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DEVELOPING MARKETS INSIGHT

4th November 2016

Market review

October was another relatively range-bound month, trading in a band of -1% to +2%, eventually returning 0.2% for the month. The result is a balance of weak currencies in the face of a strong US dollar, counterpoised by renewed strength in Latin America. This was the fifth consecutive positive month. Once again sentiment regarding US interest rates was a dominant factor. The futures market is factoring a 20% probability of a hike in November; whilst the chance of a December increase is 70%. The US presidential election is also relevant, since the surprise of the UK European referendum result in June caused a sudden 5% decline in GEM equities, highlighting how sensitive the asset type can be.

After a pause for breath in September, Latin America resumed its world-beating pace, jumping 9.9%. Once again the charge was led by Brazil's surge of 14%. Congress passed legislation to cap future spending growth in line with inflation, paving the way for interest rate reductions to commence. Mexico recovered 5%, as Donald Trump dropped behind in the opinion polls. The country, and especially the peso, are gripped by the imminent election. Colombia was the weakest regional market, slipping 1.3%, as the electorate voted against a peace deal with FARC. It was suggested that the amnesty terms for former terrorists were too lenient.

EMEA declined a modest 0.2%, held back by South Africa's 1% loss. The rand actually appreciated 2%, as fraud charges were dropped against Finance Minister Pravin Gordhan. Nevertheless, weakness in gold and platinum (down 2.9% and 4.3% respectively) held back the miners, and thereby the benchmark. Turkey lost 0.8%, depressed by the lira's 3.2% slippage. The currency has hit an all-time low as the central bank cut overnight rates in spite of persistent inflation. Egypt was the best market, adding 8.5%, with continued gains in all three index constituents, especially Global Telecommunications.

Asia slipped 1.4%, with heavyweights China and South Korea losing 1.9% and 3.7% respectively. The renminbi slipped 1.5% to its lowest level in the modern era, which is positive for Chinese manufacturing in its export market. The won was also weak, losing 3.9%. Samsung Electronics issued a profit warning on the back of recalling smartphones prone to catch fire. In spite of this, the stock still gained in local currency, and rests close to its all-time high. The Thai market initially slipped over 6%, following the death of King Bhumibol Adulyadej, but a subsequent small rally left the country with a 2.3% monthly retreat. Taiwan was the region's only positive market, with an accretion of 1.4%. The technology heavy market was supported by continuing positive news, especially in semi-conductors, in the wake of Qualcomm's bid for NXP. TSMC also hit an all-time high.

Energy was the best sector, advancing 4.9%, in spite of crude oil's 1.6% loss (Brent blend). The reason being Petrobras's 34% jump, on news of asset sales and successful bond issuance. Communications was the worst sector, hit by weakness at China Mobile.

Economic chaos in Venezuela

From an equity investment perspective, Venezuela's importance has mirrored its decline into economic and social chaos. When MSCI established its emerging equities benchmark in 1988, Venezuela had a double-digit percentage weighting. It was evicted in 2006, as Hugo Chavez's fully fledged socialism, including nationalisations and expropriations, took hold. The stock market still exists, but barely trades; the volume can some days be counted in hundreds of US dollars.

By contrast, fixed income investors remain active in the sovereign and quasi-sovereign credits. Indeed, last week the state-owned oil company PDVSA managed to swap bonds maturing next year into longer dated bonds in 2020. The only reason it was able to do so was by offering collateral in CITGO, its US oil refining and fuel retail business. The deal is complicated, but bondholders may face the prospect of owning a petrol station as opposed to a US dollar credit.

The country remains firmly split, with Chavez devotees still backing his successor, Nicolas Maduro. Whilst the opposition now holds a majority in Congress, following last year's elections, hyperinflation is taking hold, with stories of retailers having to weigh bolivar notes. The price is being severely paid for excess state profligacy, established when the crude oil price was substantially higher.

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DEVELOPING MARKETS INSIGHT

South Africa – pressure mounts for Zuma

2016 has been a better year for South Africa than 2015 – at least on the face of it. The currency has strengthened from 17 to 13.50 versus the US dollar, 5 year CDS levels are back to 'stable' 250s levels, and stability was preserved on the political front with charges against Finance Minister Pravin Gordhan dropped. Nevertheless, the anti-corruption fight against President Zuma and his close circle is intensifying and the probability of him stepping down ahead of his 2019 compulsory retirement is substantially increasing.

October's 'state capture' report by the anti-graft ombudswoman significantly raises the stakes for Zuma. The report suggests multiple irregular links between him and the controversial Gupta family and ordered a judge-led inquiry to further investigate potential conflicts of interest. Zuma's attempts to stop publication of the report solidified previously opposing sides (Democratic Alliance and Economic Freedom Fighters) and prompted widespread anti-Zuma protests in Pretoria. Within the African National Congress (ANC) calls are increasing for his early resignation and the appointment of Cyril Ramaphosa (ANC Deputy President and financial market favourite) to take over immediately on a temporary basis (and to take over permanently at the ANC conference in December 2017). In October, three more unions called for Zuma's resignation: the National Health and Allied Workers Union, the South African Democratic Teachers Union and the National Union of Mineworkers.

While we think that the pressure on Zuma to step down will continue rising within the ANC, we also believe that he will resist it until the end as any weakness could potentially result in criminal charges against him and imprisonment. Moreover, President Zuma's powerbase in the ANC and KwaZulu-Natal is still very substantial and taking down Zuma may tear the ANC apart and cause the party to split. This would undoubtedly be the biggest transformation of the South African political landscape since Nelson Mandela's election. Still, Zuma is unlikely to go without a fight and it is more likely that he and his camp will go on the offensive in the coming months. Hence, while the anti-Zuma tide is rising and his early resignation would undoubtedly be cheered by the markets, it is too early to call for a major power shift in South Africa. Failure to control succession could easily land President Zuma and a whole swath of his allies in prison on charges including corruption. As such, expect a fight to the death in the ANC and more volatility in South Africa.

Outlook

GEM equities further outpaced the Developed World in October, and the YTD total USD returns are 16.3% and 3.5% respectively. Barring a significant reversal, the year looks likely to see GEM equities beat the developed counterpart for the first time since 2012. If this happens it would mean five out of ten years have seen relative outperformance. All GEM countries, except Greece, have delivered positive returns this year.

This year the regions of Latin America and EMEA have been over-delivering in terms of GEM performance, especially the recoveries in Russia and Brazil. This was from significantly oversold positions, and is not a readily repeatable event.

For GEM to progress further it will need more input from Asia, particularly China. The mood in China is moderately constructive. Recent manufacturing and factory gauges have been revisiting two year highs.

Earnings valuations are above historic averages but still at a substantial discount to mature markets, which could provide some support.

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