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DEVELOPING MARKETS INSIGHT

4th October 2017

Market review

September's decline of 0.4% brought an end to the winning streak of positive monthly returns for GEM equities, which had endured eight months. It was a balanced month, with 11 of the 21 trading days showing gains, and 12 out of the 24 constituent countries advancing. The main drag was weakness in EMEA.

Latin America was the best region, improving 1.6%, led by Brazil's 4.2% rally. The country is enjoying interest rate cuts, with the latest taking the overnight benchmark SELIC rate to 8.25% from 9.25%. Additionally, President Temer looks likely to serve out his term until October 2018, allowing reform progress. Mexico was weak, down 3.6%, with disruption caused by the large earthquake near the capital.

Emerging Asia was flat. The Philippines was the best market, adding 3.3%. The country is enjoying vibrant economic growth, likely to be close to 7% this year. Thailand was also strong, increasing 3%. Despite being Asia's best currency this year (the Thai baht has appreciated 6.9%) the kingdom is still enjoying strong exports (+9% year-over-year) – mainly electronics and agriculture. China was stable, moving up 1%. Investors are currently relaxed about the balance of growth versus overheating, the view being that markets will not be excessively perturbed ahead of the 19th Communist Party Congress later this month. India was the worst market, slipping 3.7%. The rupee depreciated 2.2% as the implementation of a new sales tax disrupts consumption, with inflation also being a concern.

EMEA was weak, losing 3.9%. Greece was the world's worst market, tumbling 14%, due to panic in the banking sector. There were reports of "internal control deficiencies" at Piraeus Bank. Turkey gave up 9.6%, with lira softness of 3%. The country has been criticised by Chancellor Merkel over its human rights. It also had the distraction of a Kurdish independence referendum. Russia was the best market, adding 4.5%, helped by crude oil's 9.9% boost to US$56.7 (Brent blend), its highest level in two years.

In September, Technology was the best sector, adding 3.5% – semi-conductor companies were especially strong. Industrials was the worst sector, declining 5%, as component makers in the Apple assembly chain slipped on a lukewarm reaction to the new iPhone.

Kurdish referendum

On 25th September the autonomous region of Kurdistan held a referendum on independence from Iraq with over 93% votes cast in favour (of independence). Kurdistan has enjoyed unprecedented independence from Baghdad since the 2001 Iraq war, with a separate parliament, army, budget, currency and foreign relations.

Current Kurdish president Masoud Barzani has been considering such a vote for a long time. The move was strongly opposed by regional powers including the Central Iraqi government, Iran and Turkey. The USA, being the main supporter of the Kurdistan army, while not firmly opposing the idea of the referendum, commented that the timing of the referendum could disrupt military operations against ISIS.

Nevertheless, we think that the referendum has a better chance of success this time compared to the previous unofficial 2005 referendum for a number of reasons. Firstly, as the fight against ISIS on Iraqi and Syrian territories is close to an end, Kurdish forces are in the strongest political and military position ever to negotiate and defend their independence. Secondly, being the only well organised military force on Iraqi territory right now, they can withstand any military push from the central Baghdad government (backed by Iran) to stop independence, if it occurs. Thirdly, we believe that Turkey, being the main neighbouring supporter of Barzani, will stop short of cutting economic ties with the Kurdistan Regional Government (KRG) or halting oil transit despite its harsh public rhetoric. Barzani was a big help to President Erdogan, rallying Turkish Kurds to vote for the AKP rather than the pro-Kurdish HDP in the latest parliamentary elections and this help will be useful in the 2019 Turkish elections. Turkey has gained enormous economic benefits from the Kirkuk- Ceyhan oil pipeline as well as over US$8bn of produce exports to the KRG. Finally, Kurdish president Barzani needs to provide some political or economic benefits to his Kurdish electorate after more than ten years of instability or face losing power to other more radical Kurdish leaders. Given that Syrian territorial integrity is currently strongly supported by Russia, the easy gain for the KRG would be either concessions on more territory that is de facto controlled by the KRG but are disputed by the Central Iraqi government, a more preferential oil revenue split agreement or the ultimate goal of full independence.

Hence we think that the KRG will use the referendum results as another pressure point on the central Iraqi government to gain more independence and concessions on oil exports out of Kurdistan but will stop short of an immediate declaration of independence. As such, we think that the risk of immediate further military confrontation in the region is overestimated and we believe that the selling pressure on the Turkish market due to this referendum will diminish in the coming months.

