03 September 2015

BLACKFRIARS ASSET MANAGEMENT

Developing Markets Insight

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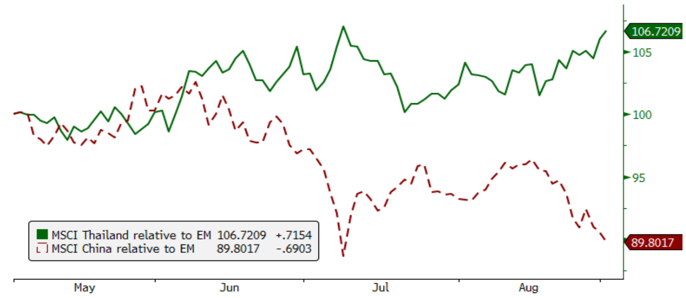
MARKET REVIEW

In August GEM equities continued to be under severe pressure, with a drop of 9%. All 23 countries were in negative territory. Latin America was again the worst region, losing 10.5%, most currencies hit all-time lows against the US dollar. Asia lost 9.2%, as China's currency devaluation shook sentiment. EMEA was slightly less weak, slipping 7.2%. It had the "best" market in Euro-resilient Czech Republic, down 2.8%, and clearly the worst market in Greece, tumbling 35.2%, where a third bailout was immediately succeeded by the prospect of another election. The market was suspended in July, and had some catching up to do.

Health Care fell the least, losing 3%. The worst sector was Financials down 11.1%.

MSCI Thailand and MSCI China relative to EM



Source: Bloomberg

CHINA: HOW LOW CAN IT GO?

The Shanghai Composite index has fallen 38% since its peak in June. It is reasonable to ask whether we are likely to see further declines from here. Certainly the margin fuelled blowout that began early in the year has pretty much fully unwound.

Value of outstanding margin loans vs SSE Composite Index

Source: Wind, FT Confidential Research

However, there are still some 500 stocks suspended on the A share market which would almost certainly fall if they re-opened. Further, the authorities are still actively supporting the market so we still expect to see some downward pressure.

If we look to valuations for support we might have to wait a while. According to a report published by the excellent Gillem Tulloch last week, the average stock with a market capitalisation exceeding US$1bn in China trades on 44x PER and 5.4x price-to-book! The main stock market indices look cheaper but they simply reflect China's mega-banks which are not recognising non-performing loans. However, it is not all doom and gloom. Valuations in the H share market are much more reasonable and it is clear that the service sector in China is still doing well. Whilst we would definitely not want to own a Chinese A-share ETF we can find specific companies that are well managed and growing profits.

THAI RECOVERY

Whilst the world has been focused on the malaise in China over the last few months, somewhat unnoticed, Thailand has begun to outperform again.

Thailand 2Q GDP came in slightly ahead of consensus expectations at 0.4% QoQ sa, or 2.8% annualised, which is substantially higher than the 0.9% recorded in 2014. The main problem this year has been the drought which has hurt farmers' incomes, which in turn has caused a rise in NPLs at the banks. The good news though is that the rain eventually started in August and the proper Monsoon trough has finally arrived in the upper northern Thailand region. It won't be enough to undo the damage, but it should stop things deteriorating further moving forward.

Last month Prime Minister Prayut (finally) decided the weak economic performance warranted changes in his cabinet. Somkid Jatusripitak has taken the helm as the main figure to drive the country's sagging economy, taking over the economic affairs post from outgoing Deputy Prime Minister Pridiyathorn Devakula. Three weeks later the result is the new three stage economic stimulus package.

Phase one is Bt120 billion worth of new capital, split into three projects. Bt60 billion funding for the Village Fund Programme, Bt36 billion in cash handouts to the 7,255 tambon (1 tambon contains around 10 villages), and Bt24 billion worth of small government projects. This should be able to be implemented very quickly since cash was the main constraint and approvals have already been received. Phase two of the government's latest economic stimulus package is aimed at helping small and medium-sized enterprises, and will begin in a week or two, while the third phase aimed at wooing foreign investors will be initiated via a roadshow in three months' time, according to Khun Somkid.

NIGERIAN OUTLOOK

Nigeria's recently elected President Buhari has initiated changes in energy policy and reform of the Nigerian National Petroleum Corporation (NNPC). The NNPC, which up until now included both the state-owned oil company and the oil ministry (together accounting for 40% of Nigeria's GDP and 92% of Federal government revenue), will be divided into two parts separating commercial activities and the ministry.

The first steps to fight corruption have been taken as Buhari released a list of 113 oil tankers involved in the contraband of crude oil and banned their operations in Nigeria. Additional hope is given by President Buhari's appointment of Dr. Emmanuel Ibe Kachikwu, Harvard PhD, and ex Executive Vice Chairman of ExxonMobil Africa, as the new NNPC's Group Managing Director. With strong experience in petroleum compliance and law, Mr. Kachickwu's appointment indicates good intentions to appoint professionals untainted by previous corruption allegations as the new core of President Buhari's team.

Overall, although Buhari has been slow to confirm his administration team follow the spring 2015 elections, he seems to be determined to get it right. This gives us hope for better governance in Nigeria as the country will inevitably face tougher times in the coming months due to lower oil prices, currency pressures and constraints on the Government's capacity to issue new debt.

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