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BLACKFRIARS ASSET MANAGEMENT

DEVELOPING MARKETS INSIGHT

4th October 2016

Market review

September was a range-bound month, eventually resulting in a modest return of 1.3%, capping a good third quarter with a gain of 9%. Markets waxed and waned on speculation around possible Federal Reserve movements, with relatively little news flow from the developing nations themselves.

EMEA was the strongest region, adding 2.9%, led by South Africa's 5.8% rally. This was the best performance in GEM equities, wholly attributable to the rand's 6.5% appreciation. The majority of GEM currencies gained versus the US dollar, especially after the US Federal Open Markets Committee kept interest rates unchanged after its meeting on 21st September. Russia improved 3.9%, aided by a jump in crude oil of 7.9% (Brent blend). The commodity responded well to news of a proposed cut in OPEC production. Greece was the area's weakest market, declining 5.3%, hit by ongoing weakness in the banks.

Asia was stable, advancing 1.3%, led by China's 2.5% accretion. The market is being buoyed by increased flows through Hong Kong from mainland investors. In addition, the largest IPO in two years was listed with Postal Savings Bank coming to market, albeit to a subdued debut. South Korea weathered a faulty phone battery recall from Samsung Electronics, and registered a positive move of 1.4%. At one stage the mobile phone maker was down 10% in two days. It recovered following swift action on recalling and refunding/replacing the handsets. The worst market was the Philippines, stumbling 5.6%, hit by the peso's 4.1% depreciation. The market has been unnerved by inflammatory comments from recently-elected President Duterte.

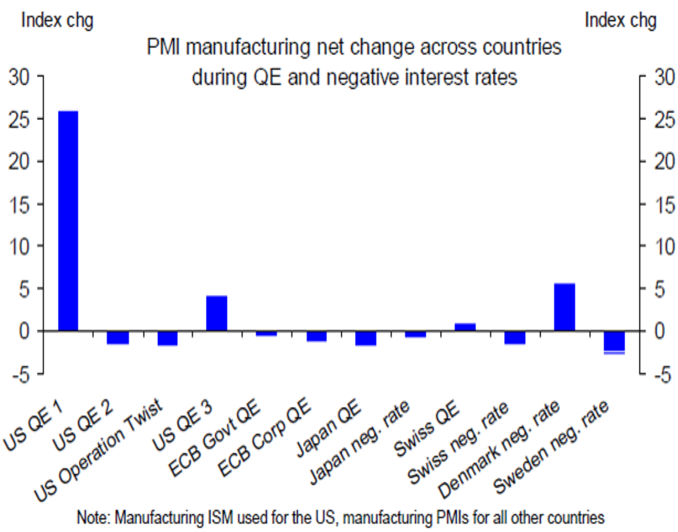
Latin America gave up its leadership of GEM equity performance in 2016, with a retreat of 0.8%. Mexico continued to be pressured, especially on the currency front. The peso lost a further 2.6%, leaving it 12.1% down for the year. Obviously the prospect of Donald Trump has been unnerving this very liquid currency market. The Central Bank raised overnight rates by 50 basis points to 4.75%, the third hike this year. It is a short-term irony that Trump's rhetoric has been helping to boost the spending power of the USD25bn+ that USA workers send back to relatives each year. All the region's other markets returned close to zero in the month.

GEM sectors were mixed. Information Technology advanced 3.75%, aided by gains in TSMC and Alibaba. Utilities was the worst sector, slipping 3%, hurt by rising coal prices that hit electricity generators.

Quantitative easing: lower for too long

Quantitative easing (QE) has been with us since 2009. Markets have become addicted to the excess liquidity and seem happy to accept that zero rates are the solution. Looking at the impact that QE and negative rates have had on ISM and PMI across countries where it has been deployed shows that, far from being the solution, in all but one instance its effect has been negligible or negative.

