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BLACKFRIARS ASSET MANAGEMENT

# DEVELOPING MARKETS INSIGHT

3rd November 2018

## Market summary

October was a weak month, with a drop of 8.7%, the worst since August 2015. Regarding the 23 trading days, 14 were negative.

MSCI Latin America actually managed to advance 3.5%, thanks to Brazil's 17.8% surge. The currency appreciated 7%. The market was reacting to Jair Bolsonaro's lead in the polls and ultimate victory in the presidential election. He is a contentious politician; yet he has chosen a market friendly investment banker, Paulo Guedes, to handle the economy. He will have control over a super-ministry combining finance, planning and industry. The main task is pension reform, since many public servants currently retire in their early 50s. All the other markets were weak, with Mexico the laggard, losing 17.4%, abetted by the peso's 8.3% decline. President elect Lopez Obrador agreed to cancel a new airport for Mexico City, in accordance with an informal public vote. It is viewed as being negative for infrastructure and inward investment.

Asia was the losing region, shedding 10.9%, the worst month since September 2011. South Korea led the way, haemorrhaging 14.3%. Stocks have been hit by weakening growth, Q3 GDP at 2% was the weakest since 2009. China retreated 11.5%, as the trade war with USA shows no sign of abating. The Philippines lost the least at 1%, along with other ASEAN markets it had underperformed North Asia in the first half of 2018.

EMEA was weak, giving back 6.8%, with all markets in negative territory. South Africa lost the most, 10.9%. The rand depreciated 4.3%, weakened by a surprise trade deficit in September. Russia gave back 4.6%, not helped by crude oil's 8.8% slippage. Turkey was relatively resilient, -2.3%, helped by a continuing recovery of 6.7% in the lira. It has recovered 18.9% from its August low.

Health Care was the worst sector, losing 13.8%, hit by weakness in Pharmaceuticals. Utilities only lost 1.5%, held up by Brazilian electricity on privatisation hopes.

## Brazil elections

Latin America has had a busy electoral year, with presidential contests in Colombia, Venezuela, Mexico, and finally Brazil. The latter garnered more international attention than usual, since the frontrunner and eventual victor was Jair Bolsonaro. How an obscure Congressman, with illiberal views, now presides over a country that prides itself as a rainbow nation, is essentially a story of voter disillusion with corruption, especially the PT party, which ruled from 2002-2016. The market response has been positive, with a 30.5% rally since his lead in the first round in September. This is not an endorsement of his character; rather the hope that Paulo Guedes, (Chicago-trained, billionaire, investment banker), will be successful in managing the economy. The freedom that Bolsonaro allows his superminister will be the key to future Brazilian performance.

## Value emerging?

Eastern Europe equity markets have been weak in 2018 due to the USA sanctions on Russia, the Turkish economic crisis and Polish pension funds' outflows and scandals. Nevertheless, a significant number of the regional companies have delivered strong operating results and their owners believe that current market valuations are unfair and do not reflect the true equity value of their companies. As a result, in Russia, more than ten companies initiated buy-backs recently: Lenta, Obuv of Russia, Lukoil, Magnit, are notable examples. While Russian stocks are trading at a Price/Earnings ratio of 5.3x for 2019 (over 50% discount to GEM), they are delivering 7.3% dividend yield, which is 110% higher than the GEM dividend yield of 3.1% and 60% higher than the Russian ten-year average. This clearly signals that companies have excess cash and are willing to give back value to shareholders. Nevertheless, the owners of Russian companies prefer buy backs to delisting, as a public listing in Moscow or London is viewed as one of the best mechanisms of defence against hostile takeovers and is of an additional value to core shareholders. In Poland, on the other hand, core shareholders prefer the route of delisting or M&A to unlock value as they also believe that the market is unfairly pricing their company's equity. In the last 18 months the Warsaw stock exchange lost over ten companies including: PFNonwovens, Olympic Entertainment, Exillon Energy and Integer. Due to the stronger Polish public courts system, takeover defence arguments are of much less importance for core shareholders in Poland.

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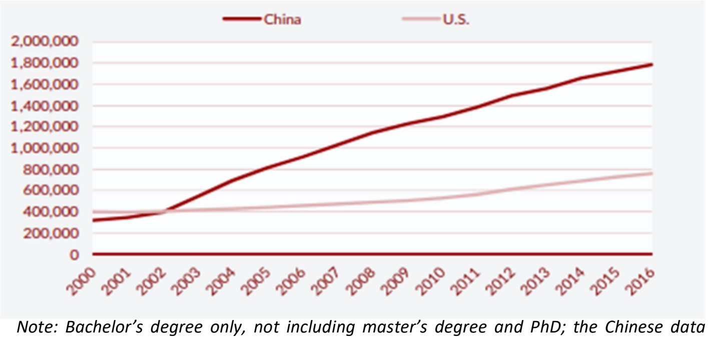
## US vs China

We do not know the end game of the current ongoing trade dispute between the US and China but the following charts from the excellent China Reality Research team at CLSA shed some interesting light on the relative competitive positions of the two nations.

**Number of college graduates with bachelor's degree of science and engineering**

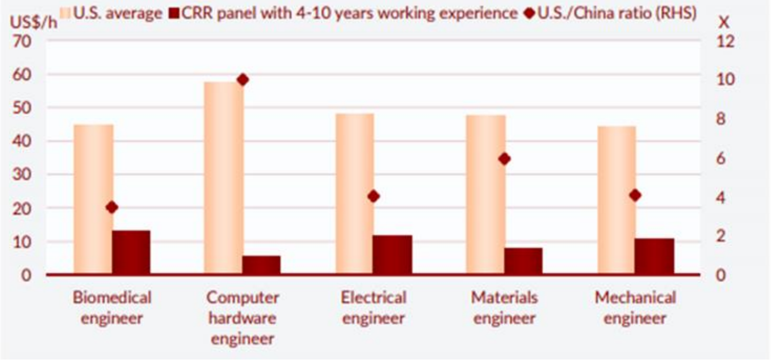



*Note: Bachelor's degree only, not including master's degree and PhD; the Chinese data doesn't include graduates from adult colleges or online colleges. Source: WIND, US Department of Education, National Centre for Education Statistics, Higher Education General Information Survey (HEGIS), CRR.*

**Total patents granted**


*Source: WIPO statistics database, CRR*

**Hourly payment rates for American and Chinese Engineers**




*Source: CRR, Bureau Labour Statistics of the U.S.*

AL, BR & TH