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BLACKFRIARS ASSET MANAGEMENT

DEVELOPING MARKETS INSIGHT

6th March 2019

Market summary

After a strong start in January, Emerging Market Equities settled into a more becalmed month, with February providing a return of 0.2%. Of the 20 trading days, 9 were positive.

MSCI Emerging Asia was the best region, gaining 1.7%. Taiwan was the lead market, with an addition of 4.8%. The technology sector, particularly semiconductors fuelled the rise. China was also strong, improving 3.5%. The expectation is that a trade deal will be achieved with the USA. Pakistan was the worst market in the region, losing 4.7%. Its border conflict with India (flat for the month) added to investor nerves.

EMEA was weak, losing 3.4%. South Africa shed 5.3%, with a rand depreciation of 6%. The country's economic and budget outlook are being damaged by electricity blackouts. Greece was the best market, increasing 5.7%. It was helped by a Moody's upgrade of its sovereign credit rating.

Latin America was the laggard region, giving back 3.7%. Brazil was the worst market, retreating 4.5%. The government is trying to advance pension reform to save 1 trillion reals. A protracted battle is expected with the legislature. Mexico gave back 4.2%. Q4 GDP at 1.7% is slowing, as private investment falters on political uncertainty. Colombia was the region's best market, jumping 5.6%, boosted by the 6.7% accretion in crude oil (Brent blend). For the second consecutive month Consumer Discretionary was the best sector, adding 4.4%. The worst sector was Consumer Staples, down 2%.

Involuntary purchase

As mentioned in this month's Asia Insight, MSCI have announced their intention to increase the inclusion factor of China A shares (from 5% to 20%). All other things being equal, this would affect the composition of MSCI Emerging Markets index as shown over the page. The third chart shows the ultimate destination with A shares having a 100% inclusion factor.

The billions of dollars now invested in passive funds have no option but to slavishly follow these changes immediately they are implemented. It is not clear to us that this is a good idea given that the Shanghai market is up nearly 30% in US$ terms since the start of the year.

Shanghai Composite A share index

By the time A shares are fully included, as shown on the third doughnut, China will be over 40% of the benchmark, and more likely higher given the ongoing appetite for IPOs in China. This dynamic clearly represents an ongoing structural support for the Chinese equity market as passive investors are compelled to continue to increase their weighting (regardless of the outlook for the underlying companies) but in our minds this concentration is unhealthy and a very good reason for not being too focussed on a benchmark when constructing an investment portfolio.

AL, BR & TH

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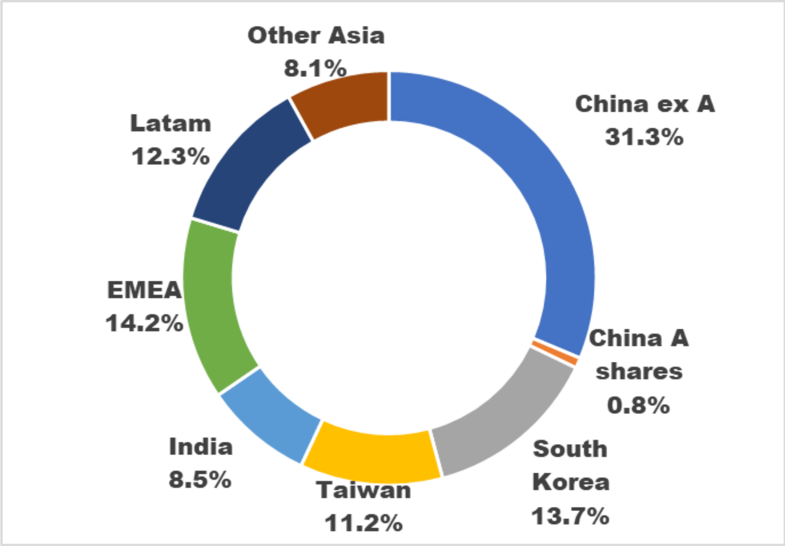
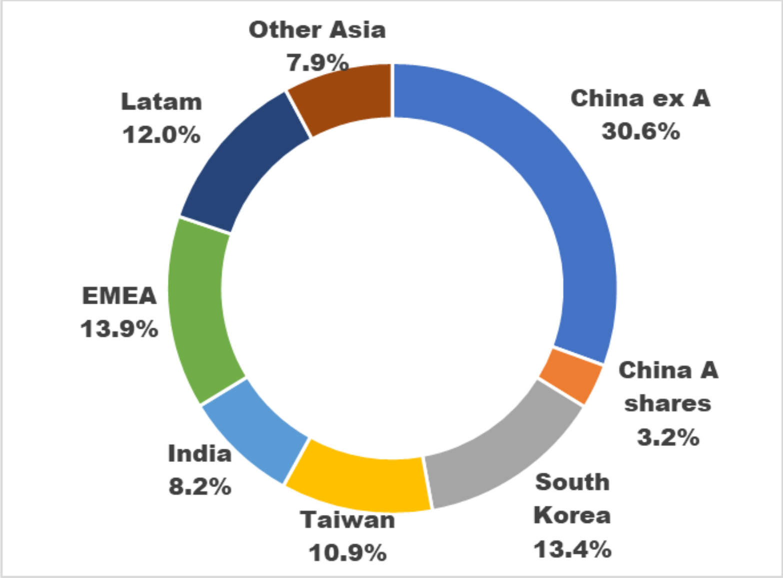
6th February 2019

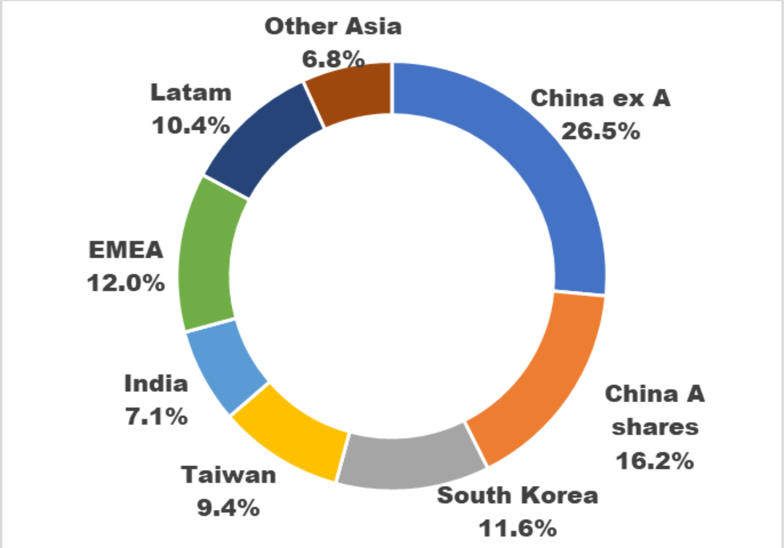
MSCI EM as at 28th Feb 2109



A-shares at 20% inclusion



A-shares at 100% inclusion



Source: Bloomberg, MSCI, Blackfriars