2nd March 2016

# Developing Markets Insight

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**Market Review**

February was a more becalmed month for world equity markets, with the GEM universe declining 0.2%. Against a recent trend, the US dollar depreciated, offering some relief to emerging markets returns.

Latin America enjoyed a rare month in the ascendency, gaining 3.8%, wholly driven by the smaller Andean countries of Peru, Chile and Colombia. Indeed, Peru's 10.2% gain was the best in the asset class. It was boosted by strong results from its major constituent, the country's largest bank.

EMEA added 2%. Egypt was the best market, increasing 5.4%. This country's exchange is dominated by domestic retail investors, who frequently account for 90% of trading volume. Russia, Poland, Turkey and South Africa all managed small accretions. The region's, and GEM's, worst market was Greece, plummeting 10.1%. It is down 98% from its all-time peak. The bailout talks continue.

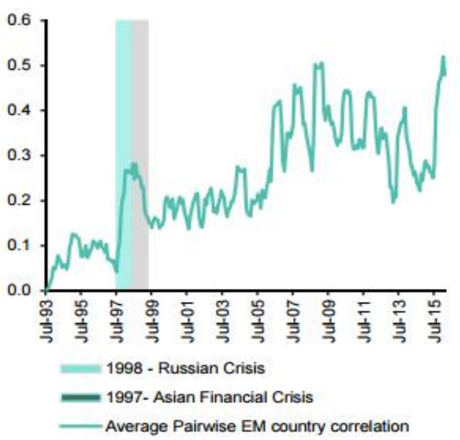
Asia was the weakest market, slipping 1.3%, dragged down by India's 7.4% retreat. The country had been a resilient performer, and is generally the most overweighted position in GEM equity portfolios. The best market was Indonesia, increasing 6.1%. The Central Bank has started cutting interest rates, from 7.5% at the end of 2015 to 7% currently, with more declines being forecast.

The best sector was Materials, rallying off historic lows to add 6.8%, as iron ore recovered 12.3%. The normally defensive Health Care sector ran into profit-taming, losing 4.6%.

**Flows**

It hardly needs mentioning that sentiment towards emerging markets has been weak. Some interesting work from Alliance Bernstein this week suggests this may now be presenting an opportunity.

**Average pairwise correlation of EM countries**




*Source: MSCI, Factset, Bernstein analysis*

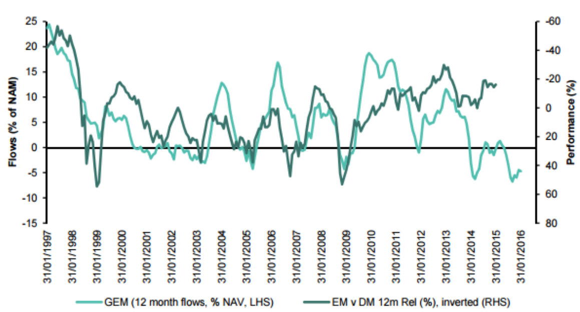
EM countries are more correlated than they were during the Asian and Russian crises of 1997-98 and after the Lehman bankruptcy. In addition, the gap in correlation between EM equities and EM "fundamentals" is also at an all-time high (see below). So EM equities are not more correlated because their underlying macro situations have become more closely aligned.

**Average pairwise correlation of EM country equities minus average pairwise correlation of EM country business confidence**


*Source: MSCI, Factset, Bernstein analysis*

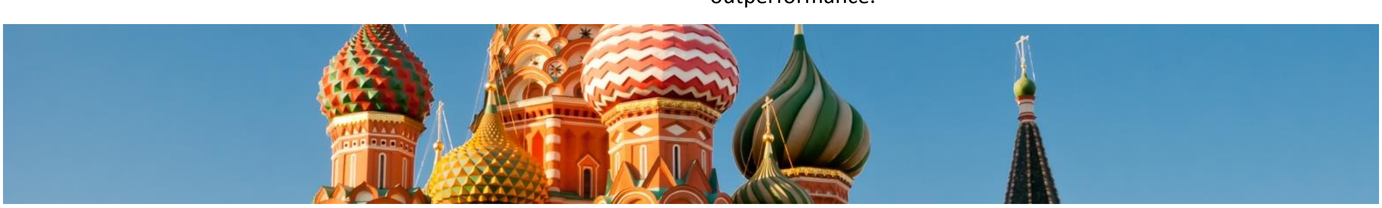
For Bernstein, the explanation is simple: flows. Dedicated GEM mutual funds and ETFs have seen USD 25bn of outflows over the last 12 months. Expressed as a percentage of market cap this is the most depressed level of flow for EM that there has been in 25 years (and again much more depressed than the equivalent flows during the Asian and Russian crises). They think that it is this high level of outflow that is behind the rapid spike upward in correlation.

**GEM flows at 25 year low**




*Source: MSCI, Factset, Bernstein analysis*

Flows have worked very well as a contrarian indicator. In the chart above, the flow is plotted against 12 month forward EM versus DM performance and it has worked well over 6 cycles. The only exception has been since the taper tantrum of 2013 when there was a sustained period of EM outflow without a mean-reverting outperformance.



**Oil**

Bernstein's work suggests that when sentiment for EM improves, or at least selling abates, we should see a period of outperformance versus developed markets. Certainly the continued oil price weakness is supportive for the bulk of emerging markets. Oil has rallied off its lows following indications that some producers are prepared to freeze production at current (elevated) levels. Only time will tell how effective this is. We note the comments from a number of the US shale oil producers that they will increase capex again if the oil price reaches the mid USD 40 range.

**Results**

Weak energy prices certainly benefitted Kepco, one of our holdings which released good results recently. Kepco is increasing its dividend and now yields 5%. The results season has been generally good for our portfolios. There are some comments in this month's Asia Insight. In addition we had good results from TSMC and Voltronics in Taiwan proving that there is life in tech outside of smartphones.

Elsewhere in EM we saw good numbers from Bank of Georgia where fee income and real estate sales surprised positively. Costs were well contained and the core banking business continues to perform well. The dividend was increased and the company now yields 3.9%

In Mexico we had the Q4 report from Fibra MQ, a REIT currently focused on industrial properties, seeking to diversify into commercial and retail buildings. The results were slightly ahead of expectations, owing to higher occupancy in the industrial segment, now at 92%. Additionally, rental increases in retail were ahead, thanks to a relatively buoyant Mexican consumer. The Mexican economy is facing the headwind of lower crude oil prices. However, its export-oriented manufacturing sector is performing strongly due to a heavily depreciated peso versus the US dollar, and subdued wage inflation compared to Chinese competitors. The stock remains a solid, defensive story with more growth available from acquisitions, which its balance sheet can easily accommodate. Finally, a yield of 8% on predicted 2016 dividend distribution has some attraction in the world of negative interest rates.

**Outlook**

The macro outlook remains challenging but, at least partially, has already been factored in to prices. As the reporting season has demonstrated, it is possible to find businesses doing well despite the difficult backdrop and these are the companies that we endeavour to put in to the portfolios.

*AL, BR & TH*