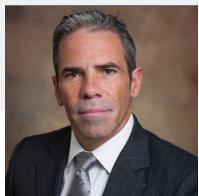




**PRICE  
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Timely intelligence and analysis for our clients.



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## Emerging Markets **EM ELECTIONS MAY PROVIDE CLARITY FOR WARY INVESTORS**

### KEY POINTS

- Emerging markets voters are likely to cast their ballots on issues ranging from economics and trade to corruption when they go to the polls in 2018.
- Emerging markets elections could help investors uncover opportunities in select markets.
- We will be closely watching ramifications of elections in Egypt, as well as upcoming polls in Mexico and Brazil.
- In 2019, we will monitor the election in South Africa, where we believe voters will judge the success of the country's new president.

More than one billion people are expected to go to the polls in emerging markets in 2018, voting on issues ranging from economic reform and trade to corruption. Some election results may hand new leaders the mandate to push ahead with economic plans and boost investor confidence in their countries; the results of others may be regarded as foregone conclusions and possibly less than democratic. In aggregate, they will provide investors in emerging markets with the opportunity to distinguish between countries at different stages of development and potentially generate significant long-term investment opportunities in debt and equity markets.

Below, we highlight three of the key elections this year.

#### EFFECTS OF EGYPT'S ELECTION TO BE FELT LONG AFTER THE VOTE

Egypt's President Abdel Fattah al-Sisi, who recently was reelected, faces

significant economic and political challenges. While his victory should provide him the political stability to push through his economic reform agenda—maintaining fiscal discipline and controlling inflation—it will be more difficult to generate the economic growth the population demands, in our view. Importantly, Sisi has the backing of the military; retaining this support will be crucial to Sisi's ability to move ahead with reforms as well as to stay in power.

In our view, Sisi will continue to promote reforms, potentially earning the support of foreign investors. While some strategies hold defensive companies in Egypt, the majority of our strategies are investing in companies that stand to benefit from a strengthening economy, including banks and other financial institutions. Given improving fundamentals, we believe government debt (both external and local) and the Egyptian currency hold attractive relative value.

**FIGURE 1: The 2018 Election Cycle Index Weights**

As of December 31, 2017.



Source: J.P. Morgan.

## MEXICO FACES CHALLENGES ON MANY FRONTS

Ongoing North American Free Trade Agreement (NAFTA) negotiations, immigration reform, U.S. tax policies, and Mexico's sputtering economy are all factors that suggest voters will elect left-leaning populist Andres Manuel Lopez Obrador in July's presidential election.

The Mexican economy is expected to grow little more than 2% in 2018 and 2019. This tepid growth rate, combined with concerns about trade threats from U.S. President Donald Trump, has bolstered the prospects of Lopez Obrador becoming the next president. However, if elected, it remains to be seen how far he would steer the country to the left. He has made a concerted effort to reassure markets that his primary aim would be to crack down on corruption, and he maintains that he has no plan to nationalize companies and that he would lead a market-

friendly government that provides "austere, responsible, and honest management of public spending and the preservation of macroeconomic balances," without tax increases, new taxes, or an increase in public debt. Still, we are concerned that he may slow or halt oil sector reforms, open corruption probes, and challenge central bank independence. As such, in some of our strategies, we are eliminating or more closely monitoring investments that may be affected by such moves.

The biggest wildcard for our Mexico outlook is NAFTA. We believe the current negotiations will likely be postponed until after the Mexican elections and perhaps even the U.S. midterm elections. However, the possibility that Trump tires of the postponement and pulls out of the treaty is, in our view, the biggest risk that investors face and is one that will persist after the Mexican elections.

Given this uncertainty, we believe that equity and fixed income valuations are unattractive, and, as such, we are underweight in both asset classes. In our emerging markets core equity strategies, we trimmed names that we believed could be negatively affected by future corruption probes, as well as those that could suffer from stagnant growth, such as financial services and real estate companies. We concentrated on companies that we expect to benefit from what we believe is a fairly durable consumer spending trend. In our emerging markets value equity strategy, we have consolidated our highest-conviction positions in defensive companies that we expect should do well in any economic cycle.

We maintain a modest underweight in Mexican sovereign bonds and favor various defensive corporate bonds. We believe there is an outsized chance of both Lopez Obrador winning and Mexico remaining in NAFTA, which is

already largely priced in by markets. We will monitor Lopez Obrador's actions more than his sometimes incendiary language, focusing especially on his fiscal discipline.

#### BRAZIL'S ELECTION COULD DETERMINE THE FATE OF MARKET-FRIENDLY REFORMS

Although Brazil recently emerged from a deep recession, it continues to benefit from a growing middle class whose demand for goods and services has buoyed many of the well-run companies that have managed to stay afloat during difficult economic times. However, while the country's leaders have made some important reforms, they have struggled to implement crucial changes to the country's pension and social security systems.