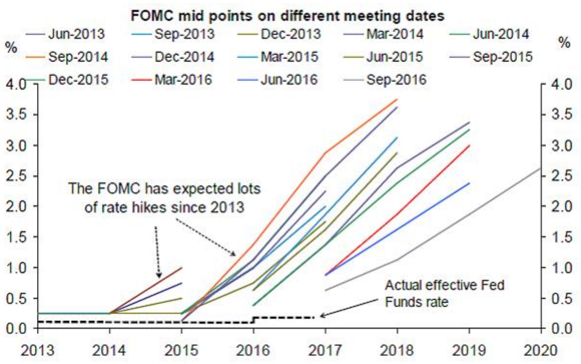
Report card for unconventional monetary policy: QE1 in the US worked. Nothing else has really worked



Source: ISM, HIS Markit, Nikkei, SVME, Bloomberg Finance LP, Haver Analytics, DB Global Markets Research; courtesy of Deutsche Bank Research

Since the Lehman's crisis, the US Federal Reserve has maintained that the ongoing (US) recovery was weak because it was facing headwinds from the healing of housing, banking, and consumer balance sheets. As a result, both the Fed and the market expected the recovery to pick up soon and rate hikes to be just around the corner (as the expectation was that the healing was soon coming to an end). The charts from Deutsche Bank below show this firstly for the FOMC and then what the market expected.

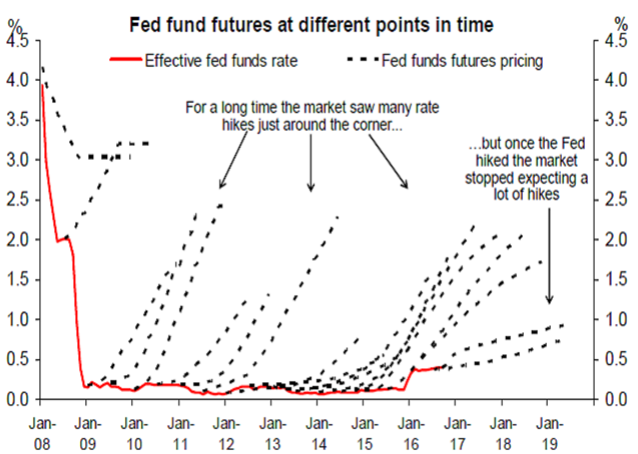
The FOMC has been too optimistic for many years



Source: Peter Hooper, FOMC, Deutsche Bank Research; courtesy of Deutsche Bank Research

Of late, however, the story has changed to one where the FOMC is more worried about the longer-term growth prospects for the US economy, primarily because of worries about low productivity growth; that is to say, there are some more permanent reasons why growth will remain low. We can see from the dotted lines on the second chart that since the rate rise last year the market has become a little more skeptical about the Fed's recovery rhetoric. If this puts pressure on central banks to change tack, then all the better. We think QE is doing more harm than good.

Market narrative has moved from a "headwinds-will-fade" story to a "low-productivity-for-long" story

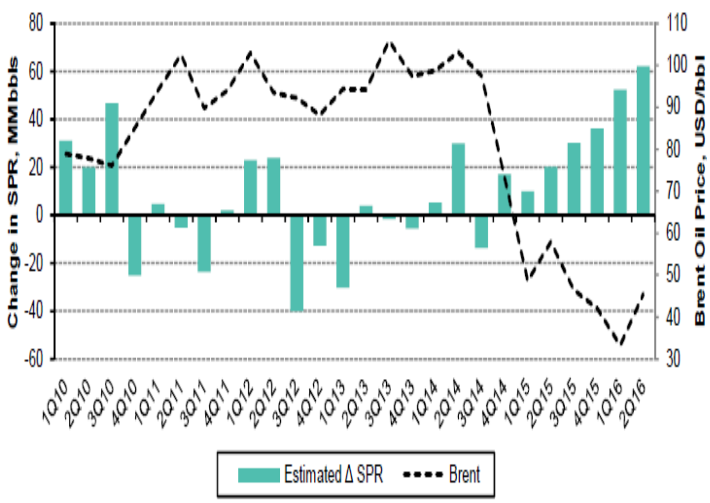


Source: FRB, Bloomberg Finance LP, Haver Analytics, DB Global Markets Research; courtesy of Deutsche Bank Research

Oil: lower for longer?

