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BLACKFRIARS ASSET MANAGEMENT

Developing Markets Insight

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Market Review

May saw a sell-off in GEM equity markets, with a decline of 3.7%, as the January-April rally of 20%+ ran into profit-taking. As with most recent movements, the decisive factor was the US dollar. This strengthened significantly on more hawkish noises from the US Federal Reserve. The result was all GEM currencies depreciated (except for the Philippine peso, due to the election result).

Asia was the most resilient region, with a decline of 1.2%. The Philippines welcomed President-elect Duterte with a 4.5% boost, comforted by the margin of his victory. Malaysia was the worst market, slipping 7.4%, as it continued to suffer the fall-out of the 1MDB scandal. This state investment fund is embroiled in embezzlement and money laundering charges. China fell in the first half of the month but recovered to lie close to flat at -0.8%.

EMEA dropped 7.9%; all markets, except Greece, suffered. The latter surged 11.4% on relief that the debt negotiations had concluded, albeit with difficult decisions postponed until 2018. The worst market was Turkey, plummeting 13.4%. The market was spooked by President Erdogan's consolidation of power, as he eased out his Prime Minister. Russia retreated 5.7%, breaking its usual correlation with the crude oil price, which actually rose 3.2%. Brent briefly traded through US$50 for the first time this year.

Latin America was hit hard, as the Brazilian political circus moved from the travelling phase to the arrival stage. The region shed 10.8%, led by Brazil's 13.6% plunge. The reasons being a combination of profit-taking (the market had rallied 70% from its January low) and the realisation that acting President Temer still has a tortured economy to heal. All the region's countries declined. Peru was the least weak, with a loss of 6.2%. Presidential elections are to be held on June 5th with two candidates, Keiko Fujimori and Pedro Pablo Kuczynski, who are viewed as market-friendly.

Information Technology was the only positive sector, adding 0.5%, helped by good results from Tencent. The Materials sector was the laggard, down 10.7%, hit by depressed steel companies.

Upcoming Election in Peru

On June 5th Peru will elect a new President. In contrast to recent races, especially Ollanta Humala's 2011 victory, the market is very sanguine about the outcome. This is because candidates are viewed as economically benign. In fairness, outgoing President Humala ultimately did little to unsettle the country, having carried a reputation for extremism.

The polls suggest a lead for Keiko Fujimori over Pedro Pablo Kuczynski. The former came close in 2011, with 48.5%. She is the daughter of three-time President Alberto Fujimori, who now languishes in prison on a corruption sentence. Kuczynski is a respected economist, and former Finance Minister. The 5 year CDS on Peru's US dollar debt has compressed from 230 bps to 161 bps, showing a general ease with the country's direction.

New Debt Relief for Greece

May saw another step in the right direction in Greece's macroeconomic reform and debt relief negotiations with the EU. After the approval of another package of reforms in the Greek parliament (pension, electricity, VAT, retail sector), the Eurogroup agreed to disburse a second ESM tranche to Greece of €10.3bn. The first portion of it (€7.5bn) may be available in June, out of which €1.8bn will be directed to clear Greek state arrears, but the lion's share will go to repay some of the Greek debt due in July 2016. In September, upon completion of further pre-agreed actions, Greece may receive another €2.8bn tranche out of which a further €1.7bn will go to clear state arrears.

A lot of critics are saying that the deal with the EU looks 'empty' since a large portion will be paid back to Eurogroup almost immediately in July and that Greece is just 'kicking the can' down the road into 2017-2018 for debt forgiveness. Nevertheless, the Greek banking system and financial markets have already seen the benefit as the yield on two year Greek government bonds came down during May from 11% to 7% and the ten year bond yield compressed from 9% to 7.2%. Moreover, the passing of reforms are a pre-requisite for the next step, which is expected within two months and which may mean a lot for the Greek banking sector. We could see reinstatement of access to ECB refinancing operations (such as a waiver of minimum investment grade criteria for eligibility of Greek government bonds, T-bills and potentially other assets to be included in collateral for ECB funding) which de facto will mean a reduction in funding costs for the Greek banks from 1.5% to 0%. This, coupled with some first signs of stabilization in Greek domestic banking deposits (which stopped declining and stabilized at approximately €121bn in May 2016), as well as the first positive signs of economic stabilization (rising capacity utilization and pockets of improvements in competitiveness), may give long needed support to Greek banks and the economy as a whole. The big risks for Greece continue to be the execution of economic reforms and potential change of the Eurogroup position towards debt restructuring after the 2017 German elections, which might lead to a tougher stance towards Greece.

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