Excerpt from the *Seafarer Funds Semi-annual Report*

Letter to Shareholders

Period Ended October 31, 2018

Andrew Foster
Chief Investment Officer

Dear Fellow Shareholders,

I appreciate the opportunity to address you once again on behalf of the Seafarer Funds. This semi-annual report covers the first half of the Funds' 2018–2019 fiscal year (May 1, 2018 to October 31, 2018).

On Decoupling

The past six months have been dismal for the emerging markets. Indeed, the past five years have been dispiriting. Over the past half decade, much of the developing world has been beset by political corruption, poor economic management, fiscal profligacy, shaky financial markets and anemic growth. The Funds' benchmark index, the MSCI Emerging Markets Total Return Index, has risen at an annualized rate of 1.15% from October 2013 to October 2018.[1] The Seafarer Overseas Growth and Income Fund has done little better, generating an annualized return of 1.32% over the same period.[2] (The Seafarer Overseas Value Fund was launched in 2016 and does not have a five year performance record.) By contrast, the S&P 500 Index has risen at an annualized rate of 11.34%. After five years of material risk with little reward, the merit of the emerging market asset class is wanting.

My personal frustration is all the greater for the "false dawn" in performance that occurred within emerging markets between June 2016 and January 2018, when the Funds' benchmark rose cumulatively 56.25%.[3] As I argued in various commentaries throughout 2017, I perceived that the surge was spurred by one-time fiscal stimulus by China. I speculated that China undertook this stimulus to facilitate an internal political transition; and I was clear that once the transition was accomplished – as it was in February of this year – the stimulus would be withdrawn. I was concerned that growth within the asset class would then revert to a lower trend rate, disappointing investors and depressing stock prices. While it is debatable what happened during this anomalous nineteen-month period, I see plenty of evidence to support my argument regarding the root cause of the "false dawn." Yet even with the benefit of such clarity, I was not able to steer the Growth and Income Fund to safety in the aftermath, frustrating me to no end.

Despite such dispiriting performance, I believe that the developing world warrants long-term investment. My view rests primarily on one idea: that the economic and financial cycles that govern the emerging markets are diverging from the developed, rich world; and as those cycles diverge, the asset class should begin to offer differentiated returns, and this in turn could generate an important diversification benefit for long-term investors. This benefit has not been available in the past, when the fortunes of emerging markets have been dominated by economic cycles of the developed world, particularly that of the U.S. Yet I think this domination is ending, and investors should contemplate a different future.

I admit, this an odd and stubborn argument to make. It is an odd argument because China – despite its wealth and scale – is acutely dependent on its bilateral trade relationship with the U.S. (The U.S. government has recently exploited this vulnerability via the imposition of import tariffs.) It is a stubborn argument because I offered a similar prediction one year ago, and I was decidedly wrong, at least with respect to financial performance of the past year. Still, I remain steadfast in the view that change is coming, and I believe that it will structurally change the characteristics of this fraught asset class.

In the argument that I advanced last year,[4] I suggested that the emerging market asset class might "decouple" from other asset classes because of three nascent characteristics: first, developing nations exercised independence in monetary policy, whereas in the past they were beholden to the policies of the U.S. Federal Reserve; second, apart from China, most developing nations adopted floating exchange rates, and were no longer tied to the U.S. dollar; third, corporate profit cycles – once deeply intertwined with international trade – were increasingly driven by domestic consumption. I wrote then that I was not certain that decoupling would occur, but given monetary independence, currency independence and profit independence, there was a better chance than ever before that it might.

While my prediction evidently failed this year, my view is unchanged. Indeed, I perceive a new, fourth component to the argument, such that I am as certain as ever: the developing world now has both the economic means and the political desire to cleave apart.

On Separation and Independence

When the term "emerging markets" was coined in the 1980s, it applied to a financial asset class associated with a diverse and divergent set of developing nations. Most countries shared little in common, save that all were poor, and most sought to promote international trade to stimulate economic growth. Today, there are few common characteristics that unite the nations within the developing world: the emerging market asset class spans countries with disparate levels of wealth, economic development, technological sophistication, infrastructure and consumption. Most countries still engage in meaningful trade; but many now enjoy much larger domestic, consumer-driven economies, and thus are not as export-dependent as they once were. Yet to the extent that trade remains in the picture, these countries still share one common characteristic: dependence on wealthier trading partners, particularly on the U.S.

