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Developing Markets Insight

www.blackfriarsam.com
+44 (0) 20 7332 2270

Market Review

March was unequivocally a good month for GEM equities, with a jump of 13.2%. All 23 countries in the benchmark advanced. Of 23 trading days, 17 were positive. It was the best month since 2011, and the 6th best in history.

Latin America led the charge, with a surge of 20.4%. As nearly always in the region, Brazil was the main determinant of magnitude and direction. It rallied 30.3%, one third of this attributable to currency strength. In spite of a parlous economic situation, the market is taking the view that the current President will be forced from office, resulting in more orthodox economic policies. All the other countries enjoyed double-digit percentage advances.

EMEA added 15.6%. Greece was the best market, increasing 23.9%, continuing to display its high-beta nature, as there was actually no good news to report, simply an exaggerated reaction to the "risk-on" mood. All other countries, except Egypt (+7.7%), saw improvements between 14% and 19%.

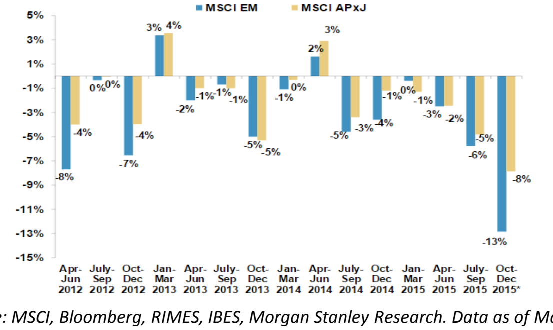
Asia was the relative laggard, albeit still with an impressive gain of 11.4%. The best market was South Korea. The won currency was the regional winner, appreciating 7.5%. Indonesia was the region's weakest country, only advancing 3.1%. It had been the region's best performer in February.

The best sector was Financials, rallying 14.7%, especially banks in Brazil. The normally defensive Health Care sector was the laggard, only improving 8.5%.

Company Earnings

Whilst equity markets performed well during March, the accompanying results season was somewhat disappointing and should lend a note of caution to the unrestrained optimists amongst the media.

EM & APxJ Earnings Surprise History



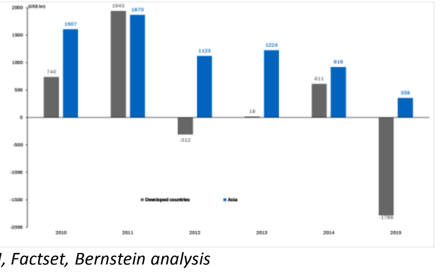
*Source: MSCI, Bloomberg, RIMES, IBES, Morgan Stanley Research. Data as of March 28 2016. *% of Mcap Reported: 77% for EM and 72% for APxJ*

Clearly a results miss is at least partly due to analysts' expectations being too high. But until this gap is closed it is hard to see markets making significant, sustained progress, although continued outperformance of developed equities is possible.

Global Growth

One reason for disappointing results is the lack of growth around the globe; something we have commented on before. If one's only source of information over the last year had been the financial press one could be forgiven for thinking that the blame for the lacklustre growth outlook could be laid squarely at China's door. Whilst we would be the first to admit that China has more than its fair share of issues, the truth behind the media hype is somewhat different, as this chart from the team at Asianomics shows.

Global Dollar-Denominated Nominal GDP Contributions



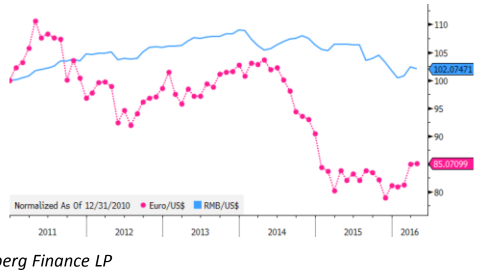
Source: MSCI, Factset, Bernstein analysis

Last year Asia continued to grow, though slower than in previous years. Despite all of its much publicised problems, China delivered the bulk of this increase with weakness in ASEAN offsetting the growth in India. The difference in 2015 was that the increase in Asia was not sufficient to offset the drag from the developed markets with the Euro area GDP contracting U$1.9trn and Japan shrinking close to U$500bn. Unfortunately we do not yet see an end to the tenure of Messrs Draghi and Kuroda.

Renminbi Falls

Another topic generating near hysteria in the press is supposed havoc being caused by the renminbi which was allowed to fall by a "massive" 2.5% in August and which has since fallen a further 1.6%. Quite why anyone would imagine a currency will only move in one direction is beyond me, but if one compares the move in the RMB with the debasement engineered by Mr Draghi since 2011 (shown in the chart below) it is quite clear to me which currency is likely to have caused more problems for global trade/markets over the last couple of years.

