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

DEVELOPING MARKETS INSIGHT

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Market review

October witnessed a reappearance of positive returns, after September's small dip, with a gain of 3.5%. The month started strongly, before running into some profit taking. Of the 22 trading days, 16 were positive.

Asia was clearly the best region, improving 5.3%, led by South Korea's 8.4% rally. The won appreciated 2.2%. There has been a reduction in the bellicose rhetoric with North Korea. In addition, the tensions with China are easing, with the latter expected to lift a travel ban, imposed over a year ago. India was also strong, adding 7.4%, buoyed by a proposal to bail out troubled state banks. China enjoyed its tenth consecutive month of accretion, the best run in its 20-year history of MSCI membership. The XIX National Congress of the Communist Party of China was deemed to have been encouraging, with President Xi looking set to rule beyond a 10-year tenure. Malaysia was the only negative market, slipping 0.2%, continuing the trend of South Asian markets underperforming the Northern ones.

EMEA was relatively calm, advancing 1%. The CE3 (Poland, Hungary, Czech Republic) were strong, with Hungary being the best, adding 5%. Its main constituent, OTP Bank, has been well supported as it expands overseas. Greece continued to be under fire, losing 2.1%, mainly attributable to slippage in the euro. Despite currency weakness in the rand and the lira, South Africa and Turkey still managed US dollar returns of 2.4% and 0.1% respectively. Russia slipped 1.9%, taking it back into negative territory for the year.

Latin America was the weakest region, declining 3.6%. Colombia lost 9%, hit by weak results from its biggest bank. Mexico was close behind, shedding 7.6%, hit by a peso depreciation of 5.4%. The market continues to be under pressure during NAFTA re-negotiations, with President Trump again threatening to simply pull out. Chile was the best market, boosted by pulp companies. The commodity has rallied over 40% this year. Brazil fell 3.3%, wholly attributable to real weakness, as the overnight SELIC rate was cut to 7.5%, within 25bps of its all-time low, with more cuts expected.

In October, Technology was the best sector, adding 7.3%, being turbo-charged by strong returns in the heavyweights: Tencent, Samsung and TSMC. Consumer Staples was flat, held back by profit warnings in Russian retailers.

Argentina

Mid-term elections in Argentina were eagerly anticipated as a gauge of President Macri's popularity. In the end his Cambiemos party was viewed as overall winner, with the ensuing expectation that he will win a second term in 2019. This will allow him to press ahead with difficult reforms that are needed. He must cut the deficit to help quell persistently high inflation, which is stuck above 20%. A silver lining to the 2001 default and subsequent 15 year freeze out of international bond markets is that the nation is relatively unleveraged. It is actively remedying the situation. It even managed to issue a 100 year bond in June, which has gained 13% since then.

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October also saw the largest IPO in 24 years when Loma Negra, the leading cement company, listed in Buenos Aires and New York. Most of the proceeds are going back to Brazil to help the Camargo Corrêa conglomerate, which has been embroiled in the Brazilian political bribery scandal. For the Argentine market, much of the good news would seem to be priced in. The market has soared 70% this year, hitting a new all time high. The PER for end 2017 is 19.5x, one of the highest in our coverage.

Argentina left it to the last minute to qualify for next year's football World Cup. A hat trick from Lionel Messi helped them to beat Ecuador to book a place in Russia next year. Other Latin American teams that have qualified include Brazil, Colombia, Peru and Mexico. The latter might find its fortunes being more heavily promoted in the USA. Fox Sports Network paid US$425m for the rights to broadcast the 2018 and 2022 tournaments. With America not reaching the finals, for the first time since 1996, the network may seek a bigger audience with Hispanics, especially the 36 million of the population that is of Mexican descent.

Turkish lira weakness

October saw significant weakness in some emerging market currencies: Turkish lira lost 6.7%, South African rand lost 4.7%, Mexican peso lost 5.3% and Brazil real lost 3.4%. Investors clearly see three major risks: firstly US Federal Open Market Committee policy; secondly, the new Fed Chair announcement and thirdly regional political risks as escalating for the "fragile three" countries (Turkey, South Africa and Brazil) and Mexico. Generally these countries face higher funding costs and impending credit rollovers.

Turkey continues to be at the mercy of global portfolio flows and currency volatility is reflecting short-term macro and political risks, which are perceived to be larger than in other emerging market nations. We can also say that the triggers for the lira sell-off were political, namely: the Kurdish independence referendum, rumours about the European Bank for Reconstruction and Development investment limitations.

But, as always with Turkey, the fundamental weakness stems from its high correlation with US rates, and their anticipated tightening. The fact that Turkish gross external financing requirements (excluding deposits, intercompany lending and trade credits) is standing at US$130bn is a major Achilles heel for the Turkish economy. A current account deficit of US$37bn was mostly funding by capital inflows of US$25bn, driven predominantly by portfolio inflows. Banks' 12 month trailing rollover ratio is at 89% and non-bank at 111%. This poses significant risk, if global liquidity dries up, and hence the market can experience episodes of elevated external financing pressures which weigh on the exchange rate. Still the Turkish government is planning to take active steps to limit small and medium sized enterprises' access to FX credit (households currently are banned from borrowing in FX) and to put a limit on the levels of FX borrowing even for large corporates. Nevertheless we expect lira volatility to continue in the coming 6-12 months as inflation is currently 'sticky' and the government's 8-9% target might not be achievable until late 2018.

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