We believe that the election in October of a market-friendly candidate is critical to the continuation of the macroeconomic policies implemented by President Michel Temer, who has been hobbled politically by mounting corruption charges against him. Ironically, current polls show that left-leaning former president Luiz Inacio Lula da Silva has more than one-third of voters' support, nearly double that of his nearest rival—despite the fact that he was convicted of corruption and jailed and may be barred from running for election. We are still in the early days of this election campaign, and market-friendly candidates are currently polling well behind Lula da Silva and Bolsonaro in a fragmented field. At this time, we believe the greatest risk is that voters elect the far-right candidate Jair Bolsonaro, who espouses a right-wing style of populism, characterized by nationalism, protectionism, and nativism.

So far, financial markets have largely taken the preelection runup confusion in stride. Brazilian equities were star

**FIGURE 2: Key Risk Events in Emerging Markets in 2018**

Date	Country	Event	Likely Outcome	Adverse Scenario	Importance/Risk
March	Egypt	Presidential Election	Sisi's victory gives him mandate to continue economic reforms.	Sisi loses support of "deep state," thus reducing his ability to carry out reform program.	 LOW
July	Mexico	General Election	Lopez Obrador wins. Congressional constraints prevent him from veering too far to the left. Mexico stays in NAFTA.	Lopez Obrador moves further to left, rolls back reforms, nationalizes, and breaks contracts. U.S. withdraws from NAFTA.	 HIGH
October	Brazil	General Election	Lula barred from running. Market-friendly reforms and slow economic growth continue.	Bolsonaro wins. His early market-friendly stance turns to right-wing populism.	 LOW
Early 2019	South Africa	General Election	Ramaphosa elected. Continues reforms and keeps left-wing of African National Congress in check.	Ramaphosa fails to deliver promised reforms and loses African National Congress and popular support.	 MEDIUM

performers this year, rising almost 31% in the 12-month period ended March 31, 2018,<sup>1</sup> buoyed by the country's growth and reform prospects, and more recently by news that Lula da Silva may be barred from running. As valuations have risen, we have pared our overweight position in the country, but we believe Brazil's long-term growth characteristics remain favorable for consumption-driven areas of the economy.

Within fixed income, we remained positioned largely in Petrobras, the national oil company, as it deleveraged its balance sheet through asset sales and cost-cutting. We will be closely monitoring any appeals made by Lula da Silva to challenge his conviction and also the electoral deadlines, especially the August 15 deadline to register a candidacy with the superior electoral

court. While we believe Lula da Silva will not be a contender in the election, upcoming months may be volatile, with protests and appeals challenging his conviction.

#### LOOKING AHEAD TO 2019: SOUTH AFRICA'S ELECTION SHOULD CEMENT CONFIDENCE IN NEW PATH FORWARD

South Africa, which will hold a general election in early 2019, has been among the highest-conviction positions in our equity and fixed income portfolios. The country embarked on a new path in February, when scandal-tainted Jacob Zuma resigned, making way for the former deputy president Cyril Ramaphosa to assume the presidency. Ramaphosa has pledged to boost the economy and fight corruption. Given our strong conviction in the country, we had

<sup>1</sup>Source: MSCI. MSCI makes no express or implied warranties or representations and shall have no liability whatsoever with respect to any MSCI data contained herein. The MSCI data may not be further redistributed or used as a basis for other indices or any securities of financial products. This report is not approved, reviewed, or produced by MSCI.

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**Overall, the election cycle, with its inherent volatility and uncertainty, should allow investors a unique opportunity to further differentiate between emerging market countries at different stages of development, unlocking value in debt and equity markets.**

increased our exposure in 2017 even before Ramaphosa came into power.

South Africa's economy is recovering from its second recession in less than a decade and has been held back by political and economic stagnation under an unpopular and scandal-ridden leader, as well as by concerns over a credit rating downgrade. We believe Ramaphosa is investor friendly and that his policies will improve growth prospects. Many South African companies have excellent management teams, and we expect the country's equity markets could continue to benefit from the change in leadership.

However, Ramaphosa has less than a year before the election to sell his economic reform platform to voters and investors. Significant optimism has

been priced into the bond markets, but it should not be underestimated how difficult it will be to turn promises into policies. In our equities portfolios, we maintain a large overweight position, expecting that the equity markets have not priced in all the positives this new leadership will bring.

We will monitor local elections, data releases, and national discussion on hot-button issues such as land reform.

#### **ELECTION CYCLE'S VOLATILITY COULD REVEAL OPPORTUNITY**

Emerging markets facing upcoming elections have made significant economic and structural reforms over the past 10 years, and thanks to improvements in their fiscal balances, current account deficits and foreign

exchange regimes have become better able to withstand external financial shocks. Barring extreme negative election outcomes, economic recoveries in these emerging markets should progress regardless of the political cycle. Still, new governments should allow countries such as Egypt and South Africa to further restore investor confidence as they push ahead with reforms, boost foreign direct investment flows, and catalyze growth. In fact, with the exception of Mexico, we believe the economies mentioned are in the early cycle of a recovery in economic activity and are strongly positioned to continue their recovery.

While the outcomes of elections in Latin America are less certain, strong institutions in those countries should be able to ensure the rule of law. Domestic stocks, both growth and value, are reasonably valued.

Overall, the election cycle, with its inherent volatility and uncertainty, should allow investors a unique opportunity to further differentiate between emerging market countries at different stages of development, unlocking value in debt and equity markets.

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