CITY OF LONDON
Investment Management Company Limited

Frontier Markets Semi-Annual Outlook

February 2017

Overview

FM: More than a Trump Card

Growth in frontier markets (FM) is likely to accelerate this year, aided in some cases by a recovery in commodity prices. As a crude approximation, the IMF is projecting growth in low-income developing countries to rise by one percentage point from 2016 to 4.7% yoy this year. Reformist countries are expected to return to growth after painful, but necessary reforms last year (e.g. Argentina), while others that have progressed further with this agenda are likely to be aided by a strong pickup in investment (e.g. Morocco, Pakistan). Meanwhile, at the other end of the spectrum, countries that have impediments to reform could also post better growth amid higher commodity prices (e.g. Kuwait, Nigeria), but we view these recoveries as fundamentally unsustainable absent supportive policies.

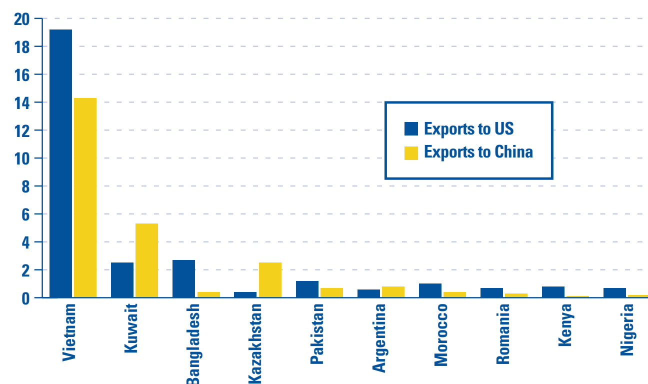
Meanwhile, the risk from a more protectionist America under President Donald Trump varies across FM and for many, exposure to the US via exports is not large. In some cases, China is a more important export market (see chart 1), which bodes well given that China's expansionist view on trade. Longer-term a more protectionist stance from America could reduce foreign investment into FM. This is important since the savings ratio in frontier is not high (estimated by Credit Suisse to be 20%, compared to 36% for EM). Given the early stage of development of FM economies and the consequent need for investment, this leaves these countries reliant on inward FDI. However, even here, the US is not a major contributor. Instead, it is the EU that is the largest contributor to FDI, accounting for around half of the total, even in FMs outside Europe. Thus, disintegration of the EU is a greater risk to FM than the Trump administration's policies. While the former risk could rise after key elections in the Netherlands, France and Germany this year, we view a breakup as still unlikely given the strong political and institutional will to hold it together.

Private sector leverage remains low in FM and is something that could become a key growth driver as it relates to increased investment, employment and economic growth. Private credit, currently 38% of GDP, has yet to recover to its 2010 high of 41% and is far below the average EM (107%), with some FMs (Argentina, Pakistan and Nigeria) less than 15%. Moreover, many countries have banks with low levels of leverage, with a loan to deposit ratio of 79% against 87% for EM and so, less balance sheet constraint.

However, while credit supply might not be a limiting factor, demand can be. Private sector credit demand can be hampered by costs and risks outside that of interest rates which could make projects financially unfeasible (e.g. costs associated with corruption). In addition, lack of participation in the formal economy would make access to formal credit very difficult. Some countries are pushing forward with private-public partnerships (PPP), which should encourage private sector participation in the formal sector. Countries that can leverage this advantage to value-added activities could raise the economy's growth potential.

Although external factors matter for FM, domestic policies are likely to be just as important for growth trajectories. For example, improvements in competitiveness in FM are required to move towards the EM level. As the Asian model has shown over the past 20 years, creating a manufacturing export base is a way of alleviating poverty, raising living standards and creating a strong middle class.

Chart 1: FM Exposure to US and China (% of GDP)



Source: Bloomberg

Strategy: More of the Same

Given the politically charged atmosphere globally and increasingly protectionist rhetoric espoused by global (and potential) leaders, it is tempting to view FM as vulnerable. However, fundamentals suggest otherwise. Moreover, the performance of FM since Trump's election victory has been superior to that of both emerging and developed equities. FM outperformed by 5.9% and 0.7%, respectively, through end-January. Valuations for the asset class are not cheap, with the P/E of 14x at a post-crisis high. However, we believe this is counterbalanced by improving fundamentals, generally low exposure to a protectionist US and an attractive dividend yield (4%), all of which should support continued healthy returns.

