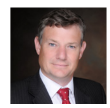
Three Factors Shaping Prospects in Frontier Markets

Elections, MSCI reclassifications, and geopolitical events poised to make an impact.

August 2019

KEY INSIGHTS

- Market conditions over the remainder of 2019 are generally expected to improve, as political and economic developments that have weighed on asset prices abate.
- With asset prices largely reflecting the challenges of the past year, a shift in sentiment could provide equities with an uplift.
- Primary catalysts set to drive asset prices include: elections, MSCI reclassifications, and geopolitical and trade developments.



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Frontier markets experienced a challenging year in 2018, but as we enter the latter stages of 2019, we believe three distinct dynamics are working to drive a turnaround in performance in the sector.

The global economy presented headwinds in 2018, but the low correlation of the asset class with the global cycle has meant that country-level political and economic developments have typically weighed on frontier markets the most.

In 2018, Argentina was mired in a crisis, Saudi Arabia struggled with foreign investor perceptions, Sri Lanka faced a leadership vacuum, and harmful tax measures in Kenya and Romania took a toll on their respective financial sectors. As these issues are addressed or fade, 2019 could present a silver lining.

Catalysts Set to Drive Markets

Adopting a broad, overarching view, we have identified three factors that have the potential to drive frontier market performance: elections, MSCI reclassifications, and geopolitical and trade developments.

Key Elections

Argentina is set for a crucial general election in October 2019, with reformist President Mauricio Macri running for reelection. Currency and equity markets were spooked by a heavy defeat for Macri in the August primary election, which was won by populist rival Alberto Fernandez whose running mate is former President Cristina Kirchner.

This result puts in serious doubt Macri's ability to win the election in October and continue with his reform agenda and market-friendly policies. If Macri manages to recover, this would be a positive catalyst for the asset class, as he is highly likely to continue his program of broad-based fiscal adjustment. But the specter of default risk is likely to weigh

(Fig. 1) Key Developments in Frontier Market Countries

Key events across the frontier markets spectrum.

As of July 31, 2019

	Recent Market Challenges	Trends and Events to Watch
Argentina	▪ Multitude of factors in 2018 necessitated a bailout from the International Monetary Fund (IMF). ▪ A ballooning fiscal deficit and runaway inflation, which sparked a run on the peso, capital flight, and liquidity concerns.	▪ Funding requirements are met until late 2019; response of authorities is promising. ▪ Upcoming elections will be vital, with markets concerned about Macri's prospects for reelection, as populist rivals compete strongly. ▪ Argentina included in MSCI Emerging Markets (EM) Index in May 2019.
Saudi Arabia	▪ Crown Prince Mohammed bin Salman (MBS) has taken steps to liberalize the country economically and socially. ▪ But the Khashoggi affair—and efforts to identify those implicated in the murder of the journalist—has weighed on foreign investor sentiment.	▪ Investors looking for signs of continuity in MBS's reform program: reducing country's dependence on oil revenues and diversification to attract foreign investment. ▪ Saudi Arabia included in MSCI EM Index in two-phase approach in May and August 2019. ▪ Likely uptick in consumption.
Sri Lanka	▪ Currency weakness and political woes in 2018 weighed on sentiment. ▪ Terrorist attacks on Easter 2019 likely to affect tourism sector.	▪ Despite political developments, economy remains on solid footing. ▪ Manufacturing purchasing managers' index high on the back of a surge in new business inflows and output as companies divert supply chains away from China.
Kenya	▪ Pandering to populist sentiment, authorities maintain a cap on interest rates that banks can charge—constraining lending and dampening economic growth prospects.	▪ Some speculation that the cap will be removed, aided by the IMF demands that it be repealed as a condition for Kenya to access balance of payments support.
Romania	▪ The introduction of a levy on bank assets if interbank lending rates exceed 2% (set to take effect in 2020) is likely to erode earnings.	▪ Any change or alleviation in tax measures should boost investor sentiment. ▪ Positive sentiment about the Romanian economy as rising wages are supportive of the consumer and banks continue to clean up their loan books.

"Argentina's reform agenda and market-friendly policies are at stake in the October presidential election.

— **Oliver Bell**
Portfolio Manager,
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heavily on Argentine assets until the election plays out.

Nigeria, meanwhile, went to the polls in February. Incumbent President Muhammadu Buhari of the All Progressives Congress ran against former Vice President Atiku Abubakar of the People's Democratic Party, winning with 56% of votes. With the country emerging from recession, economic policies are crucial. The continuity of leadership is a positive for the country, and recent economic indicators have been encouraging, including the naira attaining a more appropriate valuation, the minimum wage increasing, and both oil and non-oil sectors making gains.

