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DEVELOPING MARKETS INSIGHT

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Market review

Having been becalmed for four months, November saw a return of nervous negativity with GEM equities losing 4.6%. At one stage the market was down over 7%, but it staged a modest recovery. There was one reason for the decline: US dollar strength in the wake of Donald Trump's election victory. A basket of emerging currencies depreciated over 5% in the month; the view being his looser fiscal policy will lead to more accelerated rate rises, making the US currency attractive.

Asia held up reasonably well, losing 3.3%, aided by China only slipping 1.2%. The local market actually rose but the renminbi lost 1.7%, falling to a six-year low. The other Asian heavyweights – South Korea and Taiwan – were also relatively resilient, losing 2.6% and 2.3% respectively. The worst market was Indonesia, which shed 12.5% as it was hit by heavy foreign outflows, prompted by a flight to lower volatility.

EMEA lost 4.9%, with Turkey shedding 15%, of which 10.7% was lira depreciation. The country is deemed to be highly sensitive to US interest rates. The Central Bank was forced to raise overnight rates by 25bps to 8.5%, continuing its collision course with President Erdogan, who wants much lower borrowing costs. Russia was the best market, adding 4.8%. Most of this occurred on the last day of the month, in response to the proposed OPEC production cut. Greece was the world's best market, improving 9.8%, helped by ongoing negotiations with the IMF and EU ahead of a meeting on 5th December to approve a second debt restructuring. Egypt was the worst market, tumbling 33.5%. The currency more than halved in value, after it was allowed to float.

Latin America slumped 10.6%. Mexico led the rout, shedding 12.8%, with the peso losing 8.9% for obvious Trump-related reasons. The currency has lost 18.5% this year. The market, in USD, is at a seven-year low. Brazil ran into profit-taking, losing 11.2%, as politicians faced protests against proposed budget austerity plans. Peru managed a 3.5% gain, aided by copper's 20% rally.

Basic Materials was the best sector, gaining 2.4%, boosted by the enthusiasm for commodities. Diversified was the worst sector, losing 9.6%, hit by the fall in Mexican conglomerates.

Trump and Latin America

The outgoing Obama administration has had relatively little impact on Latin America. It was essentially involved in rapprochement with Cuba, peace in Colombia, and a worsening stand-off with Venezuela.

Obviously Mexico is the key question, having been the target of many aggressive threats regarding NAFTA, immigration and a border wall. Of the five MSCI Latin America countries, only Mexico has a large export component in its GDP numbers, approximately 40%, of which 80% goes to the USA. So Brazil, Peru, Colombia, Chile (and Argentina in Frontier) are relatively unaffected by the new USA administration. To generalise, their governments have been moving from centre-left to centre-right, so might get along with the new Republican regime.

Mexico faces a lot of uncertainty. Against this backdrop there are two possible positives: firstly, the market and currency have retreated substantially; and secondly, many of the Mexican export-based jobs are modestly remunerated. Therefore they might not be as vulnerable to Trump repatriation.

The only clear winners are tourism and mining, both helped by currency weakness; whilst not being linked to North American exports.

OPEC – smoke and mirrors

If a prize was to be given for best market 'prep' in the last few years, it would undoubtedly be awarded to OPEC and specifically to Saudi oil officials. For the last three months they have been setting the stage to announce a potential oil production cut and have definitely added more suspense in the two weeks before the announcement.

Getting the maximum price effect from the minimum cut was the task and, one has to say, it was an enormous one. But the acting was impeccable, all actors (that is to say, OPEC and non-OPEC producers) played their part and hence we are witnessing an impressive US$54 per barrel the day after the announcement.

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It should not be a surprise that some investors were caught off guard, firstly that OPEC could get together and agree a production freeze but also agree on a production cut given that members are on opposing sides of two regional conflicts: the Yemeni conflict between Saudi and Iran and the Syrian conflict between Saudi, the Gulf states and Russia.

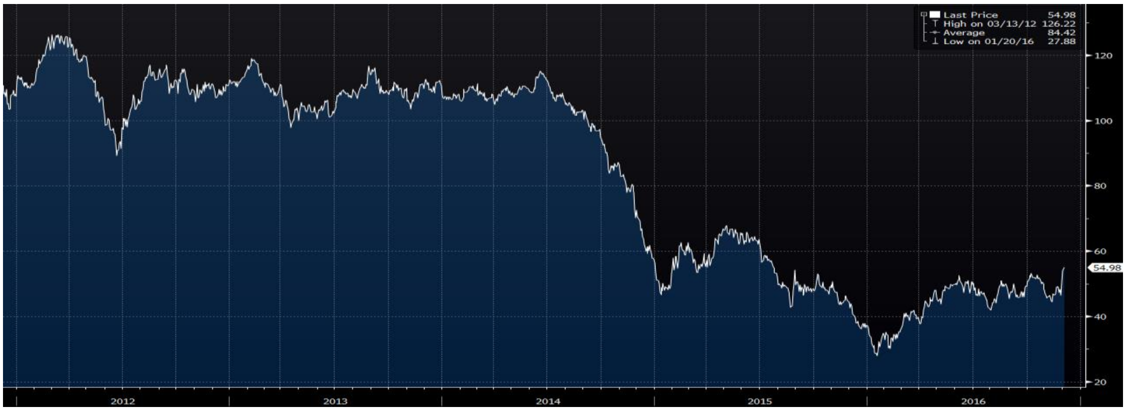
Still, those of us who are long-term investors tend to look at OPEC and say 'what a charade' as the consortium is fighting against history in a desperate attempt to delay the decline of their influence. The risk of that decline was felt so strongly that it even pushed major adversaries to come to an agreement last week. Still, fundamental analysis of supply and demand and technological progress clearly suggest that costs of oil production, new shale oil discoveries as well as alternative energy technologies have all dramatically altered the near term as well as the long term picture for oil economics.

We view the recent OPEC agreement from four angles. Firstly, from the perspective of OPEC motivation, it is no surprise to us that the main push for an oil production cut came from Saudi, who suffers the most under low oil prices and US$-peg. After all, Russia has a free-floating rouble that has absorbed most of the oil price fall and Iran survived over 20 years under US sanctions, so both are in a much better position. This cut will allow the Kingdom of Saudi Arabia to at least consider the IPO of Aramco in 2017-18, which will potentially bring in some extra revenue and cover some budget deficit holes. Secondly, with regards to the size of the cut, since June 2016 there was a clear push by all oil producers to show much higher oil production on paper in preparation for a potential freeze or cut – hence we think that a 1.2m bpd (barrels per day) cut for OPEC and 600K bpd for non-OPEC will merely bring us to the 'normal' real seasonal state of supply and demand, and in reality is more of a cut on paper only. For example, Russia's 300K bpd voluntary cut is not only subject to 'technical conditions' but will also only take Russia back to September 2016 levels of production. Thirdly, on enforceability and monitoring (for example, cheating), there is simply no current mechanism to monitor cuts and we are quite wary of the reliability of most statistics on oil reporting. Fourthly, with regards to the price effect, US shale is now undoubtedly setting the ceiling for oil price with estimations varying between US$45-60/bbl.

While OPEC can't influence the ceiling price, it can try to put a 'floor' under the oil price and that's how the current cut should be viewed: as an attempt to limit production in order to limit the downside to the oil price. Hence, while the short-term oil price bounce has breathed some air into unloved names like Russia's Gazprom and Brazil's Petrobras, we, as long term investors, think that OPEC's cut simply can't fundamentally change a 'lower for longer' oil price outlook.

AL, BR & TH

5 year oil prices



Source: Bloomberg