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Developing Markets Insight

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Market Review

June was a relatively becalmed month, which ended with a final three-day rally (+5.1%) to leave a positive return of 4% for the period. Most markets advanced, with the exception of the Eastern European bourses, which were hit by the UK referendum vote to leave the EU. Currencies mainly appreciated, led by a surge in the Brazilian real of 11.1%.

Latin America was the regional leader, gaining 11.4%. As usual the magnitude and direction is attributable to Brazil, which leaped 19.5%. The market was buoyed by acting President Temer's success in navigating legislation through Congress, aimed at slashing the budget deficit. Peru increased 11%, with the election of Pedro Pablo Kuczynski as new President. It was a close result to beat Keiko Fujimori. At the year's mid-point Peru is the world's best market, with a 50.1% accretion. Mexico was the month's relative laggard, only adding 1.1%. The Central Bank surprisingly increased its base rate by 50bps to 4.25%, citing deteriorating external factors. The peso has depreciated 6.8% this year, partly hit by Donald Trump's rhetoric.

EMEA managed an increase of 3.3%, in spite of containing five negative markets: Poland, Czech Republic, Hungary, Egypt and Greece. The latter tumbled 25.2% on fears that the European Union might be damaged by a UK exit. The region was supported by a strong South Africa, advancing 7.7%, mainly from a jump in the rand of 6.9%, helped by strength in commodities and especially from precious metals – gold was up 8.8% as investors sought safety.

Asia was relatively subdued, albeit with all eight markets in positive territory, leading to a regional progression of 2.8%. The best market was Indonesia, recovering 9.5% from May's sell-off. China was range-bound, eventually eking out a modest 1.1% profit.

All sectors were positive, with Consumer Staples in the lead (+5.3%), helped by tobacco stocks. Industrials only improved 1.4%, held back by South Korean engineering stocks.

Brexit effect on Eastern Europe & Greece

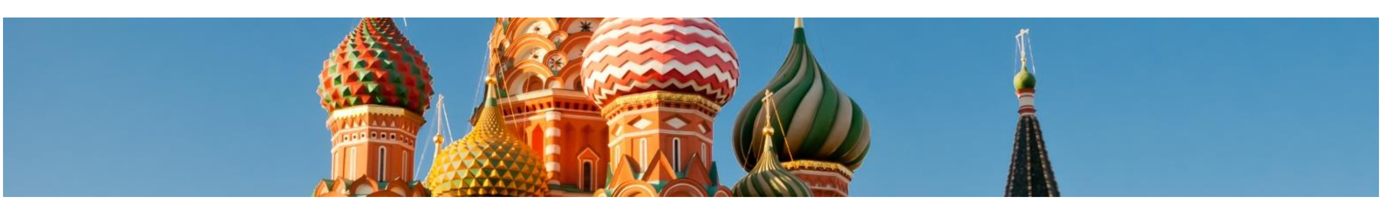
In a historic referendum, and with all the opinion polls and pundits predicting a close result, the UK has voted 51.9% in favour of leaving the EU. News of the Brexit victory immediately triggered a major sell-off in the global markets.

Outside of the UK, the biggest shock was felt in Eastern Europe and Greece with currencies, bond and equity markets affected. CE3 countries' currencies registered losses of over 6% (Polish zloty), 5% (Hungarian forint) and 3% (Czech koruna) versus the US dollar. Equity indices in Poland, Hungary and Czech Republic were down over 4%. The Greek stock market collapsed by 13% with Greek banks down 29%.

While these CE3 countries are not part of the Eurozone, the EU is their largest trading partner and they are part of the Schengen agreement. According to preliminary estimations, Brexit may shave 0.2%-0.3% off of the local CE3 economies' GDP growth in the next 2-3 years, and even up to 1% in the first year after Brexit. These effects depend on the potential disruption of trading links, the likely cut in the European budget (to which the UK has been contributing 12%) and the likely decline of international transfers from UK-based immigrants. Eastern Europe was the biggest beneficiary of EU policies since the mid-1990s and have especially benefited from EU funding for infrastructure projects since 2009. Due to their Swiss franc (CHF) exposure, Eastern European banks were immediately hit on the day after the referendum, as stronger CHF translates into higher capital requirement and increases the chances of forced conversion. The Polish construction sector also saw significant sell off on the expectation of a cut in the EU's budgetary spending on infrastructure projects. On the other hand, the devaluation of local currencies in the medium term can be positive for Central and Eastern Europe's export-oriented manufacturing sector.

