BLACKFRIARS ASSET MANAGEMENT

DEVELOPING MARKETS INSIGHT

5th June 2017

Market review

The winning streak for emerging markets equities continued in May, recovering from a modest mid-month sell-off to register a positive return of 3%. Considering trading days, the positive/negative split was 15/8. This marks the fifth consecutive month of advances, leaving the year to date at +17.3%. This is the best start to a year since 2009, when the asset class was recovering from 2008's substantial decline. The developed world improved 2.1%, leaving the year's return at 10.2%.

Asia was clearly the best region, improving 4.5%. All eight countries gained, led by South Korea's 9.2% jump. The benchmark is at an all-time high, driven by strong results, particularly from memory chip makers and industrials. China was also buoyant, increasing 8.1%, shrugging off a Moody's downgrade of its sovereign debt rating. Sentiment is positive, especially regarding property sales in smaller cities. India was relatively subdued, edging ahead 1.8%, another all-time high. The new Goods and Sales Tax will be implemented in July. It is complicated but improved collection efficiency is anticipated.

EMEA was static, with an increment of 0.2%. The 6.3% decline in Russia was balanced by strength in the other countries. Russia's performance is normally predicated on crude oil, and May followed this pattern. Brent blend was down 2.8%. Greece was the best market, surging 13.9%. This was in spite of a postponement of further debt relief disbursements. The Greek market, and also the Czech Republic (+5.9%) and Hungary (+10.9%), were relieved by Emmanuel Macron's victory in the French Presidential election.

Latin America was weak, down 2.4%, hit by political turmoil in Brazil. The market lost 5.1%. The one year anniversary of President Temer's accession was marked by an accusation of his being complicit in a political bribe. He has denied the allegation, and is currently attempting to maintain his political alliance and progress financial reforms. Peru was the best market, improving 6.3%. The Central Bank surprised with a 25bps cut in the overnight rate to 4%, taking the view that above target inflation would be subdued by sluggish economic growth. The Central Bank of Mexico is moving in the opposite direction, raising rates 25bps to 6.75%. The minutes indicated they are concerned about inflation shocks from the substantial currency depreciation.

In May, Consumer Discretionary was the best sector, up 6.2%, buoyed by South Korean automotives and Alibaba. Energy was the worst sector, down 3.1%, depressed by weakness in integrated oils.

Pakistan

Pakistan re-entered the MSCI Emerging Markets index this week, on 1st June to be precise.

Much has been made of the potential buying to come from passive funds tracking this index who will now be compelled to buy the market. But there has been less mention of the passive funds tracking the Frontier index who will be natural sellers.

The MSCI EM index weight of Pakistan is just 0.14% with only six stocks included. The weight of Pakistan in the Frontier index that it has just left was 8.9% on the last day of May, 63x greater. Our back of the envelope calculations suggest that the net passive index buying will be very modest.

MSCI Pakistan (USD)

Source: Bloomberg

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Indeed, the market has recently fallen 12% from its recent highs, perhaps a case of 'buy on the rumour, sell on the news' for the local players who dominate turnover in the market? We saw the same sort of patterns in Qatar and UAE in 2014 when those markets were similarly promoted.

The positives we discussed briefly in the April edition remain in place so we continue to study opportunities there, but will wait for the index related dust to settle before coming to any firm conclusions.

Greece

Greece, which re-entered the emerging market class and MSCI Emerging Markets index in 2013, is slowly climbing out of the 'submerging developed' status into 'emerging'. In the past nine months Greece has made noticeable steps to stabilize its troubled economy, shore up banks' capital and set up a plan to reduce its mountains of bad debt. May saw a boost to Greek banks as the European Central Bank marginally lowered the Greek emergency liquidity assistance ceiling and banks saw a stabilization of deposits. Greek government debt costs came down noticeably from 8+% to below 6% on expectations of a forthcoming global creditors agreement, and gave a 40+% boost to Greek banks stocks.

Still, the main global agreement with Greece is still outstanding and looks like it might be delayed from its original planned signing date of 15th June. It is vital that the agreement is in place before July when Greece must repay close to EUR6bn. Interestingly, large international players didn't wait for the final agreement to be signed and turned their attention to Greece's bad debts. Atlas Merchant Capital, owned by Bob Diamond, snapped up consumer finance firm Credicom and hired the ex-CEO of Greece's Piraeus Bank to enter purchasing of bad loans from the Greek banks. Under the plan, Greece's four largest banks would sell down, restructure and write down NPLs from 50% to below 40% over three years. Legislation to set up a secondary market in bad loans is being actively mulled over by the Greek government.

Without a clear resolution in June, Greece will be pushed back in to a cycle of recession due to the banks' inability to borrow at lower costs and lend to the economy to stimulate growth and repay debts. With the agreement signed, the slow but promising process of the Greek economy accelerating to 1.5-2% GDP growth by end 2018 can begin. Next month will show if the early investors' bet on a Greek banks clean-up will pay off.

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