Euro and Yuan Dollar Indices



Source: Bloomberg Finance LP

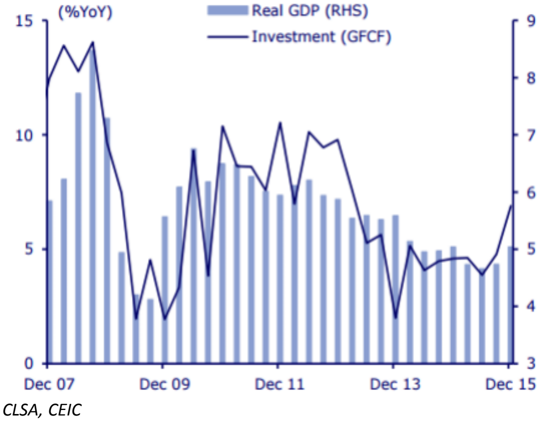
US Equity Valuations

One thing which has puzzled me since the GFC is the ability of the US equity market to maintain high valuations despite weak economic growth and deteriorating company fundamentals. It was thus interesting to read an article by GMO this month looking at the impact of Fed policies on the S&P500 and suggesting that the investor's increasing faith in the ability of central bankers to support the equity market has given rise to a "Fed premium" built in to US equity PEs. To my mind this premium is at risk as it becomes more and more obvious that the Bernanke/Yellen policies are not working with obvious implications for the relative performance of the S&P.

Indonesia

Indonesia had a relatively poor month in March, rising only 3% against 13% for the index. This is in part due to the fact that by the end of February it had already rallied 35% in US dollar terms from its low last September. Investors have been encouraged by a pick-up in growth on the back of infrastructure spending.

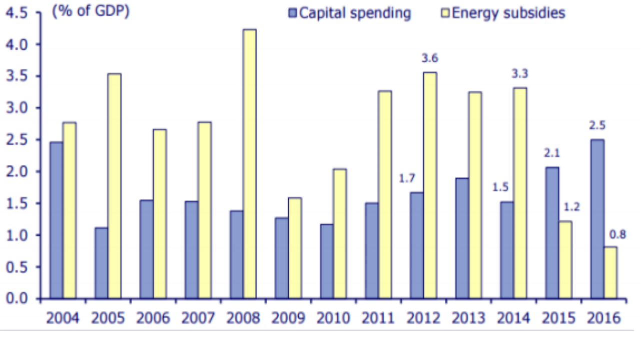
Real GDP and Investment (GFCF) Growth



Source: CLSA, CEIC

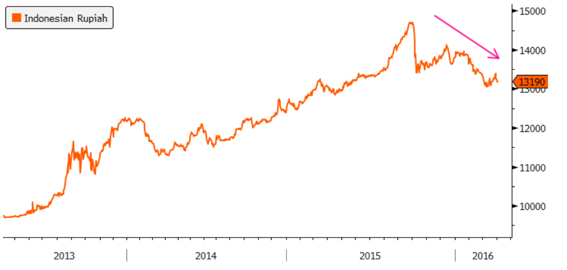
A newly re-focused President Jokowi has been able to spend more thanks to the saving on lowered energy subsidies.

Energy Subsidies vs. Capital Spending



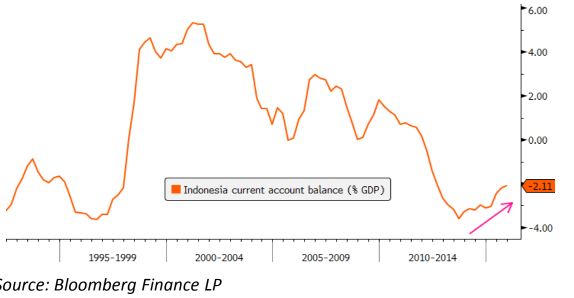
Note: 2015 provisional estimate; 2016 budget revision due by mid 2016.
Source: CLSA, MOF

The currency has stabilised…



Source: Bloomberg Finance LP

… as the current account continues to improve.



Source: Bloomberg Finance LP

The country still has some issues and we will be watching Jokowi's progress and following the macro situation closely. We look forward to visiting Jakarta later this year to dig deeper in to some stock-specific situations.

Brazilian Politics

The probability of President Rousseff being ousted has increased significantly, or at least that is what the market thinks. It surged 30.5% in March, with one third of this attributable to currency strength. The trigger was the arrest of former president Lula on corruption charges, relating to bribes from construction companies. In an apparent attempt to give him judicial immunity, he was invited to join the government, as a de facto Prime Minister. The only snag being that his phone line was being tapped by a judge, who promptly released the recordings to show the abuse of the appointment. Street protests ensued, and a key ruling-coalition partner, the PMDB, resigned. This is pure politics, distancing themselves from the damage, as opposed to moral outrage.

Short-covering whipped the market, with fallen giant Petrobras rocketing 79%! Any new leader faces the same problems, particularly inflation, recession and deficits. It will need a strong will to attack the entrenched 80% of government expenditure that goes on index-linked welfare and salary payments. As long-time followers of Brazil, one hopes there is a positive outcome. Heaven forbid that there is a scuffle over who opens the Rio Olympics on Friday 5th August.

AL, BR & TH