

DEVELOPING MARKETS INSIGHT

4th July 2018

Market summary

June continued the recent downwards trend, with a decline of 4.2%. 12 of the 21 trading days were in negative territory. This leaves the MSCI benchmark with a loss of 6.7% for the first half of the year, marking the worst return since 2013 for the first six months.

The worst region was Asia, falling 4.7%. Increased risk of tariff wars is alarming investors. All eight markets retreated, with Thailand being the worst, slipping 10.3%. There has been significant foreign selling of ASEAN markets on trade and currency concerns. China gave back 5.2%, with a currency depreciation of 3.5%, which is the largest monthly move in their history. The yuan has been hit by an escalating tariff war with USA. The most resilient country was India, which only lost 1%, supported by strength in pharmaceuticals.

Latin America receded 3.1%. Brazil was the laggard, losing 8.3%. The country is stuck with anaemic growth and political uncertainty, which will not be resolved before November's second round of the presidential election. Conversely, Mexico rallied 9.2%. The market was coming to terms with a victory for López Obrador in the presidential race. He did indeed win 52% of the vote on 1st of July, and should be able to command a coalition majority in both legislative chambers. Colombia was also up, adding 1.2%. Ivan Duque comfortably won the second round of the presidential election.

EMEA retreated 2.3%. Turkey was the weakest country, shedding 4.7%. The market was cautious ahead of a presidential election which saw incumbent Erdogan returned leader, without the need for a second round. Last year's changes in the constitution mean he could rule for a further ten years. Greece was the best market, improving 4.1%, with the prospect of a third sovereign debt extension looking likely. Russia edged ahead 0.4%, supported by crude oil's 2.3% improvement (Brent blend).

Industrials was the worst sector, down 7.8%, as trade war fears grew, Communications was the best sector, up 0.5%, aided by a recovery in Naspers.

Mexico election

With a strong and consistent lead in opinion polls, the actual election of Andrés Manuel López Obrador (AMLO) was no surprise. In the end it was a strong victory, securing 53% of the vote. In a sign of how far the previously dominant PRI party has fallen, their candidate only garnered 16%. The result was largely driven by the electorate's dismay at corruption and violence. AMLO is labelled 'socialist'. However, the reality is more nuanced. He does advocate state ownership, especially of Pemex, the national oil company. However, his period as mayor of Mexico City (2000-2005) was successful, and not extreme, involving partnerships with the private sector. The inauguration is not until December, and this adds to the pressure on the country. NAFTA talks will now stall for the rest of the year.

Argentina to re-join GEM

MSCI announced that Argentina will re-join the GEM equity index, which it left in 2009 to be a Frontier Market for the last nine years. It is a vote of confidence in President Macri, and his ability to push through reform. Opinion had been 50/50 about the likely inclusion. A \$50bn IMF bailout and 55% peso depreciation this year had possibly lessened the chances. The economy has potential; but needs to reduce inflation and deal with powerful unions. The likely weighting will be 0.6% of GEM. It is just under 15% of the Frontier Index, being the 3rd largest country. Its removal will boost the weight of all other constituents, especially the two largest Kuwait (19.6%) and Vietnam (16.4%).

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Turkey's new presidential system

Turkey held presidential and parliamentary elections in June and moved towards a new presidential system. President Erdogan was elected with 52.5% of the vote and the AKP-MHP alliance received 53.6% support. The latter was a surprise as consensus expected them not to pass the 50% threshold. Nevertheless, the result signals continuity of the current policies in Turkey. Key events to watch in the coming weeks are:

- **Composition of the new cabinet:** As Turkey is moving from being a parliamentary to a presidential republic, the concentration of power in the President's hands will increase, the position of Prime Minister will be abolished, and the number of ministers will be cut from 25 to 16. Hence the market will be closely watching not only who will be in the new cabinet but also how the new cabinet will be structured and how it will function.

- **Announcement of the economic program:** Later in July we are expecting the announcement of the economic program with answers to the following questions: a) whether President Erdogan will continue an expansionary high growth strategy at the expense of high inflation? And b) what will the interest rate policy and the level of independence of the Central Bank be?

- **Emergency rule:** One may say that the election result was the best outcome for the AKP and President Erdogan as now both branches of government are under their control, so emergency rule can be removed as promised during the campaign. Even so, the opposition candidate received a strong 30% of the vote and that was a surprise. Hence, we can see the risk of emergency rule being extended at least until the March 2019 municipal elections. The removal of emergency rule will have a positive effect on market sentiment as it will partially signal 'normalization' of political life in Turkey. But the effect will be more symbolic than

real as the key factors to watch will be economic policies in the coming weeks.

Saudi Arabia overvalued?

Saudi Arabia was upgraded by MSCI to Emerging Market status during June. The effective inclusion will take place in two moves, in May and August 2019, and MSCI estimates that Saudi Arabia will account for 2.6% of the Index. Current foreign ownership in the Saudi market remains extremely low (1.9% or \$9.5bn of aggregate market capitalisation) and we expect foreign ownership positioning to continue ahead of the 2019 inclusion. MSCI reclassification is a clear sign of support for the political reform led by Mohammed Bin Salman and the privatization effort (continued talk of an Aramco IPO). Still, as the Saudi market is heavily dominated by domestic money, the valuations look elevated. If one compares Saudi Arabia to Russia, countries with similar economic dependence on hydrocarbons, stable political leadership and population, one cannot fail to notice the significant premium that Saudi Arabia is trading at currently. With very similar 2019 Return on Equities of 11.75-12% Saudi trading at 11.3x EV/EBITDA 2019 and 13.5x Price to Earnings ratio (P/E) 2019 vs. Russia at 3.8x EV/EBITDA 2019 and 5.6x P/E 2019. Moreover, Russia is expected to pay 7% 2019 dividend yield vs. only 3.6% for Saudi. Even taking into account possible effects of a Saudi riyal peg to the US dollar, we can't justify an almost 300% valuation premium of the Tadawul Index vs. Russia and see Saudi valuation as excessive.

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