Nowhere is this dependence more acute than China. China's domestic, consumer-driven economy has grown to vast scale, and it is now the primary engine of the country's growth – not exports to the West. Yet China's burgeoning wealth has fueled an enormous taste for imported goods – goods to fuel technological advancement, goods to satisfy consumer demand. China's imports have grown so rapidly that the nation is now the primary trading partner for the rest of the developing world. This poses a problem for the country: how does it pay for such vast imports? China's currency is not accepted as a global reserve currency, and thus it cannot finance its trade deficits with issuance of renminbi-denominated bonds (as the U.S. does with dollar-denominated bonds). The only way that China can afford such consumption is by earning dollars elsewhere – and that is why it is reliant on the large and sustained bilateral trade surplus with the U.S. China does not require trade with the U.S. to grow, as it once did; it only needs such trade in order to pay its bills elsewhere.

Yet for many developing nations – and especially for China – trade with the U.S. has become a thorny endeavor. Over the past two years, the U.S. has not only sought to curb its deficits with China, it has also sought to curtail certain transfers of sensitive technologies. The Chinese government and many private companies have discovered, painfully, that the U.S. will withhold critical exports – particularly technology goods – based on a broad assortment of security and political considerations. Chinese industries have been left reeling by a combination of trade sanctions on imports, and burdensome tariffs on most exports.

I neither wish to defend nor decry current U.S. trade policy. Regardless of its merit, I believe U.S. policy will have one primary ramification: it will push China to de-emphasize its trade with the U.S. and to develop an economic model that is wholly independent of the West, one which likely envelops most of the rest of the developing world. Tariffs, sanctions and dollar-dependency have exposed China's short-term reliance on the U.S. Yet I think this exposure will spur China to undertake a rapid re-organization of its global trade relationships and domestic technology industries, and reinvigorate its efforts to internationalize use of the renminbi.

I believe the world will be surprised by how quickly China re-directs its export surpluses away from the U.S. and toward other developing nations. It will use its clout as the largest importer from developing countries to demand balanced trade in physical goods. If China cannot balance trade in goods, it will stipulate that the emerging world consume more of its service exports to offset – in other words, China will push consulting, management, processing, construction and technology services onto the developing world. Lastly, China will encourage such countries to increase use of the renminbi to fund its trade deficits, much as the U.S. does today with dollar-denominated bonds. Meanwhile, China will spur investment in its own domestic technology industries, with the aim of severing its dependence on U.S. semiconductors – thereby reducing one of its most expensive categories of imports from the U.S.[5]

China cannot create a world-class semiconductor industry overnight – and it may fail outright – but I believe the rest of this transformation is not only possible but will occur with blinding speed. I would guess that it is achievable in a decade, and perhaps in half that time. When the transition is complete, I think the emerging market asset class will function quite differently than it did during the past three decades. I suspect it will be organized around a new economic engine, and it will follow a differentiated investment cycle – one no longer dependent on trade with the West, but rather with China at its center.

For better or for worse, U.S. trade policies will serve as the final impetus for the asset class to decouple. What that will entail for expectations of performance, only time will tell; yet I am wholly convinced that it will deliver the long-promised, but oft-failed diversification benefit from the emerging market asset class.

We appreciate the trust and patience that you have extended to our firm amid such challenging conditions. Thank you for the opportunity to serve as your investment adviser in the emerging markets.

Andrew Foster
Chief Investment Officer
Seafarer Capital Partners, LLC

November 15, 2018

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[1] The annualized return of the MSCI Emerging Markets Total Return Index is measured between October 31, 2013 and October 31, 2018.

[2] References to the "Seafarer Overseas Growth and Income Fund" pertain to the Fund's Institutional share class (ticker: SIGIX). The Investor share class (ticker: SFGIX) generated an annualized return of 1.19% over the five year period.

[3] The cumulative return of the MSCI Emerging Markets Total Return Index is measured between June 30, 2016 and January 31, 2018.

[4] www.seafarerfunds.com/funds/ogi/portfolio-review/2017/09/Q3#decoupling

[5] My colleague Nicholas Borst recently published a white paper (www.seafarerfunds.com/commentary/chinas-tech-rush) that discusses China's efforts to advance its technological capabilities and establish leading positions in semiconductors and other high-tech industries.

Glossary

Renminbi (RMB) is the official currency of the People's Republic of China. The name literally means "people's currency." The yuan (sign: ¥) is the basic unit of the renminbi, but is also used to refer to the Chinese currency generally, especially in international contexts.

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The MSCI Emerging Markets Total Return Index, Standard (Large+Mid Cap) Core, Gross (dividends reinvested), USD is a free float-adjusted market capitalization index designed to measure equity market performance of emerging markets. Index code: GDUEEGF.

The S&P 500 Total Return Index is a stock market index based on the market capitalizations of 500 large companies with common stock listed on the NYSE or NASDAQ.

It is not possible to invest directly in an index.

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