From here, we watch for a stronger government focus on economics and the convergence to one exchange rate. Investors would likely welcome efforts to deliver market-driven policies and the introduction of measures to boost domestic business and investment.

MSCI Reclassifications

Countries shifting from the frontier to the emerging markets universe typically attract inflows ahead of index inclusion, as we have seen in the case of Qatar, the United Arab Emirates, and Pakistan in the past (see Figure 2).

Argentina was included in May 2019 and **Saudi Arabia** began a two-phase inclusion, commencing in May and

Oct. 2019

Argentina set for crucial presidential election with reformist incumbent Macri up against populist rivals.

(Fig. 2) Catching the Reclassification Rally

Markets have tended to rally into index inclusion.

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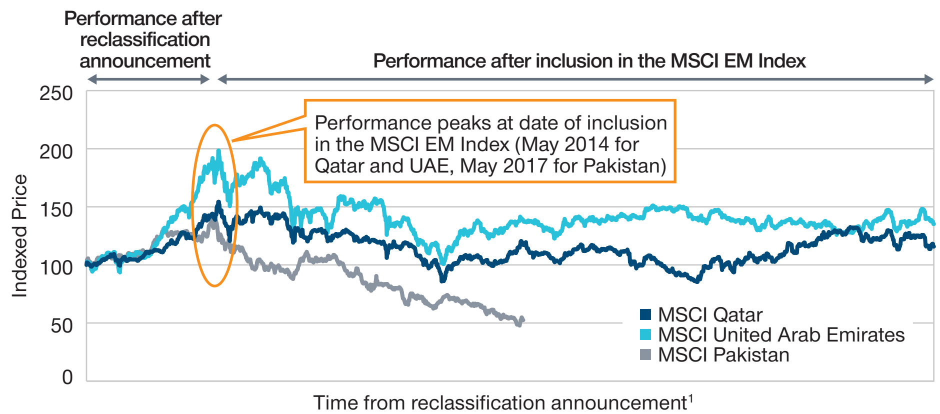

Past performance is not a reliable indicator of future performance.

Sources: MSCI via FactSet (see Additional Disclosures).

[1] As of August 28, 2019. Data are rebased for comparison purposes to 100 as at the date of reclassification announcements: June 11, 2013, for Qatar and UAE; June 14, 2016, for Pakistan. Qatar and UAE moved to the MSCI Emerging Markets Index in May 2014, while Pakistan moved in May 2017.
Data for illustrative purposes only.

due for completion in August. **Kuwait**, which has already been upgraded by index provider FTSE, is due to be reviewed midyear by MSCI (for inclusion in 2020) and looks set to meet the criteria for inclusion.

Markets that are upgraded are typically subject to significant inflows ahead of inclusion, as passive fund investors look to fill quotas in accordance with the new weightings. This tends to benefit existing investors, and our approach is to gain exposure to this trend and gradually reduce our holdings after index inclusion if valuations have become too stretched through the process.

Of course, fundamentals must still be to be taken into account when determining the right level of exposure. Developments, such as those seen in Argentina recently, represent a stronger driver of performance than flows.

Geopolitical and Trade Developments

Investors are closely watching the ongoing trade tensions between the U.S. and China. A bout of volatility hit global markets in early August, following new tariff impositions by the U.S. Retaliatory currency depreciation by China raised the prospect of a currency war to accompany the trade impasse. If these tensions ease and negotiators are able to secure a trade deal, investor risk appetite should pick up, benefiting frontier markets.

Meanwhile, countries such as Vietnam and Bangladesh, because of their role in the global supply chain, stand to benefit from ongoing tensions, as companies look to shift production away from China and are attracted by the cheap labor on offer. Vietnam, for its size, is disproportionately geared into the global economic cycle due to its large export market.

Conclusion

Our bottom-up stock selection has been guided by these catalysts, and we are well positioned in key areas should they come to have an impact. Maintaining a diversified portfolio helps in this regard. Investors should keep short-term market volatility in perspective when compared with long-term market results. Seeking to

(Fig. 3) What to Watch in Frontier Markets

Key election, MSCI reclassifications, and geopolitical events.
As of July 31, 2019

"time" equity markets in this environment will be very difficult. We believe selectivity is more likely to deliver durable returns during difficult periods.

In our view, the outlook for frontier markets should continue to improve as several of the country-level developments weighing on markets resolve. With much of this already reflected in asset prices, markets are potentially primed for an improvement in sentiment as elections, MSCI reclassifications, and trade and geopolitical developments play out over the year.

WHAT WE'RE WATCHING NEXT

Against this backdrop, we are more favorable to Saudi Arabia (off benchmark), Sri Lanka, Vietnam, and Kuwait. On a sector basis, we are finding attractive investment opportunities in cheaply valued banks and consumer-oriented stocks that benefit from favorable population dynamics in frontier markets.

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