In the medium term, Brexit has been a significant blow to the overall 'EU project' and it's fair to say that it threatens the whole existence of the EU as an organisation. Hence, geopolitical risks for CE3 countries, as well as Greece, have risen substantially and may trigger a revaluation of the risk premium applied by the investment community. Nevertheless, medium to longer term events are much harder to predict. We expect the next two years to bring significant change to the domestic political landscape in the majority of EU countries; most importantly, Germany and, to lesser extent, France. It looks almost certain now that Chancellor Merkel will lose her post in Germany's 2017 elections and there is still a question over whether a 'grand coalition' of CDU/CSU and Social Democrats will be able to get a majority of the votes. Most likely, anti-integration parties will get significantly larger representations in parliament in the next election and Germany's political leadership will look significantly different.

With Austria and Poland both electing anti-EU leadership in the last 12 months, one can only expect that other EU countries will experience a similar political trend Another possibility is that Europe takes the British result as a 'wake-up call' and seeks to reform and improve its policies. Still, the speed and extent of such reforms are impossible to predict at the current stage. Blackfriars' view is that in the short term the European Union will try to reform to survive. Its choices are 'change' or 'die'.



Nigerian devaluation

On 20th June, after more than a year of expectation, Nigeria finally floated the naira and removed the fixed peg against the US dollar, leading to a devaluation of 40%. Nigeria was one of the last energy exporting countries to give up the peg after the 50% collapse of crude oil prices from 2015. Since June 2015, the naira has only depreciated by around 25% versus the US dollar, compared to an approximately 90% devaluation of the Russian rouble, which is a fully floating currency. As such, we see levels of 280-300 NGN for 1 USD as fair devaluation levels implied by the rouble.

Still the question remains whether the Central Bank of Nigeria has fully floated the naira or moved from one quasi-peg to a new quasi-peg. Egypt's March 2016 devaluation shows that it is moving to a similar status quo, but its modestly devalued exchange rate is not really a constructive approach. Moreover, with lower energy prices, an absence of policy reforms and FX shortages, Nigeria has already experienced significant slowdown of GDP growth from 6.2% in 2014 to 2.1% in 2016 (expected) and inflation rising from 9% in 2015 to 17% in May 2016.

The devaluation comes as another step by newly elected President Buhari to adjust the economy to lower energy prices and push through needed budget, fiscal and government control reforms. With the Nigerian Business Confidence Index dropping into negative territory in 1Q 2016 and significant slowdown in services and industrial growth, we think that the Central Bank of Nigeria will have to return to more orthodox monetary policy to control inflation. The government also needs to implement a series of structural reforms in agriculture, electricity, anti-corruption and public-private partnerships. The new president's first steps are positive, but only significant reforms will allow Nigeria to exceed the 6% GDP growth levels that it experienced during the oil boom era of mid-2000s.

Outlook

A good showing in June means that GEM equities are beating the developed world by 5.7% (GEM +6.4%, DM +0.7%) at the halfway point of 2016. This is the best H1 relative performance since 2009. The benchmark's main positive contributors have been Brazil, Taiwan, South Africa and Russia. The only substantial negative was China. In terms of stocks, the league is headed by goldminers, several of which have more than doubled. The losers have been Greek banks and Brazilian exporters.

A more supportive view of the outlook for emerging markets could be based upon: 1) Relative valuations, especially compared to fixed interest; 2) Stable currencies; 3) Operating margins at a 17 year low; and 4) Capex discipline leading to improved cash flow and dividend payments.

The downside, as always, centres on risk appetite, US dollar strength and renminbi fluctuations. The UK Brexit vote has shocked markets. However it also served as a reminder that emerging market equities are not always the riskiest asset to hold.

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