DEVELOPING MARKETS INSIGHT

5th December 2017

Market review

November was a relatively calm month for Global Emerging Equities, with a modest advance of 0.2%. The benchmark had advanced over 3%, before a final week sell-off brought it back down. Of the 22 trading days ten were positive.

EMEA was the best region, improving 3.4%, led by South Africa's 8.9% rally. At first sight this is surprising, since the sovereign rating was downgraded to junk by Moody's, with Standard & Poor's expected to follow. The rally was mainly attributable to strength in Naspers, which is nearly one third of the index, and an appreciation of the rand by 3.5%, as an interest rate of 6.75% tempted the yield hungry. Russia enjoyed the continued strength in oil, with Brent crude oil blend at a two-year high, the market improved 3.4%. Turkey was the worst market, slipping 7.9%. Investors have several concerns, including relations with the USA and NATO, and the President's call for lower interest rates, despite double-digit inflation.

Asia was virtually unmoved, at +0.1%. Malaysia and Thailand were the lead markets, both up 1.8%. Along with all other constituent Asian countries, their currencies improved against a weakening US dollar. China gained 1.6%, helped by strong results from Tencent, marking an 11th consecutive monthly gain for the country. Taiwan was the laggard, shedding 3.3%. It was hit by a broker downgrade of TSMC, which is one third of the benchmark.

Latin America was the weakest region, declining 3.0%. Chile was the worst market, slumping 11.8%. It was hit by the result of the first-round Presidential poll, where market favourite Sebastián Piñera fared less well than expected. He should still prevail in the two candidate, second round on December 17th. Brazil shed 3.1%, hit by weak results at Petrobras. Colombia was the best market, gaining 2.7%, recovering from a weak October.

In November, Industrials was the worst sector, down 2.2%, hit by weakness in a Brazilian toll road operator. Health Care was the best sector, aided by South Korean pharmaceuticals.

The managers have been travelling during the month with visits to India/Sri Lanka, Poland and East Asia. Thoughts on the sub-continent can be seen in this month's Asia Insight. First up here – Poland.

Poland: the best of both worlds, for now

In the last ten years Poland has transformed itself from a second-tier European economy to a European power-house and 'locomotive of growth'. How did this happen? Successive Polish liberal governments since the early 2000s have focused on setting up special economic zones, leveraging on the country's close proximity to Germany and other Eastern European countries, as well as a highly educated post-Soviet bloc workforce. These zones had beneficial regulatory and tax regimes that helped to attract significant investment from German manufacturing leaders. The era of low interest rates post-2008 allowed some local businesses to borrow at attractive rates and to expand manufacturing. Even after the more populist Law and Justice (PiS) government came to power in October 2015, a focus on increasing minimum wages, social pay-outs and cutting the retirement age has supported the economy through increased private consumption.

DEVELOPING MARKETS INSIGHT

Poland is entering 2018 clearly in an advanced stage of its business cycle and is experiencing acute pressures (and benefits for workers) of severe labour shortages and significant wage inflation. Even the influx of an estimated 1.5 million Ukrainian temporary workers since 2015 has not alleviated wage inflation, which is reaching 8% for 2017 and expected to stay between 8-10% in 2018. According to some estimates, wages in Poland (and a few other Central and Eastern European countries) will reach and in some cases exceed those of Eurozone members Italy, Spain and Portugal.

De facto we are approaching the final stage of the Eastern European integration process, which started in the late 1990s. For Poland in 2018-2020 this will mean more affluent households and stronger demand for housing and consumption. It will also mean the convergence of real estate capitalization rates and a cost of borrowing for businesses similar to Western European levels. For now, these factors should bring two more solid growth years for Poland. Historically low interest rates of 1.5% will allow Poland to reach 5% GDP growth in 2018 before inflationary pressures will start to bite at the end of 2018, or in early 2019, when growth will slow down to 3.5-4%.

Still, the risks of the economy overheating are growing, and growth beyond 2019 will require pragmatism, not politicism, from the Government in three ways. Firstly, the influx of cheaper Ukrainian and Belarussian labour needs to be supported by institutionalising their path to citizenship (a highly politicized issue). Secondly, availability of banking credit for small and medium sized enterprises and households needs to be balanced with taxation of the banking sector and reforms post the CHF-loans crisis. Thirdly, stock market stability urgently requires prudent reform of the Polish pension system and implementation of a third pillar of the pension system. These measures, together with stable politics, could support the Polish economic miracle beyond 2018, but without them, the miracle will be short-lived.

China’s influence in East Asia

Travelling around East Asia (visiting Hong Kong/Macau, Indonesia and Taiwan) China’s pervasive influence was perceptible everywhere. The management of the Chinese economy has implications right across Asia and the ramifications of the recently concluded 19th Party Congress were a frequent topic of conversation. The consensus view was that President Xi had been successful in consolidating his position and was now much better placed to push through some of the painful (to some) but necessary reforms that China needs. In truth, given the opaque nature of Chinese politics, we won’t know how solid his situation is until we see evidence of more radical changes beginning to emerge. A good place to start would be the abandonment of the GDP growth target which, at current levels, locks China in to an ultimately self-destructive path of a debt fuelled, fixed asset investment led economic model.

Macau

The visit to Macau revealed an intriguing mix of the old and the new. The Macau Peninsula will remain a place for gambling but there seems to be little growth or investment there. The casino properties are quite smart but there would seem to have been little investment in the town itself which is a shame as there are many historic buildings.

DEVELOPING MARKETS INSIGHT

All new investment is focused on the reclaimed land of Cotai and even here it has been primarily on the casinos. The infrastructure is lagging. There is a new ferry terminal which was an oasis of calm and efficiency after the chaos on the Hong Kong side at Sheung Wan but moving around on Cotai between the various casinos and hotels was not easy. The local cab firms have a large vested interest in delaying the Macau Light Rail Transit, which is still not complete. Access from China, though easier than it used to be, is still restricted and somewhat arduous. Nonetheless the Chinese visitors still come in large numbers and arrivals are rising again.

It is VIP players that catch the headlines, but the real money is made from the mass market. They are much higher margin and lower risk. The difficulty is that you need lots of people. The local Macau authorities are wary of a mass invasion as the local population are vociferous in their complaints if visitors overload the (limited) infrastructure and the People's Republic of China (PRC) authorities are still ambivalent about actively encouraging gambling.

What seems likely is that the neighbouring island of Henqing, in the PRC, will be developed as a holiday resort with theme parks, entertainment, hotels etc and a trip to Cotai will be part of that experience. It is probable that the licensees will be 'encouraged' to assist in the development of Henqing.

New holdings

A wide range of companies were met on the trip, both existing holdings in the funds and candidates for new positions. To date, two new positions have been added to the portfolio, both in Taiwan. The first is eMemory: the world's largest provider of logic-based, embedded, non-volatile memory, an essential building block in a vast array of devices such as smartphones, home electronics, the Internet of Things, smart cars etc. The other is Golden Friends: the number three player in the Taiwanese elevator market. Very different companies but both with solid growth prospects and a strong base of recurrent income.

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