The oil price jumped this week on the surprise announcement of a modest production cut (750k bpd) by OPEC. It remains to be seen how effectively this can be implemented. One factor which has been supportive of the oil price may now be about to reverse. China has played a key role in stabilizing world oil markets, despite its weaker economic growth, through filling of its strategic petroleum reserve (SPR), which it has been doing at a rate of 500k bpd. Since the beginning of the year the SPR has risen by 60% to 370 million barrels in July.

The recent build in SPR coincides with the collapse in oil prices



Source: China NBS, OGP report, Bloomberg, Bernstein analysis and estimates

Filling of the SPR has accelerated significantly following the collapse in oil prices as the government takes full advantage of low prices to build up its reserves. If and when prices start to rise again, China is likely to pull back on filling of the SPR which will act as a net increase in supply, at least partially offsetting the mooted OPEC production cuts.

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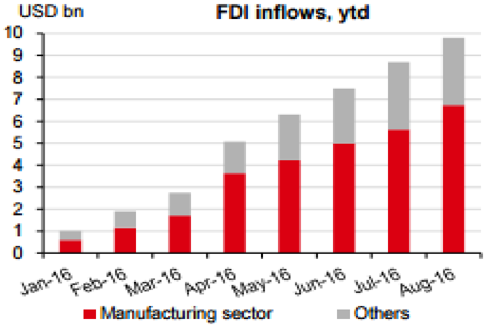
Vietnam – looking good

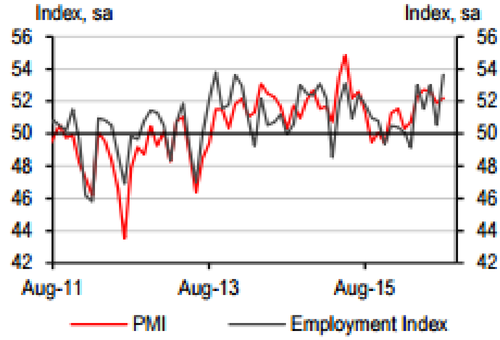
Manufacturing and exports continue to do well in Vietnam, reflecting the country's continued competitiveness as illustrated by the charts below.

FDI continues to grow with manufacturing the key component



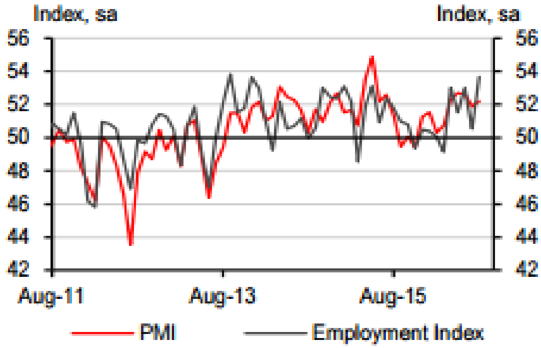
Source: CEIC, HSBC

Confidence in the sector is rising and employment growing



Source: Markit, HSBC

The trade surplus continues to widen



Source: CEIC, HSBC

There are some clouds on the horizon. Inflation has been a persistent problem, currently contained under the 5% target but price pressures are growing (food, wages). The budget deficit is growing, partly due to lower oil prices, and consequently fiscal policy is strained. However, we remain optimistic about the prospects for the economy there. The government has been good at signing free trade deals, they are working hard to privatise state-owned companies and have been pro-active in helping to resolve the debt problems at the state banks. As long as we continue to see steady progress on domestic reforms, we think Vietnam will continue to perform well.

Outlook

GEM equities have enjoyed the best relative performance versus developed markets since 2009. For the first nine months, the former has gained 12.1%, compared to 5.6% for the latter. At the beginning of the year, the momentum was provided by recoveries in Brazil and Russia. In recent months Asia, including China, have contributed. The key has not necessarily been good news, but rather the absence of bad news. Rate rises in USA continue to be postponed. China seems to be muddling through. Inflows to the equity asset class have turned positive and now total USD10.7bn YTD. However, this is dwarfed by the USD49bn that has flooded the emerging markets fixed income market. Valuations are above historic averages but are still at a substantial discount to mature markets, which could provide some support.

AL, BR & TH