01 May 2015

BLACKFRIARS ASSET MANAGEMENT

Developing Markets Insight

www.blackfriarsam.com

+44 (0) 20 7332 2270

MARKET REVIEW

In April GEM equities sprang to life. After a sluggish first quarter which showed a modest 2.2% return, the asset class subsequently leapt 7.7%, with 17 out of the 22 trading days in positive territory, and making it the best month since January 2012. Latin America bucked its recent, and long, status as dunce, with a surge of 10.3%, as Brazil, and particularly Petrobras bounced. EMEA was close behind, adding 8.4%, with the Russian recovery continuing. The country is now up 39% this year. Asia, increasing 7%, was enjoying China's 16.7% surge, albeit held back by profit-taking in India and The Philippines.

The best sector was Energy, which gained 16.8%, obviously a beneficiary of crude oil's 21% recovery. The worst sector was Information Technology, only increasing 2.4%. It had been topping the charts previously, and essentially could not keep pace with a "risk-on" rally.

The seemingly incessant headwind of US dollar strength, which has cropped 30% of total returns since 2011, abated. This allowed the majority of the benchmark's 23 currencies to appreciate, with the Russian rouble in the lead, up 11.3%.

The underperformance of GEM equities versus the Developed World started in 2011, and has stretched to a 50% difference in returns. It may be premature to predict its cessation. However 2015 has, thus far, seen the erstwhile laggard gaining 10.1% compared to 4.7% for the more mature markets.

All returns above are stated in US Dollar terms.

OIL OR BEER?

One might think that Petrobras' $15bn write-down of assets, owing to a weak oil price, coupled with a $2bn charge to cover bribery allegations, might be dimly viewed. However the stock had already declined over 80% from its 2008 high. Back then there was euphoria as enormous oil fields were discovered in the mind-boggling depths of the Atlantic Ocean. Fast-forward seven years and the reality is a litany of over-spending, corruption and waste. This has erased more than $200bn from its market capitalisation. However the losses were in line with expectations. Moreover the publication of delayed, audited accounts avoided a technical default on debt securities. This led to short covering, and the company's voting and non-voting shares leaping 58% and 43% respectively.

From an asset perspective the company could be attractive, and Shell's recent bid to buy BG reinforces the potential of the deep Atlantic, where BG has significant stakes. The problem is that the reservoirs were discovered when oil was over $100 per barrel, and they were clearly commercial. The breakeven price of recovery is estimated to be $40 per barrel, so the profit margin has been squeezed.

Petrobras market capitalisation of $60bn, for revenues of $100bn contrasts markedly with Brazil's largest company by value, Ambev. This highly efficient brewer and soft drinks enterprise is valued at $100bn for $12bn of sales, at a very impressive profit margin. It has also made Jorge Paulo Lemann the richest Brazilian, with a net worth of $25bn. He overtook Eike Batista, whose oil assets peaked at $30bn, only to plummet, on oil production difficulties, to negative net worth. So beer over oil is the clear winner.

KAZAKHSTAN ELECTIONS & KZT DEVALUATION

Pres. Nazarbaev was re-elected in Kazakhstan with 98% of the vote and 95% turnout. Post win, Pres. Nazarbaev commented that there will be "no sharp" KZT devaluation. We believe that given the recent strengthening of RUB and the volatility in oil prices, Kazakhstan may wait until 2H 2015 to conduct partial Kazakh Tenge devaluation. Nevertheless, given the historical KZT quasi-peg to the rouble due to the large trading volume between neighbouring countries, we believe that the KZT will have to devalue by ~30% to 240 KZT/USD in order to restore the purchasing equilibrium to the Russian rouble.

In the meantime, to lessen short-term pressure on the KZT the authorities started a de-dollarisation program, which includes a cut in the recommended FX deposit rates, tighter regulation of FX exchange, a doubling of the insurance on KZT-denominated deposits to KZT 10mn (~US$53,864), and a prohibition to set prices in "units" (a thinly disguised reference to USD or EUR). As a result, dollarisation of deposits slowed down, with the FX share of deposits edging down to 53.3% in March from the peak of 56% in January, although 67.3% of household deposits are still kept in FX. Moreover, Kazakh authorities have also restricted Russian and Belarussian imports, despite the states' membership of the Customs Union.

Devaluation expectations are still prevalent in Kazakhstan as continuously weak oil and commodity prices are not bringing relief to KZT. While Nazarbaev ruled out sudden devaluation, we think that NBK will be forced to weaken KZT in August-September 2015 to prevent further erosion of FX reserves and competitiveness with Russia.