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BLACKFRIARS ASSET MANAGEMENT

DEVELOPING MARKETS INSIGHT

13th March 2018

Market summary

After a long period of sustained positive momentum, February saw the reappearance of volatility and a negative return. The benchmark lost 4.6%, its worst month since August 2015. Most of the damage occurred at the beginning of the month with a 9% decline which was then partially recovered. Of the 20 trading days, in some markets curtailed by exchange closures for Chinese New Year and Carnival, only eight were positive. 22/24 country constituents suffered losses. The reason behind the sell-off was contagion from the USA, where a pick up in inflation raised fears of more precipitate interest rate hikes.

Emerging Asia was the laggard region, losing 6.4%, with India's 6.7% retreat being the worst. It was hit by a proposal to tax long-term equity gains and the prospect of higher inflation because of commodity prices. China was close behind, with profit-taking, after an unbroken 13 month positive run. It gave back 6.4%. From its all time January high it fell 13.4%, before clawing back 9.8%. Corporate results and earnings revisions are still strong. Thailand was the only winner, gaining 2.3%, helped by a proposal to boost the minimum wage for the first time since 2013.

Latin America gave back 3.6%, with all constituents declining. Mexico continues to be pressured by NAFTA re-negotiations and presidential elections. It fell 7.1%, of which 1.5% was peso depreciation. The central bank increased interest rates to 7.5% to combat inflation at 5.4%. Brazil slipped 2%, in spite of a cut in the Selic rate to an all-time low of 6.75%. The market had surged 16.8% in January. Chile lost 3.8%, hit by copper's 2.6% loss.

EMEA was relatively resilient, only shedding 1.8%. Russia had an accretion of 0.9%, in spite of crude oil losing 4.7% (Brent blend). The country was helped by a 25bps cut in interest rates to 7.5%. In addition Standard and Poor's raised its sovereign rating to investment grade. South Africa was relatively calm, slipping 0.3%, untroubled by Cyril Ramaphosa replacing Jacob Zuma as president. Poland was the worst market, slumping 9.9%. There was a weaker than expected Purchasing Managers Index number. For the longer term, the country would be hurt by trade and tariff wars, which President Trump and the EU might ignite.

In February Consumer Discretionary was the worst sector, down 5.7%. More defensive Health Care was only down 1.4%. The CRB Commodity index shed 1.7%

One horse race

The National People's Congress (NPC) passed a motion, tabled last week, to eliminate term limits for the Chinese presidency. Of the three major positions held by current President Xi Jinping - the other two are General Secretary of the Chinese Communist Party and Chairman of the Central Military Commission - the presidency was the only one with term limits.

There had already been lots of discussion about how exactly an ascendant Mr Xi would continue to be a dominant force in Chinese politics, albeit behind the scenes, after he stepped down in 2022. This news makes it clear that Mr Xi intends to formally retain all three positions well after 2022/3.

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This type of behaviour rarely, if ever, ends well and so should be viewed as a long-term negative. China's road away from revolutionary politics over the past several decades has been aided by relatively orderly leadership successions. The steady return to 'great leader' politics in recent years risks eventual instability.

The market has taken the news positively – investment horizons generally don't span decades these days. The risk of uncertainty surrounding succession plans four years from now is removed and it confirms that the multi-year aspects of Mr Xi's agenda - including tighter control of the financial sector, supply side reform, the Belt & Road Initiative and military upgrading - are secure and will remain in focus for many years to come.

Stormy waters ahead in the US?

It is (morbidly) fascinating to compare the vice-like grip on power shown by President Xi with the tenuous hold on power that President Trump seems to have. It is not really my place to comment on the qualities of the US President but this uncertainty comes at a very tricky time for the US economy and market.

The stock market is already very jumpy as evidenced by the events at the beginning of February. Everybody (well nearly everybody) understands that the market is expensive and the era of easy money is ending but breaking the old mentality of buying the dips is hard (it has been the right thing to do since the global financial crisis) and no-one wants to leave the party too early. This increases the likelihood of a mad rush for the exit at some point.

US 10 year Treasury yields

Source: Bloomberg Finance L.P. 2018

The Treasury market looks to be ending its 30 year bull run as we see increasing signs of inflation coupled with the tapering of the Fed's QE policy.

'VIX'

Source: Bloomberg Finance L.P. 2018

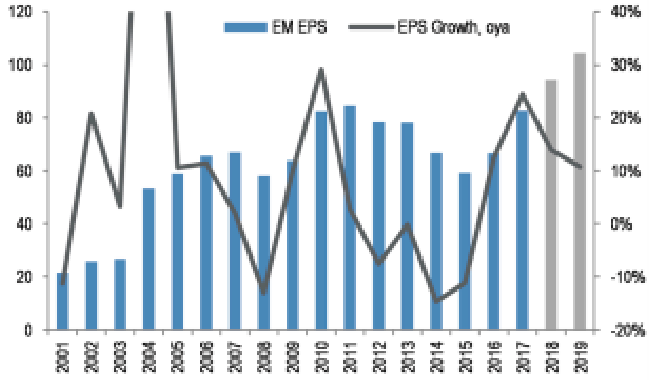
US M2 money supply YoY growth

Source: Bloomberg Finance L.P. 2018

Another worry is the level of money supply growth which is following US bank credit growth ever lower. A very good article here by Russell Napier on this. (You might need to register for the site – it is free).

In emerging markets, the 2017 results announced so far have been generally good and earnings are expected to grow at a double digit rate for the next couple of years.

Bottom up EPS and EPS growth



Source: JP Morgan EM Equity Strategy

With valuations still looking reasonable, in isolation emerging markets look set fair. We will have to see how well they weather a storm in the US if one blows in.

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