This is not to say that there no risks, as illustrated by countries that are slow to reform, but more that frontier economies are generally progressing and this is being reflected in market performance. We view reformist countries favourably, expecting a greater degree of shelter in an increasingly volatile environment. For these reasons, our allocation is broadly unchanged from August. We keep Morocco and Argentina as core *overweights* given reformist governments, whereas we stay *underweight* Kuwait, Kenya and Nigeria amid ongoing political risks.

With a potentially increasing home bias among global investors, it is arguably now more important for FM economies to distinguish themselves from others. Those that, for example, set up economic free zones and make it easier to do business are likely to be key beneficiaries of financial flows and to post superior investment performance.

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Latin America

Argentina

Overweight

Foreign investment has returned under Macri and the economy is set to expand this year, but mid-term elections could be key for successful reform.

Argentina's economy is set to rebound from an estimated 2.0% contraction in 2016 to grow by 3.0% in 2017. Indeed, momentum in some areas was already building in 2H last year. Industrial production fell by 2.3% yoy, recovering from a trough of 8.0% in October and the economic activity index recovered from -5.7% yoy in July to -1.4% in November. The yoy rise in auto production and exports accelerated to the highest levels since 2010, while that of auto sales rose to the highest in over a decade.

Investment is also likely to drive growth as international investors return. In January, the government announced a deal whereby international oil companies alongside state energy company YPF will invest up to $15 bn in the Vaca Muerta shale formation, which has the second-largest shale deposits in the world, and $5 bn of which will be invested this year. President Mauricio Macri's administration made concessions to both oil companies (subsidising gas prices and eliminating an oil export duty) and labour unions (granting more flexible working conditions). This illustrates the current government's ability to strike a deal and move investment forward by engaging all parties, something that has been missing for many years in Argentina.

At the same time, while inflation remains elevated (estimated at close to 40%), it is expected to nearly halve to 21% this year. The reduction of electricity subsidies by up to 90% and consequent rise in electricity tariffs is one factor that will keep upward pressure on prices this year and inflation above the central bank's (BCRA) 17% target. BCRA's key policy rate has remained at 24.75% for over two months and the Bank is likely to remain cautious amid increased tariffs as a growth headwind on the one hand and, on the other, still elevated inflation expectations justifying a tight policy stance. The central bank has been setting the rate weekly since Macri took office in December 2015 in an attempt to normalise policy, but will move to fortnightly rate setting in March. BCRA Chairman Sturzenegger has said the aim is to move to a monthly rate setting meeting, which would indicate more stable economic conditions.

Last year, the trade account posted a $2.1 bn surplus (0.4% of GDP), rebounding from a $3.0 bn deficit in 2015. This was largely the result of a 6.9% yoy contraction in imports compared to a 1.6% rise for exports. However, the recovery in activity is set to lead to a rebound in imports and a shrinking of the surplus closer to balance. Overall, rising investment and a fall in savings as consumption increases is expected to lead to a widening in the current account deficit to 3.0% of GDP this year, from an estimated 2.7% in 2016.

The government managed to beat its primary fiscal deficit target last year, posting a 4.6% of GDP shortfall compared to a 4.8% target. However, fiscal accounts were aided by a one-off windfall from a tax amnesty, which ends in March. Excluding this effect, the underlying deficit was 6.0% of GDP and suggests fiscal slippage as real transfers and capital spending doubled in 2016. Government spending rose to 25.3% of GDP last year, up by 0.9 of a percentage point yoy.

Meanwhile, in December, Finance Minister Alfonso Prat-Gay was pushed out of his position and Macri split the ministry into two departments: the Treasury division to be led by Economy Minister Nicolas Dujovne and the Finance division headed by new Finance Minister Luis Caputo. Although Prat-Gay had targeted a 4.2% deficit this year, a more realistic target from Dujovne is likely to be announced. The economy minister has said there will be a spending review and there are plans for tax reform.

