BLACKFRIARS ASSET MANAGEMENT

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

5th September 2016

Developing Markets Insight

Market review

August continued the recent positive trend with a gain of 2.5%, making it the third consecutive month of accretion. The market had been more than 2% higher but retreated slightly over renewed anticipation of a US interest rate hike, with markets now suggesting December.

Asia, having been relatively out of the spotlight this year, was the best region. It advanced 4% with all countries, except the Philippines, improving. China led the way, with a jump of 7.4%. This moves the country into the black for the first time this year. It had a sharp fall in January but is now up 5.9% for the first eight months. In spite of weakness in the renminbi, the benchmark was helped by strong Q2 results from Tencent, which is now nearly 14% of the index. Other countries were becalmed, with modest currency strength being the main feature. The Philippines ran into profit taking after Duterte's post-election rally.

Latin America was also calm, with an increase of 0.7%. Brazil paused for breath, edging up 0.9%. The impeachment of Dilma Rousseff was legally executed on the last day of the month and the Olympics were completed without any major problems. Some events had noticeably empty seats. This can perhaps be attributed to the severe economic downturn affecting the nation. Chile fell 4.1% as copper retreated 6.3%. Colombia was GEM's best market, climbing 9.6%, enjoying a peace deal being struck with the Revolutionary Armed Forces of Colombia (FARC), hopefully ending 52 years of civil war.

EMEA slipped 2.6%, pulled back by South Africa's 7.7% retreat. This was predominantly attributable to rand weakness (-6.1%). The market is concerned that Finance Minister Pravin Gordhan may be ousted by President Zuma. The Czech Republic was GEM's worst market, slumping 10.2% as Komercni Bank was hit by an increase in capital requirements as the Central Bank sought to safeguard the sector. Russia was the region's best market, adding 2.5%, in response to crude oil's 10.8% jump (Brent blend).

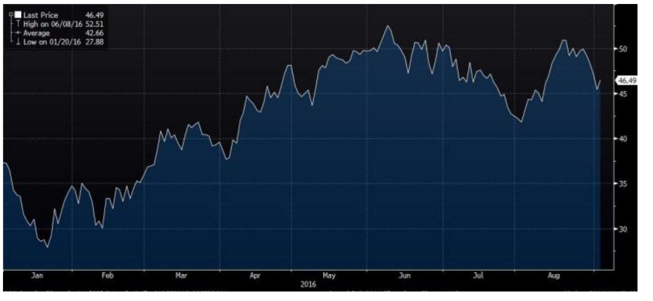
GEM sectors were mixed. The heavyweights, IT and Financials, which represent nearly half of the benchmark, were up 5.4% and 4.2% respectively. Telecommunications was the worst sector, down 1.8%, hit by weakness at South Africa's MTN.

Oil price outlook

One of the key tenets of our investment thinking over the last few years has been that we are in a broad deflationary environment. Most commodity prices peaked in 2011 with oil managing to sustain higher levels before spectacularly collapsing in 2014. This is a positive backdrop for (most) emerging markets as they are net commodity consumers.

The oil price has recovered strongly this year and currently sits at USD$46.49/bbl, up 67% from its January low.

