Frontier Markets: An Attractive Entry Point?

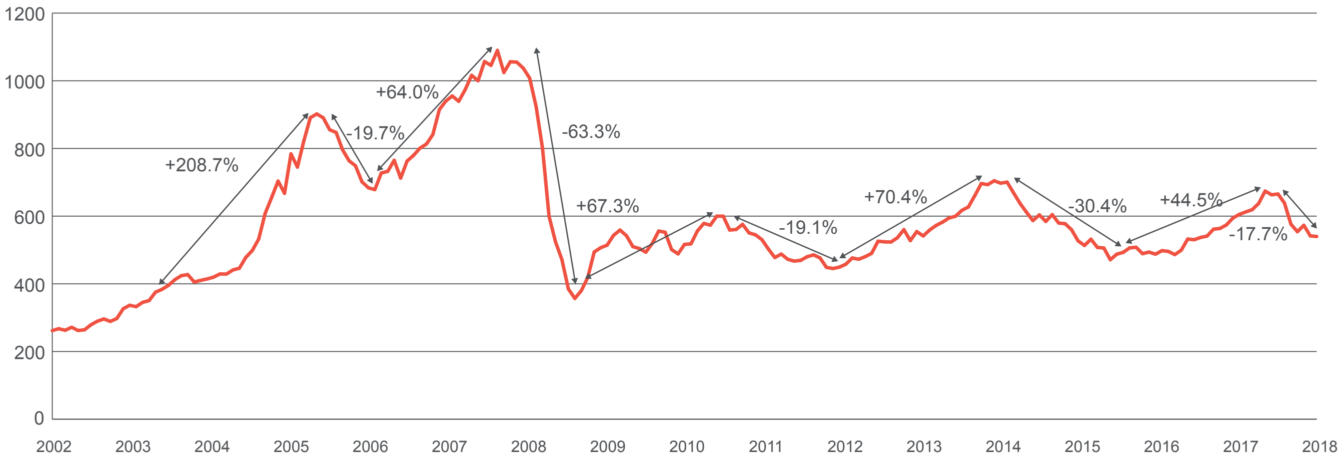
September 2018

Frontier markets have suffered significant declines in recent months and are now down over 14pct year-to-date to the end of August. However, this decline follows two years of substantial rises in the markets with a gain of 15% in 2016 and over 30% in 2017. As such, this correction should be partially viewed as a normal consolidation period after a 45% rally in frontier and an even larger rally in broader emerging markets (over the last two years). The current strength of the US dollar would be one key reason for the pull-back as well as the idiosyncratic currency crisis in both Turkey and Argentina. Our view is that both the lira and the peso collapse are more due to internal, self-induced economic travails rather than an incipient global emerging and frontier market crisis.

From a more general perspective, one of the key attractions of frontier markets is the secular nature of their economic growth which is more dependent on internal reform and developmental improvements than on global cyclical forces such as US interest rates or developed market economic cycles. This “cycle independence” should mean that it is relatively hard to have a comprehensive “global frontier market crisis” in contrast to when the world did experience an emerging market crisis in 1997/98 and a developed market crisis in 2008. Frontier economies can behave independently of each other geographically, economically and structurally, so that while some markets may suffer from a commodity price decline (e.g. oil in 2014 hurt countries such as Nigeria and Saudi Arabia), this may actually prove a boost for other frontier markets which are importers of oil (such as Pakistan and Bangladesh). Similarly, a rapid increase in the price of agriculture products such as we saw in 2011 would affect relatively low income frontier markets but, at the same time, agricultural economies may enjoy an upturn in growth.

The emerging market crisis of 1997/98 was an “asset-wide” crisis in that similar economic problems embroiled most of the emerging world at the same time, mainly because they all faced similar problems: a huge imbalance of hard currency debt which was allowed to build up in the economies within a fixed exchange rate regime. In this way, the Tequila crisis in Mexico in 1994 led to the Asian crisis in Thailand, Korea, Malaysia and Indonesia in 1997 and then culminated in the Russia default of 1998 and the Argentine default of 2001.

FIGURE 1:
MSCI Frontier Markets Index



Source: Bloomberg, as at 03 September, 2018

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But it is important to note that several large emerging market economies, notably India and China, avoided significant economic problems in this period and in some ways, even the 97/98 emerging market crisis cannot truly be called a global emerging market event. (It could be argued that the Chinese devaluation of 1993 was the first domino in this chain reaction but China was at the time a much less economically significant country.)

