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BLACKFRIARS ASSET MANAGEMENT

DEVELOPING MARKETS INSIGHT

3rd August 2018

Market summary

July broke five months of negative returns, with a gain of 2.2%. The trading days were balanced between 11 days each of advances and retreats. 18/24 country constituents were in positive territory. However China and South Korea, which represent over 40% of the index, were weak, thereby holding back the overall gain.

Latin America was the best region, increasing 9.2%. Brazil improved 11.8%. From its early February high the market had tumbled 32.6%, and was perhaps due some respite. The October election remains a source of uncertainty. In the meantime, progress was achieved in the privatisation process of nationalised electric utilities. Mexico was also buoyant, up 8.7%, boosted by a peso rally of 5.1%. The currency has appreciated over 10% since mid June. President-elect Lopez Obrador has been calming markets. In addition a 7.5% overnight rate offers a reasonable carry trade. Colombia was the only negative market, slipping 1.8%. At the end of June it was the best market for the half year, +11.9%, offering some opportunity for profit taking.

EMEA was well supported, adding 4.8%, led by Qatar's 11.6% jump. The diplomatic rift with Arab neighbours has lasted one year, and continues. However an increase in MSCI index weighting has helped inflows. Poland recovered from a 27% slump in the first half of the year, to register an improvement of 11.2%. The zloty's 2.2% gain over the euro, was the best move in over two years. Turkey was the worst market in both the region and the index. It lost 7.2%, wholly attributable to lira weakness. The failure of the Central Bank to increase overnight rates, in the face of rising inflation, leads the market to suspect political intervention.

The laggard region was Asia, just scraping an advance of 0.7%. China slipped 2.5%, with the renminbi losing 3%. This comes on the back of June's record 3.3% depreciation. The currency has retreated 8.6% since April. At 6.81 per US dollar, it is below its 6.96 high of early 2017. If the seven barrier is not defended with intervention, it would signal a shift in strategy, as continued economic growth is favoured in the face of tariff skirmishes. Thailand was the best market, with an accretion of 7.8%. The ASEAN area had been lagging the broader Asia index, and July saw a modest reversal. The Philippines was also cheered, up 7.5%.

The best sector was Energy, gaining 7.1%. Although crude oil fell in July, -6.5%, the 11% gain for the year has been helping oil companies' cashflow. Health Care was the worst, down 6.1%.

US macro

The US 2Q18 headline number was strong (4.1% annualised QoQ) and the US equity market is within 2% of its all time high. All seems to be going well on the domestic front for Mr Trump. Some care is warranted though we feel.

It is likely that 2Q18 will mark the peak growth in this cycle given the one-off nature of the tax reforms introduced earlier (as well as the relatively weak 1Q). We also believe that ultimately the trade conflict that Mr Trump has initiated will harm the US economy and dampen growth.

The prospect of US yield inversion is worthy of consideration. The current 10Y-2Y yield spread has fallen to as low as 28bps, which is the lowest since August 2007. Historically, there have been only four instances of yield-curve inversion since 1976, namely Aug '78, Jan '89, Feb '00 and most recently Dec '05. Notably each yield-curve inversion has been followed by a period of economic recession. While there has been a lag between the start of the inversion and the recession, the 100% track record suggests we should pay attention to this signal.

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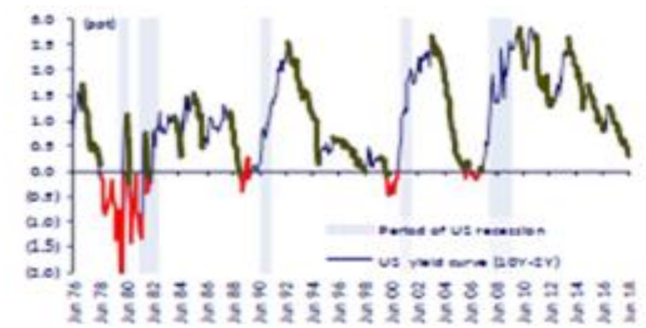
US yield curve (10Y – 2Y)



Source: NY Fed, Bloomberg, CLSA

The current low level of the 10Y-2Y spread does not necessarily imply that we will get an inversion. The curve has fallen below 30bps level seven times since 1960 but has only subsequently inverted on five occasions. Generally, the inversion is caused by increases in the 2Y yield and this would be consistent with the current action of the Federal Reserve (Fed), progressively raising the Fed funds rate.

For the US equity market, we are concerned about the effect and possible repercussions of ongoing, record share buybacks combined with the growth of ETFs as a market participant.

S&P500 share buybacks rose by 38% QoQ and 42% YoY to U$189bn in 1Q18. Corporate debt levels have risen significantly to fund these purchases and this debt has been issued on increasingly easy terms ("covenant-lite") to the borrowers as investors chase yield. A lot of this debt is held in Bond ETFs where there is a sizeable liquidity mismatch (easy to buy – hard to sell).

In addition, the debt funded equity buy-backs have helped sustain the global short volatility trade (estimated at 1.5 – 2.0 trillion dollars). We had a brief episode in VIX back in February when it spiked up 95% (to 37). Two VIX exchange traded products saw their value collapse from $3bn to $150m (-95%).

Further potential issues lurk in the loan ETF and plain vanilla equity ETF markets if buyers lose confidence and a large number try to exit at the same time.

These are not new concerns and are not certain to happen in the next few months or even years, but they are valid reason to approach the market with a degree of caution.

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