order book by close to 40%. Moreover, VATW is now focused on securing E&P projects and streamlining construction to improve margins and cash collection. All of the above factors have boosted sentiment on the stock and we expect good results to continue.

Our top detractor in 2Q 2023 was **Sido Muncul** (SIDO IJ), Indonesia's largest herbal medicine company. Its product portfolio includes over 300 SKUs, with notable products like Tolak Angin, the number one herbal remedy for cold symptoms with a market share of 72%, and Kuku Bima Ener-G!, a pioneer in fruit-flavoured energy drinks with a 40% market share in Indonesia.

What drove the stock down?

Sido's stock price was subdued by soft 1Q23 business results, impacted by inflationary pressure on low-income consumers, a focus on travelling and leisure by middle and upper-income consumers, as well as regulatory restrictions affecting Sido's pharma segment. Despite the slow performance in 1Q23, we maintain conviction in Sido based on its brand strength, market dominance, distribution channel expansion in Indonesia and abroad, and a promising new product launch pipeline.

NEW POSITION

One of the new positions we initiated this quarter was **InPost** (INPST NA). The company provides parcel delivery services in Poland, France, the UK, Spain, Portugal, the Benelux countries and Italy through a combination of 30,000 APMs (automated parcel machines) and 26,000 PUDO (pick-up drop-off) points, as well as door-to-door delivery. APMs represent a more cost-efficient (~30% cheaper) and environmentally friendly option (~75% lower carbon footprint) compared to traditional door-to-door delivery.

InPost's logistics infrastructure in Poland is underpinned by a highly efficient technology platform and comprises first, middle and last-mile capabilities, solidifying its dominant position in a dynamically growing market.

While Poland remains the core business for InPost today, its growth opportunities for the next decade lie in France and the UK, the two out of three largest e-commerce markets in Europe.

In 2021, InPost entered France via the acquisition of Mondial Relay, obtaining a 20% market share in the parcel delivery business. Although UK operations are still on their way to break even, the recently announced 30% acquisition of a local logistics provider, Menzies Distribution, represents a major milestone in InPost's efforts to secure its proprietary logistics infrastructure in that country.

In 2022, InPost delivered approximately 750 million parcels across its markets.

OTHER NEW BUYS AND SELLS

During the quarter, we also initiated a new position in **Greenpanel Industries**, **Tokai Carbon Korea** and **Copa Airlines**.

We exited **Integrated Diagnosis Holdings**, **Network International**, **AfreecaTV** and **Dynasty Ceramic**.

WHAT IS OUR EAR-TO-THE-GROUND APPROACH TELLING US?

Global Alpha was back on the road with company meetings and conferences in the first half of 2023. During 2H, we will continue attending conferences, aiming to visit in person almost 100% of our holdings.

The lower dynamism of the recovery in China has cast some doubts on consumer spending, and earnings growth has been, on average, revised downwards for this year. As mentioned in the introduction, we expect stimulus to come, thus we are monitoring every signal from policymakers who have started to be more concerned.

In India, our conversations with companies and local references still account for strong earnings momentum in mostly all our holdings. This is in line with the message we received during our visit to Mumbai in February. Amid the global slowdown, we will pay close attention to monitoring this solid expected growth in FY24, considering well-known high valuations. It is also relevant to monitor inflation data, considering the last report was higher than expected.

This spring, we were in Dubai for the largest conference dedicated to companies in the MENA region. The city was visibly in the midst of an upcycle and we met 30+ companies over four days.

Saudi Arabia and the UAE are coming off an IPO boom and there were plenty of newly listed companies at the conference. The market lacks depth compared to other emerging markets, but we could clearly see the impact of a concerted policy push to invite more FDI, encourage more IPOs and build a deeper capital market. We met a few family-owned companies that have recently gone public with the intent to professionalize management and diversify into new segments. Almost all companies across sectors were bullish on Vision 2030 and its impact on the region. Diversifying the economy while oil prices remain strong remains top priority.

We also had the opportunity to meet the top central banker from Egypt, Gov Hassan Abdalla. After two devaluations, Egypt remains hungry for FX (USD) with its main source of FX being the Suez Canal, tourism and exports. There is now a concerted push to reduce dependence on these traditional sources of FX by pursuing FDI via stake sales in publicly owned companies. Apart from FX, containing inflation and moving to a flexible exchange rate remain the other top priorities for the governor.

In June, we made an insightful trip to Poland, where we explored its dynamic investment landscape and remarkable progress the country has achieved since its establishment as a democratic state. The country's strategic location, skilled workforce, EU membership and market-oriented reforms in the last decade made it attractive for investors. Poland offers a large consumer market, a thriving start-up ecosystem and has attracted major players in the EV battery and semiconductors industries. However, concerns about inflation, political uncertainties and the ongoing war in Ukraine pose challenges. During the visit, our team engaged with our holding companies, explored new ideas and participated in consumer and technology conferences. One of the corporate meetings served as a confirmation for a new position initiated in July.

In Korea, we continue to be surprised by the development of companies linked to EV batteries. In general, we believe that the sector has run beyond its fundamentals. We must remember that some stocks linked to the sector are up more than 100% in the year; however, a large part of their profits will come from 2025 onward and it is still very difficult to determine their magnitude. However, we cannot ignore that the number of electric cars will continue to increase exponentially and, more importantly, the penetration of many of the EV battery materials (such as silicon anodes or electrolytes) is also increasing strongly, benefiting related companies through both effects. While EV materials penetration numbers will increase in the coming years, figures are being overestimated by many analysts, in our view.

We maintain positive views on Indonesia, Mexico, Poland, Chile and China, always as a result of our bottom-up approach. Nevertheless, we are constantly looking for alternatives in other geographies and our portfolio remains well diversified among countries, industries and currencies.

The Global Alpha team

About Global Alpha Capital Management Ltd.

Global Alpha Capital Management Ltd. (Global Alpha) is an independent and privately owned investment management firm focused exclusively on global and International small cap portfolio management. The team believes that portfolios built from the bottom up using a global thematic perspective and a risk-controlled, low turnover approach are key to generating consistent added value for clients over time.

For more information about how Global Alpha can help you achieve your investment objectives, please contact:

Eric Hasenauer
Senior Vice President,
Co-Head of Institutional Sales
Tel: 917-945-0960
ehasenauer@cclgroup.com

John Ricketts
Co-Head of
Institutional Sales
Tel: 203-615-4847
jricketts@cclgroup.com

Gary Simonette
Vice President,
Institutional Sales
Tel: 443-340-2791
gsimonette@cclgroup.com

Stephen Reynolds
Vice President,
Institutional Sales
Tel: 312-375-7353
sreynolds@cclgroup.com

Tim Marzec
Vice President,
Institutional Sales
Tel: 708-705-2019
tmarzec@cclgroup.com

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CONNOR, CLARK & LUNN

Connor, Clark & Lunn (USA) Ltd.

220 North Green St.
Chicago, IL 60607

50 Washington Street, Suite 1013
Norwalk, CT 06854

Performance figures are stated in U.S. dollars. Gross performance figures are stated after trading fees and before management fees and operating expenses. Net performance is stated after trading and management fees and before operating expenses. Operating expenses include items such as custodial fees for segregated accounts and for pooled vehicles would include charges for valuation, audit, tax and legal expenses. Such additional operating expenses would reduce the actual returns experienced by investors in segregated accounts and pooled vehicles. Sector performance shown is net of trading fees but gross of management fees, performance fees and operating expenses. Further information about the Emerging Small Cap Composite is available by contacting the firm.