DEVELOPING MARKETS INSIGHT

5th January 2017

Market review

After a nervous November, GEM equities were more becalmed in December, managing a modest return of 0.2%. That leaves the asset class with a fourth quarter loss of 4.2% but an annual gain of 11.2%. This breaks a run of three consecutive negative years between 2013 and 2015. From its January low to the August high the return was 34.7%. This strength was subdued by a return of US dollar strength, exacerbated by Trump's election victory. Developed markets returned 7.5% this year, meaning that a four-year winning streak versus GEM equities has been broken. The outperformance gap of emerging over developed had been as high as 10% in August.

EMEA had a strong month, gaining 7.2%, with all ten constituent countries in positive territory. Russia led the way, advancing 12.5%. It has bounced 54.8% this year, aided by the rouble's appreciation of 16.4% and crude oil's 45% recovery (WTI blend). Greece was the laggard market, adding only 1.4%. For the whole year it was the worst GEM market, losing 12.1%, held back by ongoing debt renegotiations. It is a small market, but it is worth noting the 57% depreciation in the Egyptian pound in 2016, one of the largest annual devaluations in GEM history.

For the month, Latin America returned 0.9%, capping a strong year's return of 31%. In December, Colombia was the region's best market, improving 8%, helped by crude oil's 8.7% rally (WTI blend). Brazil improved 0.8%, cementing its world-beating 2016 return of 66.2%. The positive sentiment regarding economic improvement continued, with pension reform progressing in Congress. Chile lost 0.4%, slightly depressed by copper's 5% weakness. For the whole year, Mexico was the region's only negative market, falling 9.2%, depressed by the peso's 19.3% rout over concerns about trade, migration and remittances with America.

Asia was the weakest region, both for the month and the year, returning -1.4% and +6.1% respectively. In December, Indonesia was the best market, adding 5.4%, recovering from the previous month's 12.5% rout. China was the worst market, losing 4.1%. It just managed to remain in positive territory for the year (+0.9%). It has had a volatile year, trading through a range of 35% to remain essentially unchanged. Sentiment remains balanced between reasonable growth and credit quality fears. For the year, the best market was Thailand, with an accretion of 26.6%. The economy is being boosted by extensive, publicly-funded infrastructure spending. The worst market was the Philippines, down by 6.6%, hit by newly-elected President Duterte's inflammatory comments.

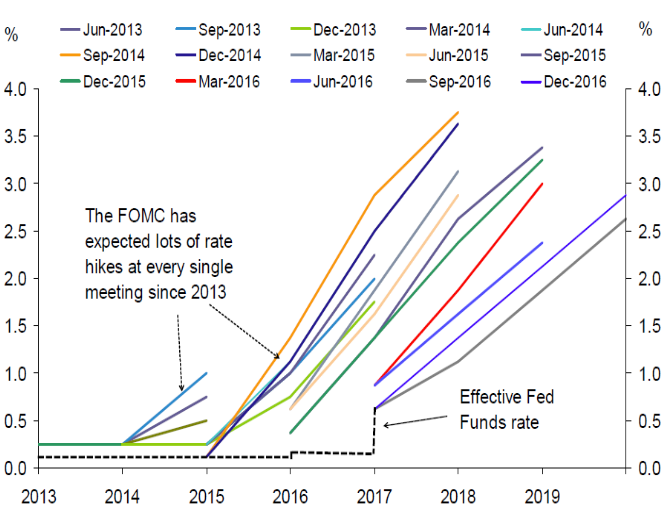
In December, the best sector was Energy, up 5.2%, helped by crude oil. The worst was Health Care, down 2.6%. This mirrors the result for the last twelve months, since the best sector was Energy, up 35.6%, as crude oil jumped 45%. The worst sector for the year was Health Care, down 7.1%, hit by weakness in pharmaceuticals.

Fed finally delivers rate rise

Our view that US rates would remain unchanged all year was almost right. After much deliberation the Federal Reserve finally put through the first rate rise of 2016 at their December meeting, increasing the Federal Funds Rate by 25bps to 0.75%. They are talking about three further increases in 2017 but given their forecasting track record (see chart below) this is likely to be incorrect.

The Federal Open Market Committee (FOMC) has consistently mis-forecast the level of US interest rates.

FOMC mid points on different meeting dates



Source: FRB, DB Global Markets Research

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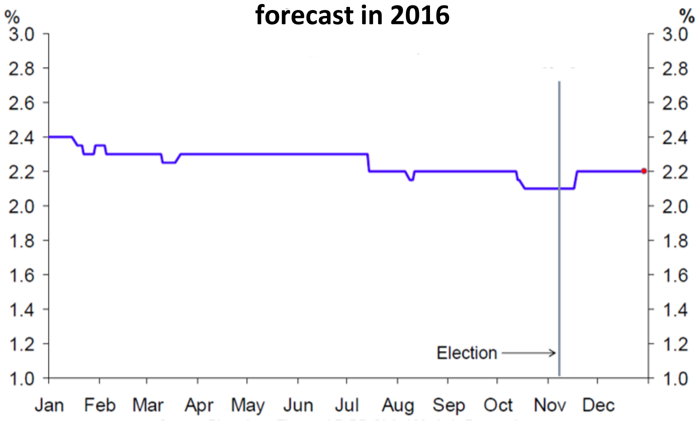
Since the US election there has been much talk in the market of a return to growth, not just in the US but elsewhere in the developed world. This is not a view shared by either the world's economists……

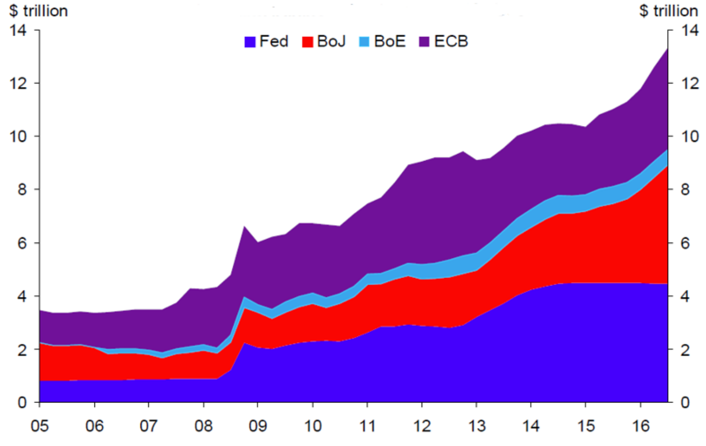
US GDP 2017 consensus economic forecast in 2016



Source: Bloomberg, DB Global Markets Research

…… or the Central Banks of the major economies who continue to print money aggressively to support what they obviously perceive as fragile economies.

Central bank balance sheet measured in USD



Source: FRB, BoJ, BoE, ECB, Haver Analytics, DB Global Markets Research

The year ahead

The reality is that the outlook for the coming year is even harder to predict than usual. What president-elect Trump's policies will actually be and how they will impact the globe is almost a complete unknown.

In Europe, there are elections in the Netherlands, France and Germany this year (plus the UK triggering of Article 50) which could seriously affect the course of events for the EU, if not threaten its very existence.

For emerging markets, this uncertainty is challenging to say the least but, from a bottom up perspective, we still see good opportunities to buy. Our approach will be to continue to focus on businesses exposed to strong domestic stories where there is less dependence on the external sector.

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