2016 oil prices

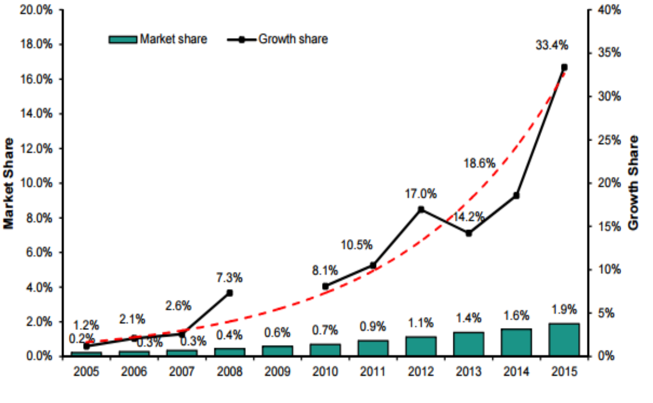


Source: Bloomberg

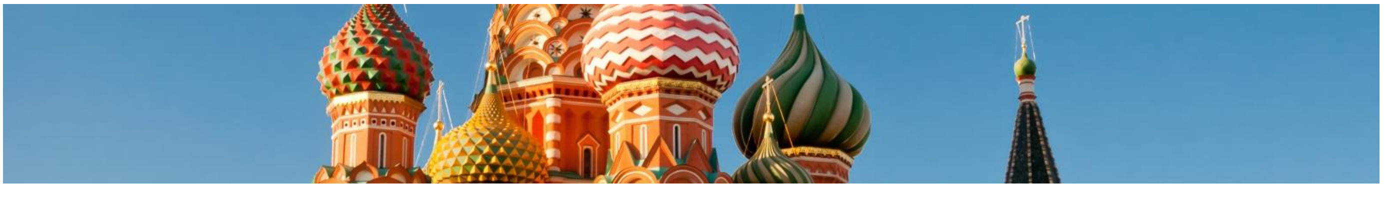
Our view is that there is limited upside from here in the short term, both due to geo-political tensions preventing any OPEC led production cuts and also because US shale producers are likely to increase their production as oil moves above USD$50. If we are correct, then this will be a boon for emerging markets, particularly Asia.

The longer term oil price is notoriously difficult to predict but a recent chart published by the excellent Michael Parker at Bernstein certainly gives food for thought.

Wind & solar share and growth share of global energy market



Source: BP Survey 2016, Bloomberg, Bernstein analysis



The share of the total energy market provided by wind and solar was just under 2% in 2015 but this is missing the point somewhat. What is much more interesting is that wind and solar together took a growth share* of over 33%, a ~15% increase on 2014, in a year when the oil price collapsed to a three decade low. Looking at the graph, one can infer that the growth share will continue to accelerate and, depending on the assumptions used, within the next 3 to 5 years wind and solar will be more than 100% of incremental demand which in turn implies demand for fossil fuels will start declining in absolute terms. By 2020, if this analysis is correct, although the absolute share of renewables will still be small, the trend will be very clear and the implications for those with decades of reserves will be profound.

** growth share is the percentage of incremental energy demand each year addressed by wind and solar.*

Brazilian politics

Whilst Rio hosted the Summer Olympics, the politicians in Brasilia were busy with the impeachment trial of Dilma Rousseff. The charge was one of budgetary mal-administration, mainly relating to the use of state-owned banks to provide credit to fill funding holes. The proceedings started at the end of 2015 and her Presidency was suspended in May 2016. The last day of August saw the Senate vote 61 to 20 to complete impeachment. Acting President Michel Temer was immediately sworn in. He will serve until the end of 2018.

In another important vote, the Senate did not bar Rousseff from public office. This means she could stand for election again. Clearly a market that has nearly doubled (+96% off January low) in the midst of a severe recession is expecting improvements. President Temer has a great opportunity to make the tough decisions without the political necessity to be populist.

Argentinian yield

Since President Mauricio Macri settled with hold-outs in May, the market has been happy to buy debt from this recidivist defaulter. In its 200 year existence as an independent nation, it is considered to have defaulted five and seven times on domestic and international debt respectively.

Nevertheless, the country has this year issued USD30 billion in new debt. This has come from sovereign, provincial and corporate issuance. As an example, the 10 year USD sovereign bond currently yields 5.8%. A similar yield and maturity is available on issuance from Banco Galicia, the nation's largest private bank. With government debt/GDP at a relatively modest 50%, investors are happy to take the coupons, without dwelling extensively on history.

Outlook

GEM equities have been having a reasonable year, without the help of China, which represents 22.5% of the benchmark. In August the largest constituent country joined the advances. Reasons for improving sentiment include: better than expected Q2 results, continued consumption growth and the approval of the Hong Kong/Shenzhen share-trading link.

The asset class has also been helped by the strength in high yield fixed income, which has improved discount rates. For example, the CDS on 5 year Russian USD debt has compressed from over 6% at the beginning of 2015 to just over 2% now. It is estimated that every 1% decrease in the Brazilian discount rate improves net present value by 15%.

AL, BR & TH