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

BLACKFRIARS ASSET MANAGEMENT

DEVELOPING MARKETS INSIGHT

5th April 2017

Market review

A positive tone continued to buoy GEM equities in March, with the benchmark adding 2.5% for the month. That leaves the asset class ahead 11.4% for the quarter, the best three-month return since Q1 2012. The outperformance compared to the Developed World currently stands at 5% year to date.

Asia was the best region, improving 3.3%. As in February, India was the lead market, jumping 6%. It has been supported this year by a relief that the demonetisation shock of 2016 has not hit the economy excessively. In addition, the ruling BJ party was successful in state elections. China improved 2.1%, aided by a strong recovery in industrial profits and a halt in the trend of foreign currency reserve depletion. The Philippines was the laggard, edging up 1.4%. Inflation is heading towards 4%, which could mean a hike in interest rates, which currently stand at 3%.

Latin America was mixed, returning 0.6% overall. In a break from recent patterns, Mexico was strong, surging 9.8%, of which 5.8% was peso appreciation. The currency has recovered 13% from its January low. This is down to a combination of being severely oversold in 2016 and the struggles of President Trump to put rhetoric into legislation. Brazil was weak, slipping 4.5%. The government is struggling to pass pension reform, whilst weakness in oil and iron ore was also a negative.

EMEA edged up 0.5%. Its largest constituent, South Africa, improved 4.4% despite a 10% sell-off in the rand. There is open conflict between president Zuma and Central Bank governor Gordhan. The currency weakness saw strong rallies in gold-mining stocks. Russia was calm, with an accretion of 2.1%. The weakness in oil (Brent blend -5%) was outweighed by the rouble's 3.6% gain. The currency is up 7.7% in 2017, making it GEM's second best currency after the Mexican peso (+8.6%). Egypt was the region's worst market, slipping 6.7%, hit by the pound's 15% devaluation, as inflation hit 30%.

In March, the Communications sector was the best, up 4.8%, helped by strength in Tencent and Naspers. The worst was Basic Materials, down 0.8%, hit by mining and steel weakness. Iron ore shed 11.9% in March.

China's improving outlook

As mentioned above, the first quarter has been a good one for developing markets. The reporting season has had a positive tone, with a resulting upgrade to the earnings outlook for this year.

A critical factor in the improving outlook has been China, where the stimulus package launched by the Chinese authorities in late 2015 (in response to the collapse in the A-share market and concerns over a hard landing in China) is having the desired effect. We are seeing strong infrastructure spending and a rise in commodity prices, partly due to the capacity reduction measures seen in the materials and mining sector. The property sector is strong and auto sales are booming. This recovery has led to a marked improvement in corporate cashflows which in turn has resulted in an improvement in asset quality at the banks.

Last month, China's official PMI climbed to a five-year high of 51.8. The Caixin PMI softened to 51.2, but remains at a high level and has been in expansion for nine consecutive months, the longest period since 2010. China's economic recovery is multi-faceted and goes beyond the usual credit and investment: both large and medium enterprises are solidly in expansion; inventory restocking continues; the service sector is strong; exports, which have been a large negative drag, are improving in-line with global PMIs; and positive earnings revision has seen market earnings continue to be revised up through the earnings season.

Whilst there is still a possibility that President Trump could throw a spanner in the works and questions remain over the longer-term growth trajectory, it would seem that the Chinese economy is set fair for the rest of the year, especially as we have the nineteenth Party Congress coming in the fourth quarter.

Returns are in US dollars

DEVELOPING MARKETS INSIGHT

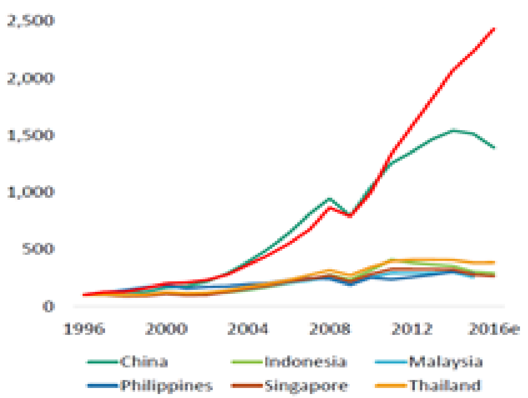
On the road

The team has been out on the road during Q1. Of the many countries visited, three stood out as worthy of comment.

Vietnam

One of the Frontier's stronger macroeconomic stories rolls on with business and consumer confidence hitting multi-quarter highs, driven by growth in FDI and exports (both dominated by Samsung). The US withdrawal from TPP was a negative but expected, given Trump's campaign rhetoric.

Export index (1996=100)



Source: The World Bank

We met over twenty companies and, alongside the perennial favourite Vietnam Dairy, there were three which were particularly interesting in our view:

Nam Long Investment: a property company focussed on providing first time buyers with affordable housing, predominantly in the Ho Chi Minh City area. The IFC and Keppel Land from Singapore own stakes in the business.

Mobile World: a company that has quickly become the #1 player in the retailing of mobile phones and consumer electronics through its thegioididong and Điện máy XANH brands, both off line and online. It is now looking to build on this success and its retailing expertise by opening mini market FMCG stores under the Bách hóa XANH label. The owner and CEO is very entrepreneurial.

Thien Long Group: the number one stationery company in Vietnam now rapidly developing its overseas client base. Originally a family business, now professionally managed. Strong growth potential but being handled sensibly.

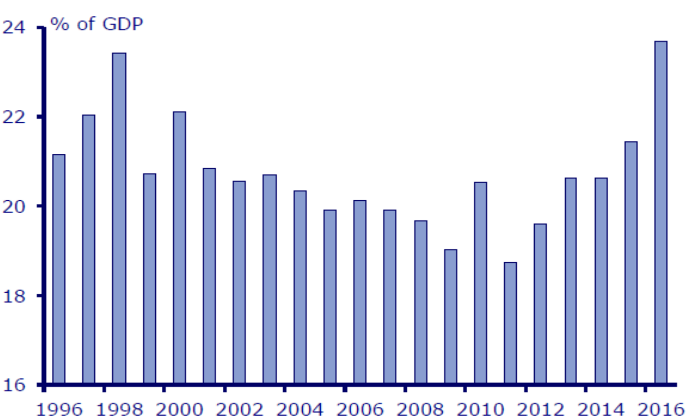
Sri Lanka

A relatively small country but with lots of potential. Please see this month's [Asia Insight]for more details about our visit.

Philippines

The mood on the ground was surprisingly positive. All the companies we met were upbeat about their prospects and were looking to invest in their business. The new President remains popular although there is much discussion on some of his methods. Infrastructure spending remains the key macro theme (the journey from the airport to the centre of town was much improved courtesy of the newly opened Ninoy Aquino International Expressway) and there is plenty still to do. In order to be able to fund the planned expenditure, President Duterte needs to ensure that his tax reform bill is passed. This will be a major test of his political abilities at a national level and will determine whether the Philippines remains an attractive market into 2018.

Investment to GDP ratio



Source: Blackfriars, CLSA, CEIC Data, BSP, IT & Business Process Association of the Philippines

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