At the heart of all these events was poor policy: monetary, fiscal, political or a combination of all three. The current crises in 2018 in Turkey and Argentina are, we feel, in essence repeats of these mistakes. The key difference is that we believe that these countries are the exception rather than the rule in today's EM/FM universe. They are very big "crisis" events for the two countries involved and indeed the declines of the lira and the peso eerily mirror the declines of the baht and the won in 1997 both in speed and extent (c. 3-5 months and 50% loss in value peak to trough).

In the normal course of events, the uncorrelated nature of frontier economies normally means that individual frontier economies and their equity markets exhibit low correlations between each other as well as with the developed world and, as such, a diversified portfolio of global frontier markets also has low levels of correlation with other equity markets or other asset classes. There are sporadic occasions each decade when this lack of correlation breaks down, most notably in the 2008 global financial crisis and to a lesser extent in late 2014 and early 2015 when oil prices fell very sharply and the world experienced widespread negative interest rates on large parts of the world's bond markets.

The events of Q2/3 2018 are now also resulting in higher levels of correlation between frontier markets primarily because the currency collapse is occurring in a major index country, Argentina, alongside events in relatively small emerging markets such as Turkey. It is interesting to note that developed market equities have been strong in 2018 so frontier markets actually stand out as the weakest equity markets so far in 2018. Year-to-date, frontier markets are down -14% in USD terms versus emerging markets (-7%) and the MSCI World AC Index (+3.5%). Emerging markets have been less affected so far primarily because Turkey is a very small part of the universe but also because most emerging markets have incrementally improved their external positions ever since the Taper tantrum of 2013 and have been in a better position to weather the external shocks posed by 2018, notably higher US interest rates and a stronger US dollar.

So far the 2018 economic crisis has been contained to just two countries: the idiosyncratic events in Turkey and Argentina. Turkey's current crisis stems from several years of overly expansive macroeconomic policies which resulted in worsening external balances. Under President Erdogan, money policy has been too loose and this led to a speculative attack on the Turkish Lira which was amplified by a simultaneous political dispute with President Trump. The result has been a sharp fall from TRY3.8:$ to 6.6:$ over the course of several months. Argentina also suffered from fiscal imbalances, high inflation and external trade and current account deficits but arguably the new Macri government's only real fault was the speed of fiscal consolidation as they were forced to deal with over a decade of poor economic management under the Peronists. The Argentine peso has fallen from 18:$ to 38:$, despite the IMF announcing a $50 billion package and the central bank's increase in interest rates to 60%. The Macri administration will have to navigate carefully in order to achieve an economic recovery as it has a lower public approval rating than it has done for the last few years. The IMF have called for a significant adjustment of the fiscal deficit which will likely result in cuts in capital spending, reductions in transfers to sub-national governments and very austere public sector wage policies. However, the new level of the peso is now consistent with the very cheap real exchange rate levels post the 2001 default and, as such, we expect the Argentine trade deficit to decline as the economy slows and, with the harsh medicine taken, the medium term recovery of the Argentine economy is likely. This is in stark contrast to Turkey where there has been virtually no remedial action and the government remains stubbornly resistant at calling for the help of the IMF.

Equity markets in both countries have fallen sharply, with both down over 50% in USD terms YTD 2018. Our strategy has been cautious on Argentina for several quarters due to concerns over the level of over-valuation of the peso. We remain underweight despite increasing our weighting to financials during recent months. Valuations have reached attractive levels and we remain of the view that the government can stabilise the situation using their current policy tools and the IMF $50bln assistance. As discussed above, this is one of the rare occasions where the sharp declines of one frontier market have actually led to a sharp fall in other parts of the universe. Of course, it is never a simple cause and effect situation.

The Vietnamese equity market has seen a sharp correction over the same period as the Argentine market. It is hard to say whether this would have occurred anyway, absent an Argentine peso crisis, as it was largely due to retail margin pressure after a very sharp rally in Q1. Either way, it is hard to reconcile the fact that Vietnamese banks have fallen 40% in the same period as the Argentine banks fell 60% without attributing some of this move to an increase in correlations. However, this correlation in market crisis moves is in stark contrast to the actual lack of correlation in the underlying economies. Argentina has experienced a true currency crisis and will see a sharp drop in economic activity and interest rates were hiked to 60%. In Vietnam, the currency has barely budged relative to the US dollar, economic activity continues to show 6% to 7% GDP growth rates and interest rates remain in mid-single digits.

