

7<sup>th</sup> January 2016

# Developing Markets Insight

## Market Review

December, appropriately for such a weak year, ended with a decline of 2.2%. This leaves the asset class with an overall loss of 14.9% for 2015, making it the fifth worst year in 27 years of MSCI history.

For the month, and the year, Asia was the most resilient region, losing 0.7% and 9.8% respectively. Indonesia rose 5.1%, boosted by further stimulus plans to encourage FDI. In December Asia's worst market was Thailand, losing 7.7%, as a wireless spectrum auction saw a new entrant paying a high price, with a destabilising effect on sector sentiment.

Latin America slipped 4.3%, capping a poor year which saw an overall slump of 31%. Mexico was the worst country, dropping 5.1%. The Banco de Mexico kept its commitment to follow US Fed moves, and duly increased the overnight rate by 25bps to 3.25%. The Brazilian real lost 48.8% last year, easily positioning it as the worst GEM currency.

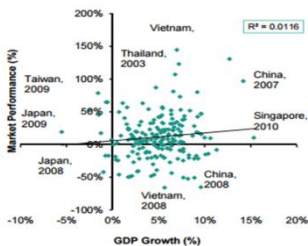
EMEA struggled in December, falling 7.2%, in spite of hosting GEM's best market in Egypt, which rallied 12.3%, having slumped 17.5% in November. The regional damage was caused by heavyweights Russia and South Africa (2/3rds of region), which tumbled 10.3% and 10.5% respectively. The rouble shed 10.6%, as crude oil hit a 12 year low. The rand depreciated 7.5%, whilst President Zuma sacked and replaced his Finance Minister twice.

Most sectors receded, Energy was the weakest, down 4.9%, hurt by crude oil. Brent blend shed 16.4% in the month, hit by Opec's decision to maintain current production, and the prospect of more Iranian supply. Healthcare was the best sector, edging up 0.5%, helped by the industry's current round of global M&A.

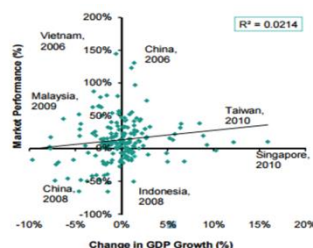
## Asia

The focus in Asia for 2015 was China and this looks likely to remain the case this year. China is undoubtedly going through a difficult period as it attempts to move away from its previous fixed asset investment led growth model. The resultant slower growth is having a knock-on effect on the growth rates in other Asian markets and also on commodity prices. However, we should remember that a) there is no correlation between GDP growth and market performance (see chart below)

**GDP growth and Equity Market Performance: Asia since 2000**



**Change in GDP growth and Equity Market Performance: Asia since 2000**



and b) much, if not most, of Asia benefits from weaker energy and materials prices as businesses are predominantly consumers rather than producers of these items.

Despite the macro uncertainty there are still businesses doing well in China, not only in the consumer space, and we continue to find opportunities there. Further south we are more optimistic on ASEAN in 2016. A number of the specific issues facing these markets have been fully discounted and are gradually being resolved. We expect these markets to perform much better this year.

## Latin America

After a dismal performance in 2015, one might hope for a recovery in 2016. However the outlook, especially for Brazil, remains cloudy. This country faces its most prolonged recession since 1901, and a possible impeachment of its President. A desperate optimist might cling to a devalued currency and improving exports, and possible M&A from corporates still interested in the world's eighth largest economy. Mexico and Colombia need to adjust to lower oil prices; but the former does look to be the best house in a difficult neighbourhood, albeit with the highest valuation. Peru hosts the only scheduled Presidential election in April. Latin America has never returned four consecutive negative annual returns, let's hope it can hold on to that record.

## EMEA

While MSCI EMEA overall performance was weak (MSCI EMEA -20% in 2015), the dispersion of returns was very wide as the region included the best and worst performing global markets. Hungary delivered +36% and Russia +4.2%, whilst Greece returned -61% and Turkey -32%. Undoubtedly weak commodity prices were the main factor behind the region's index "heavyweights" South Africa and Russia's underperformance, but domestic uncertainty and volatility were behind the weak performance of Greece, Turkey, Poland and a few Middle Eastern countries. Currency devaluations in South Africa, Russia and Turkey added additional pain to foreign investors as countries tried to preserve their competitiveness and current account balances. Russia, Turkey and Poland are trading on 2016 valuations below 1 standard deviation of their 7-year average, while South Africa is still trading at elevated valuations due to the dominance of materials companies in the index.

In 2016 Russia and South Africa will face tough decisions to keep budget deficits under control (projected at 3% for Russia and 4.2% for South Africa) assuming commodity prices will stay depressed, while Turkey may be subject to higher currency and capital volatility as the Central Bank will be facing the effects of higher Fed Funds rate and tighter global liquidity.



We are not expecting anti-Russian sanctions to be removed before mid-2016. CE3 countries continue to look the most resilient due to their link to Eurozone and Draghi's QE and also the relative stability of their currencies versus the Euro. Finally, Middle East and GCC countries will be most vulnerable due to falling oil prices finally taking effect on domestic policies (budget deficits are forecasted to reach -13% for Saudi, -15% for Oman, -7% for Qatar). Additional risks may emerge from potential de-pegging leading to capital flight, and, last but not least, significant geopolitical tensions.

## Outlook

After three concurrent negative years, the sentiment in GEM equities is extremely depressed, as evidenced by the record outflows of USD74bn from the asset class and institutional investor positioning. As always uncertainties abound including: China's decelerating growth, the pace of further US Federal reserve tightening, the multiple Middle Eastern conflicts, and the price of commodities, though one might expect that these well-known issues would by now be discounted by the markets (witness the muted response to the long awaited US rate rise last month).

The underperformance of GEM equities versus the Developed World has reached 69.5% over the last five years, and stabilisation, or even a bounce, is not an unreasonable expectation. Valuations are fair in emerging markets, especially with regard to price/book value, which is currently around 1x, a ratio which traded as high as 2.8x in 2007. Clearly different investment decades but also a substantially divergent pricing by the market. Macro volatility notwithstanding, the structural trends in developing markets continue to provide good growth prospects for the companies there and we continue to look for the better managed businesses who can successfully take advantage of the opportunities presented to them.

AL, BR & TH

