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BLACKFRIARS ASSET MANAGEMENT

DEVELOPING MARKETS INSIGHT

9th January 2019

Market summary

Emerging Market Equities* ended a disappointing year, losing 2.7% in December. 10 trading days were positive, with 11 in negative territory. For the year the loss was 14.6%, making 2018 the 6th worst performance in the index's 31 year history.

MSCI Emerging Asia was the worst region losing 3.2%, dragged down by China's 6.1% retreat. The market continues to fret over the conjoined risks of trade wars and a slowing economy. The worst market was Pakistan, shedding 11.7%, its annual decline of 34.8% also being the worst in the region. The leading market was Malaysia, advancing 1.6% during the month.

The EMEA region gave back 1.6%. Turkey closed a year to forget, shedding 5.2% in December and 41.4% for the year. Its status as the year's laggard is almost entirely down to a massive depreciation of 40.3% in the lira. Russia lost 3.5%, all currency weakness. The country's sentiment is often linked to crude oil, which slumped 8.4% (Brent blend) in the month. Poland was the lead market, with a modest accretion of 0.2%.

Latin America was relatively resilient, losing only 0.8%. Mexico was the best market, improving 3.3%, all down to the peso which was boosted by a rate rise of 25bps to 8.25%. This tightening cycle, over three years, has seen 5.25% of hiking. Chile was weak, down 3.6%, as the peso responded to copper's 4.5% decline.

Industrials was the best sector, adding 0.4%. The worst sector was Health Care , losing 7.6%.

Overview

While it would be good to be able to say some upbeat things about the prospects for the coming year, as we see it, the outlook remains difficult.

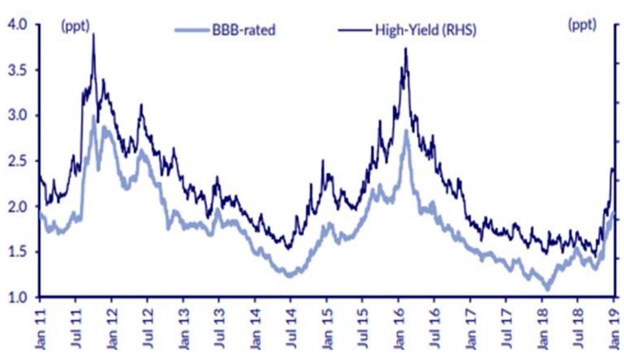
China growth

Unless the US-Sino trade war escalates dramatically or there is a full blown domestic financial crisis (neither of which are our base case assumptions) it is unlikely that China will ride to the rescue of Emerging Markets again with a large, co-ordinated stimulus. Xi Jinping seems set on a (sensible) course of adjusting policy to a lower growth trajectory and gradual de-leveraging. This is much better than the alternative of a continuing boom then a gigantic bust but will take time for markets to adjust to the new reality.

US rates

The Fed is still in tightening mode though there are many different opinions as to how much further short-term rates will be increased. Corporate borrowing costs via the bond market have risen sharply over the last 12 months.

Bloomberg Barclays US corporate bond yield spreads (BBB-rated and High-Yield corporate bonds)



Source: Bloomberg

Of note though, the US yield curve is at or close to inverting, depending on where on the curve you look. This may temper Mr Powell's enthusiasm for further rate rises although it does raise questions about the outlook for US economic growth.

Donald Trump

Trump's room for manoeuvre will be more restricted going forward given the Democrat gains in the mid-terms but he still retains the ability to be very disruptive in the short term via Twitter even if ineffectual in the long term.

US equity

The US equity market looks horribly overvalued, even after the recent correction. James Montier of GMO has written about this recently here. Well worth a read.

Bright Spots

There are some bright spots. For example, EM valuations are not stretched, the oil price is weaker than expected and there is plenty of room for central banks in Asia to ease should US dollar strength abate. Trying to predict how all these factors will play out and affect our markets is, in our view, next to impossible and creates a false sense of clarity. We much prefer to focus on finding and owning great businesses with management capable of handling whatever the macro environment sends their way.

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