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BLACKFRIARS ASSET MANAGEMENT

DEVELOPING MARKETS INSIGHT

4th September 2017

Market review

August continued the recent, prolonged trend of positive momentum, with a gain of 2.2%. There was a brief mid-month decline, when the benchmark lost 3.3% in three days; but a subsequent rally registered the eighth consecutive monthly advance. 15 trading days were positive, versus nine in the red. For the year to date, the return is a healthy 28.3%.

Latin America was the best region, adding 4.6%. All five constituent countries improved, with Peru leading the way, jumping 8.5%, helped by an increase in the gold price of 4.1%. Brazil was also strong, increasing 6.3%, boosted by a proposal to privatise the state-owned electricity company, Eletrobras. Mexico was the laggard, with only an advance of 1%, as NAFTA negotiations re-commenced with the US and Canada.

EMEA was also strong, up 4.4%, with Russia rallying 8.1%, helped by rouble appreciation and in spite of weakness in crude oil, with Brent blend slipping 0.5%. The continued strengthening of the Euro currency supported Poland and Hungary. Greece only added 1.1%.

Asia returned a positive 1.4%. Thailand was the best market, with an accretion of 4.5%. The market was relieved that the trial of former Prime Minister Shinawatra had not resulted in disturbances. She did not appear in court and is thought to be outside the country. China continued its strong run, improving 4.2%, with ongoing exuberance in the property sector. South Korea was the region's and GEM's worst market, slipping 2.5%, depressed by North Korea's ongoing missile provocation.

In August, Basic Materials was the best sector, adding 6.3% – iron ore has rallied nearly 50% from its mid-year level. Technology was the worst sector, declining 2.3%, as Samsung Electronics ran into profit taking.

Outlook for the coming months

As we all head back to our desks after our summer holidays there are three things occupying our minds that will determine how markets perform over the coming months.*

1. The US economy

A mixed bag. Positive 2Q GDP numbers, employment report and PMI numbers are counterbalanced by increasing distress in the auto loans market, subdued wage growth and slowing credit expansion (though one could reasonably question the effectiveness of a number of these indicators). Certainly, the Fed seems increasingly reluctant to accelerate its tightening either through interest rates or reducing its holdings in US Treasuries.

We don't believe that the US economy will slip back in to recession but neither do we believe that it has reached 'escape velocity'. As such, we continue to expect modest GDP growth and little progress toward 'normalisation' by the Fed.

2. The Chinese economy

Better than expected. The last of the 1H results are now in (see chart on next page) and the numbers, in aggregate, were positive on three counts. Corporate China has turned around the direction of revenue and profit growth. Given the size of the debt load, shrinking profits were a real concern for debt servicing capability but these numbers ease that concern. Second, the US$12 trillion group is seeing profit expand faster than revenue (implying margin expansion and operating leverage). Third, total assets expanded faster than total debt (financial deleverage). That is great news for the health of China, Inc. and even better news for China's much-maligned banks. Consensus expects that there will be some modest deceleration in the second half but certainly these numbers should remove any worries about a hard landing.

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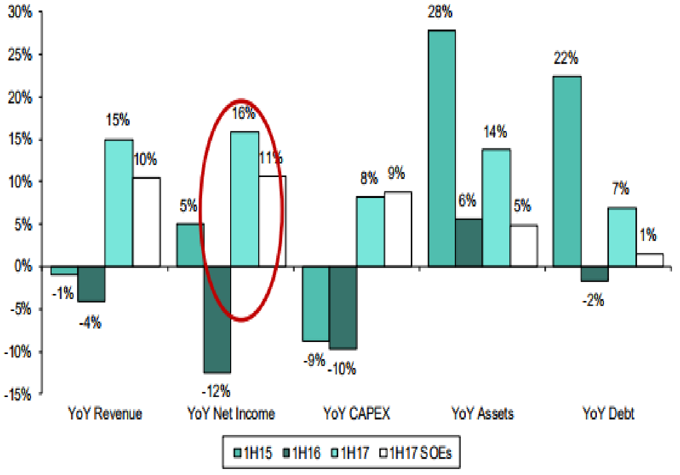
China domiciled/exposed publicly traded company results
(~4,000 companies; ~$12 trillion market cap)



Source: Bloomberg, Bernstein analysis. 1H17 numbers include Shenzhen listings

3. North Korea

Unpredictable. For what it is worth, we think armed conflict in unlikely, although that assessment is made harder with Mr Trump as President. However, until some negotiated stabilisation of the situation is achieved, markets will remain jittery and the risk is to the downside. The MSCI EM benchmark is up over 25% YTD including 2.2% last month despite the tensions on the Korean peninsula, so clearly the market is not currently factoring in any negative outcomes. There is a good article on US options for dealing with North Korea here.

* These are the 'known-unknowns'. There is always the possibility that an 'unknown-unknown' will spoil the party.

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