In conclusion, the economic crises in Argentina and Turkey have caused severe declines in their equity markets. These -50% declines have in turn have caused early signs of market contagion in various other frontier markets such as Egypt and Bangladesh. This is despite continued positive underlying trends in their economies and development paths. Referring to just these two examples, Egypt's foreign exchange reserves continue to rise, inflation is moderating and the country's fiscal reform programme is working as the budget recently announced the smallest fiscal deficit in seven years and its first primary surplus in over a decade. A strong manufacturing export base in addition to robust remittances continues to support Bangladesh's economy. Individual frontier markets remain in a constant state of differentiation and our investment process is constantly trying to find growth at the best price across this range of countries at different points of their development path. Previous emerging market crises have led to contagion and synchronised economic and market declines. So far, we believe that the Turkish and Argentine crises will remain contained within those markets and the recent decline in frontier markets presents attractive valuation opportunities.

The tables at the end of this document highlight how attractive a selection of blue chip names across the main frontier markets look relative to both recent and all-time highs. Most of these stocks show very significant declines from peak levels both in market capitalisation terms as well as valuations. This represents a significant long-term buying opportunity at historically low multiples. Our investment process is designed to avoid markets as they undergo significant declines as part of their longer term secular developmental growth. Over the last decade, several key markets have fallen sharply from -30% to -75%: Bangladesh in 2011, Vietnam in 2012, Nigeria in 2014, Saudi in 2015, Egypt in 2016, Pakistan in 2017 and now Argentina in 2018. With the right remedial policy measures, these countries up until Egypt in 2016 have all experienced strong recoveries both economically and in market terms. We believe both Pakistan and now Argentina will now be in a position to recover over the next few years and we will look to find opportunities in both these markets and the rest of the universe. The 2018 "crisis" has indeed been a challenge to navigate but, so far, remains a -20% pullback event peak to trough as opposed to the much worse crisis of 2008. As you can see, there have been several 20% declines (2006 – sharp correction after bull market and 2011 – the Greek crisis) and one sharper correction of 30% (2014/15 – the oil price crash). 2008 remains the real crisis of the last two decades with a 63% fall. Given the current strength of the global economy and equity markets, the house view remains that the 2018 market correction is unlikely to morph into a global frontier crisis.