Government debt

Over on the next page are some interesting graphics on the size of government debt relative to different measures of ability to pay (the original can be found here).

Japan looks bad however you cut it (which is not new news) but when looking at the ratios based on government revenues, the US comes out as next worst. This must surely cast some doubt over the affordability/likelihood of President's Trump's proposed tax cuts. It certainly leads us to conclude that dollar strength should not be a foregone conclusion.

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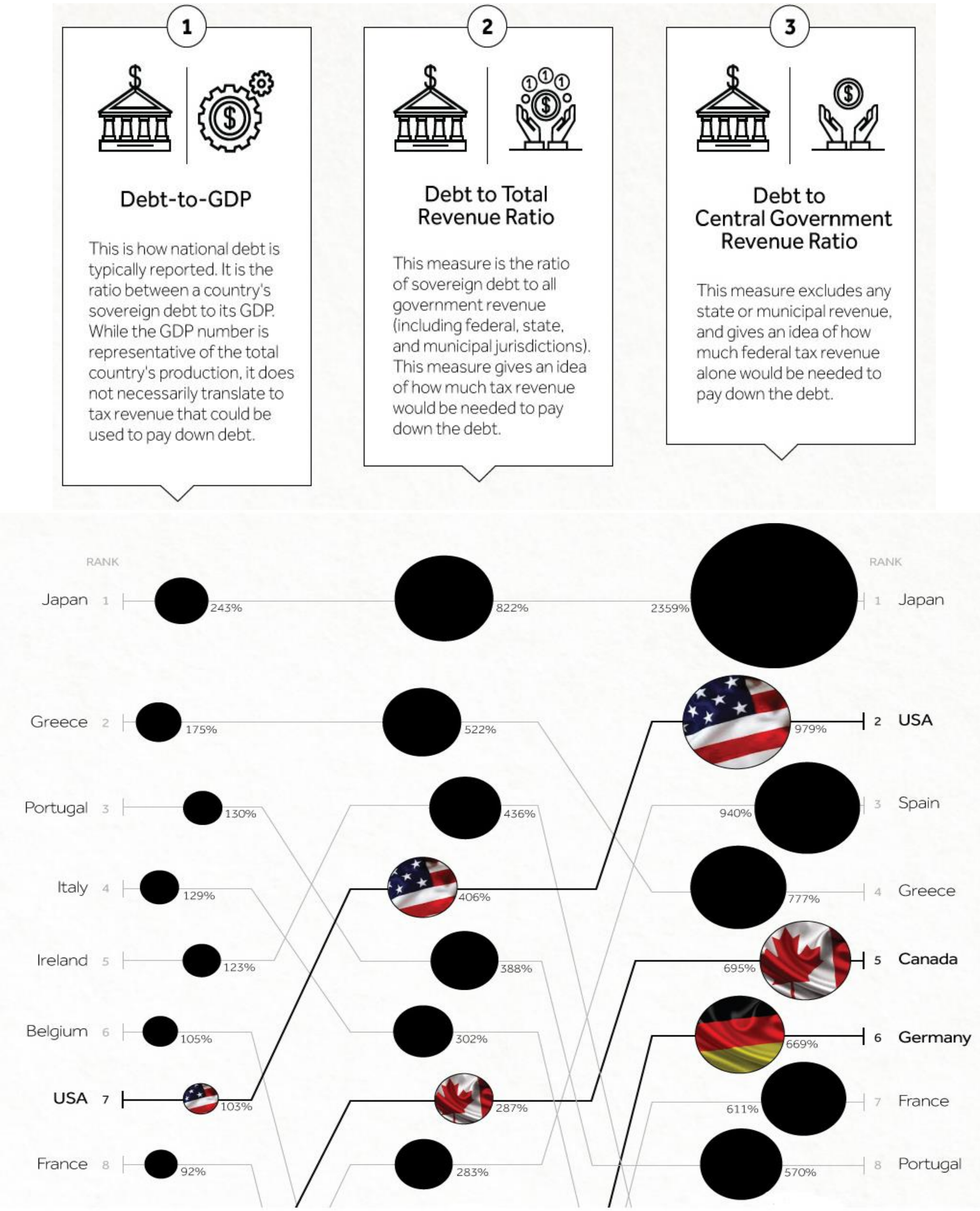
Measures for visualising debt



Note: This data is derived from the OECD's statistics on central government revenue, total government revenue, and debt-to-GDP, and only covers countries within that organisation.
Source: Visual Capital