6th May 2016

BLACKFRIARS ASSET MANAGEMENT

Developing Markets Insight

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

Market Review

April was a relatively calm month, with a modest accretion of 0.5%, as the GEM equity markets consolidated after the substantial jump in March.

Latin America continued to set the pace, advancing 6%, mainly fuelled by Brazil's 10.4% surge. The market has rallied 69.1% from its January low. This is wholly attributable to the probable impeachment of President Rouseff, and the expectation of economic reform, which is sorely needed. Peru was the world's best market, improving 13.6%. The first round of the Presidential election resulted in a June run-off, with two candidates (Keiko Fujimori and Pedro Pablo Kuczynski), who are viewed as market-friendly.

EMEA was also positive, with an advance of 3.8%. Egypt was the best market, surging 13.3%, reacting positively to the pound's devaluation. Russia improved 7.8%, aided by crude oil's gain, with Brent Blend leaping 21.5%. Poland was the region's – and GEM's – worst market, losing 7.8%. It was dragged down by the banks, which continued to react negatively to the recently introduced bank tax.

Asia was the relative laggard, slipping 1.3%. Taiwan lost 5.3% as technology stocks suffered in the wake of Apple's weak results. India and Thailand managed small gains of 0.5% and 0.6% respectively. China lost 0.2%, with strength in energy stocks being balanced by weakness in financials.

Energy was the best sector, advancing 6.3%; as mentioned regarding Russia, crude oil was strong. Information Technology was the laggard, down 3.6%; as mentioned regarding Taiwan, Apple was weak after its Q1 results.

The Brazil Soap Opera Continues

The impeachment process is now with the Senate, having been passed by a two thirds majority of Congress. On May 11th the Senate needs a simple majority to start proceedings. The President then has to step down, being replaced by the Vice President. The Senate then has 180 days to hold a trial. It needs a two thirds majority to find the President guilty and remove her from office.

If there is an alleged legal error, the President, at any time, can appeal to Congress. When President Collor was faced with impeachment in 1992, he resigned to avoid the process. President Rousseff has shown no inclination to do the same.

The market is not excited about the prospect of Vice President Miguel Temer. He is a wily, 75 year old political veteran. Rather, the anticipation derives from the prospect of him appointing a Finance Minister with a reforming agenda. The likely candidate is Henrique Meirelles, who was Central Bank Governor from 2003 to 2010. He is widely respected. He is also known to harbour political ambitions. There is the possibility that he might be eyeing the elections of 2018, having steadied the Brazilian ship.

EMEA

In April Emerging Markets took a breather after the +12.8% March rally and were up +0.5% as an asset class. But EMEA markets continued to outperform with MSCI Russia up +7.8% due to stronger Brent crude oil prices (+21.5%), MSCI Turkey increasing 4.3% on money inflows and Poland down 7.8% due to continued concerns over the political climate and weak Polish zloty. Commodities were strong across all the classes with oil gaining 19-26% (depending on blend) on the back of talk of possible production cuts by Saudi Arabia and Russia, and aggressive short covering ahead of the Doha April OPEC summit. Metals were also strong (Aluminium +10%, Nickel +11.3%) on the back of the G20 Shanghai summit, as well as weaker USD after Janet Yellen's comments that an April rate hike is unlikely and her indication that "2% inflation is a target and not a ceiling". As such, a period of lower interest rates is likely to continue. Quantitative easing measures by the largest world economies continued with Japan's Haruhiko Kuroda confirming his intension to increase the size of QQE (quantitative and qualitative monetary easing).

Russia was a good performer on the back of stronger oil and metal prices as well as President Putin's comments on budget discipline as a key priority for the Government. Continued inflation concerns led the Central Bank of Russia to keep its key rate unchanged at 11%. Nevertheless, USA shipped its first LNG tanker to Portugal, which could become major competition and a treat to Russian piped gas to Europe in the medium-to-longer term.

Turkey saw significantly higher headline 4Q15 GDP number of 5.7% vs. 5% expectations, but the number was distorted by the greater number of working days and post-adjustment real GDP growth was only 4.1%. We believe that 3.5-4% GDP growth for 2016 is a more realistic number given the significant drop in tourism revenue and political concerns after the Prime Minister's unexpected resignation. Turkish political risks continued to rise due to the increased probability of a weaker succeeding Prime Minister, possible constitutional change in the Presidency of the Republic of Turkey and increased Turkish-Kurdish tensions in the Parliament, which may lead to the Peoples' Democratic Party (HDP) being banned.

While Crude prices are continuing to hover above $43/bbl we see Russia as stable. We believe that rally in commodities is close to peak and unlikely to continue significantly further. Markets need to test whether 1Q 2016 commodities rally (metals and crude oil) were a sustainable trend driven by real underlying demand improvement or were driven by short-term speculators.

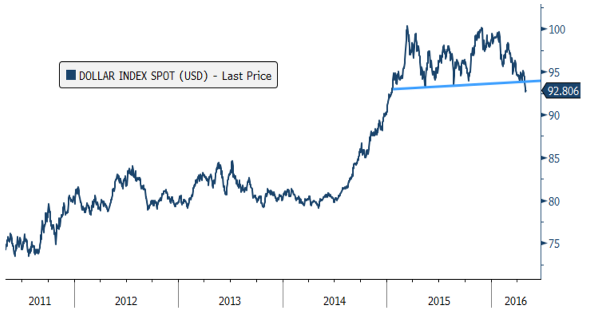
US Dollar Weakness

For the majority of the post-GFC period we have become used to seeing a strong dollar. However, since the long awaited Fed funds rate increase in December last year the dollar index has been weak as expectations of a series of further rises this year have diminished. Additionally, with both the BoJ and the ECB setting negative interest rates, there is further downward pressure on the dollar as investors perceive that rates in Japan and the Eurozone cannot fall further, providing support for the yen and the euro.

Historically, dollar weakness has been good for emerging markets as it signalled easier monetary conditions and a reflating US economy. True to form, this recent bout of softness in the USD has been accompanied by a decent EM rally and outperformance of developed markets.

Following the most recent Fed meeting the dollar index has broken a key support level.

DXY Currency Dollar Index Spot



Source: Bloomberg

This implies further dollar weakness which should be good for emerging markets. Two notes of caution: firstly, the period from May to October is, on average, a period of weak performance for EM; and secondly, in a recent piece published on ERIC's research exchange platform, Russell Napier posits that the reasons for dollar weakness are very different this time and not at all bullish for equities.

AL, BR & TH