USD	Market Capitalisation All Time $				Market Capitalisation 12 Months $				P/B All Time				P/E All Time			
	Peak	Trough	Current	% Curr vs. Peak	Peak	Trough	Current	% Curr vs. Peak	Peak	Trough	Current	% Curr vs. Peak	Peak	Trough	Current	% Curr vs. Peak
Nigeria																
Dangote Cement	26,187.2	8,087.3	10,734.2	-59%	13,140.8	9,663.4	10,734.2	-18%	9.71	3.06	5.43	-44%	18.47	7.53	15.64	-15%
Nestle Nigeria	6,252.7	194.4	3,284.9	-47%	3,601.0	2,543.1	3,284.9	-9%	36.16	7.64	26.71	-26%	32.55	15.50	27.63	-15%
Guaranty Trust Bank	5,701.6	75.6	2,927.3	-49%	4,457.9	2,927.3	2,927.3	-34%	2.88	0.96	2.18	-24%	9.87	3.12	5.99	-39%
Nigerian Breweries	8,747.4	405.7	2,163.0	-75%	4,069.3	2,163.0	2,163.0	-47%	12.18	4.23	4.57	-62%	33.85	10.50	21.41	-37%
Pakistan																
Oil & Gas Development	13,753.0	2,218.1	5,331.5	-61%	6,764.4	4,904.9	5,331.5	-21%	5.90	0.89	1.21	-79%	9.97	4.62	8.41	-16%
Habib Bank	4,324.0	490.9	1,801.3	-58%	2,819.3	1,801.3	1,801.3	-36%	3.08	0.59	1.15	-63%	11.35	5.92	9.01	-21%
MCB Bank	4,829.8	69.7	1,938.9	-60%	2,534.7	1,850.0	1,938.9	-24%	5.48	0.84	1.56	-72%	11.57	7.10	10.72	-7%
United Bank	3,216.0	364.8	1,572.9	-51%	2,383.6	1,536.6	1,572.9	-34%	5.05	0.61	1.20	-76%	10.76	5.21	9.87	-8%
Argentina																
Grupo Galicia	10,398.3	24.0	3,090.7	-70%	10,398.3	2,685.2	3,090.7	-70%	4.28	1.93	1.95	-54%	17.52	3.27	8.63	-51%
Banco Macro	9,071.3	6.5	2,584.9	-72%	9,071.3	2,301.0	2,584.9	-72%	3.19	1.54	1.82	-43%	14.91	2.03	6.53	-56%
YPF	27,307.4	3,414.0	5,752.2	-79%	10,332.3	5,179.9	5,752.2	-44%	3.00	0.69	0.77	-74%	72.98	0.70	14.72	-80%
Grupo Supervielle	3,015.3	486.9	568.2	-81%	3,015.3	486.9	568.2	-81%	3.48	0.29	0.44	-87%	15.10	2.86	3.88	-74%
Vietnam																
Vingroup	15,616.7	213.4	14,169.8	-9%	15,616.7	5,583.0	14,169.8	-9%	8.73	2.01	7.35	-16%	50.25	10.34	44.53	-11%
Hoa Phat Group	4,448.2	231.1	3,643.2	-18%	4,448.2	2,324.2	3,643.2	-18%	5.50	0.66	2.32	-58%	11.81	4.48	9.08	-23%
Vietnam Dairy Products	13,726.2	519.4	9,764.0	-29%	13,726.2	9,428.7	9,764.0	-29%	10.30	2.44	8.73	-15%	28.45	15.30	23.81	-16%
Masan Group	5,268.4	840.3	4,296.2	-18%	5,268.4	2,419.6	4,296.2	-18%	8.08	2.53	5.88	-27%	33.34	11.22	25.19	-24%
Bangladesh																
Brac Bank	1,183.2	117.6	981.5	-17%	1,183.2	802.3	981.5	-17%	3.79	0.63	2.12	-44%	16.95	4.70	14.62	-14%
Square Pharmaceuticals	2,959.6	559.0	2,439.0	-18%	2,959.6	2,304.9	2,439.0	-18%	6.18	2.90	4.17	-32%	20.05	15.63	16.41	-18%
Grameenphone	8,323.2	1,368.0	6,224.5	-25%	8,323.2	5,705.9	6,224.5	-25%	16.70	3.69	12.58	-25%	19.52	12.62	15.98	-18%
LafargeHolcim Bangladesh	2,133.1	300.1	736.7	-65%	987.2	717.7	736.7	-25%	9.00	3.42	4.08	-55%	31.41	13.60	18.34	-42%
Egypt																
Commercial International Bank	7,054.0	324.0	5,736.7	-19%	6,232.2	4,717.4	5,736.7	-8%	4.45	1.27	3.57	-20%	13.44	3.24	12.50	-7%
Eastern Tobacco	3,636.4	203.2	2,617.2	-28%	3,636.4	1,605.9	2,617.2	-28%	6.51	0.92	4.26	-35%	15.81	4.65	10.35	-35%
El Sewedy Electric	3,665.0	326.2	2,357.3	-36%	3,111.0	1,136.2	2,357.3	-24%	6.29	0.77	3.10	-51%	10.82	4.58	8.80	-19%
Talaat Moustafa Group	4,867.3	783.8	1,347.0	-72%	1,647.1	907.7	1,347.0	-18%	1.13	0.22	0.84	-25%	18.65	4.48	14.25	-24%
Saudi Arabia																
Al Rajhi	94,100.4	6,560.1	36,861.9	-61%	39,083.5	27,068.2	36,861.9	-6%	4.50	1.58	2.62	-42%	18.40	8.59	14.03	-24%
SABIC	199,258.7	8,798.6	100,759.7	-49%	104,308.9	78,031.7	100,759.7	-3%	8.10	0.99	2.31	-71%	35.80	9.57	15.97	-55%
National Commercial Bank	39,517.9	17,304.6	35,345.9	-11%	39,517.9	24,681.4	35,345.9	-11%	3.05	1.25	2.32	-24%	17.70	6.32	12.13	-31%
Samba	33,687.0	5,077.9	15,300.5	-55%	17,651.5	11,731.8	15,300.5	-13%	5.00	0.78	1.32	-74%	12.63	5.95	10.89	-14%

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