The reform-centric Macri administration has attracted international investors and this has continued ytd, in spite of heightened global uncertainty. This was illustrated in January as $7 bn of dollar-denominated government bonds were sold, above the $3-5 bn target, and the issue was more than three times oversubscribed. The 10-year USD bond has a 7% yield, 50 bps lower than its September sale. However, Caputo has said the government is not aiming to raise much more capital this year and is targeting only $3 bn in additional issuance. Separately, in a move reflecting the country's return to international capital markets, J.P. Morgan Chase added Argentina's peso bonds to its benchmark indices in January.

The poverty rate has more than doubled since end-2015 to 32.2%. This reflects a somewhat perfect storm for living standards, due to reforms since Macri's election including the floating of the peso and its subsequent devaluation (-15% yoy versus US$), monetary tightening and reduced subsidies and government spending. These policies are likely to benefit Argentina in the medium–term, but are a political risk in the short-term. Legislative elections in October will be important in terms of the outlook for the reform agenda as Macri's Cambiemos coalition seeks to gain seats and potentially a majority in the Chamber of Deputies, where it has been relying on divided Peronists to push through legislation to date.

Market Strategy: Argentina's equity market has continued to outperform FM over the past year and though valuations have risen, we do not view them as stretched at present given the ongoing reform agenda. We therefore expect investor appetite for Argentine assets to remain healthy. We concede that some of the investment case hinges on October's mid-term elections, but in the meantime expect the equity market to benefit from a favourable backdrop and keep our *overweight*.

Asia

Vietnam

Overweight

External demand supported activity last year, but a recovery in the agriculture sector should lead to an acceleration in GDP growth this year.

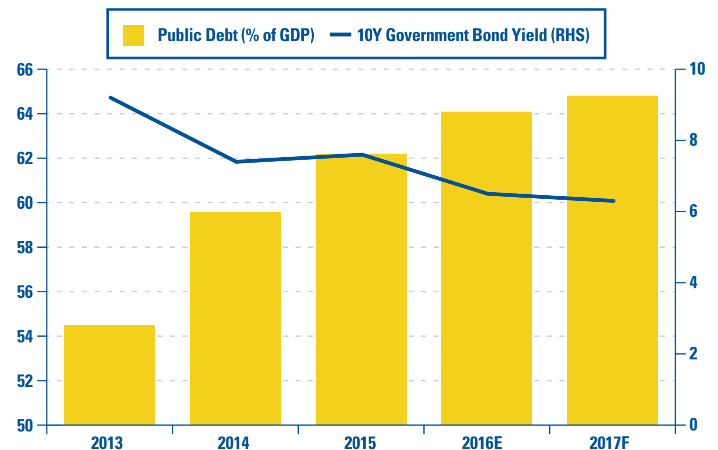
GDP growth decelerated to 6.2% yoy in 2016, lower than the growth target and the previous year's post-crisis high (both 6.7%). The manufacturing sector continued to drive growth, with output up by 11.9% over the period. FDI into Vietnam has continued apace at 5.5% of GDP last year. This has aided the sector in ramping up production and boosting exports, which rose by 14.8% yoy in Q4 as the launch of several new smartphones boosted the tech sector. Conversely, household demand was lacklustre, as indicated by decelerating retail sales (average monthly rise of 9.6% yoy in 2016, half the rate in 2012) and auto sales (up 13.3% yoy in December against 45.5% a year earlier).

Activity is expected to accelerate this year to 6.5% as manufacturing and exports continue to drive growth. The agricultural sector is also set to recover this year, a departure from last year when a drought trimmed output. This is likely to have at least three positive effects on activity: 1) recovery in output for the sector; 2) rising incomes for agriculture workers (nearly half of employment) and 3) by extension, improved household consumption.

However, one key downside risk for growth is the increased probability of trade protectionism arising from the US under the Trump administration. America has withdrawn from the Trans-Pacific Partnership and President Trump has stated that he would seek to protect the country from "the ravages of other countries making our products, stealing our companies and destroying our jobs." Given that Vietnam's trade surplus with the US is worth 16% of Vietnamese GDP, this development raises uncertainty around the long-term outlook. From this perspective, there is a case for keeping monetary policy loose, with the State Bank of Vietnam (SBV) having kept its refinancing rate at 6.5% since March 2014 and credit expanding at a double digit pace last year.

Conversely, there are some key reasons for SBV to remain vigilant. The rising budget deficit (estimated at 5.8% of GDP last year from 5.4% in 2015) is pushing state debt close to the 65% of GDP limit set by the National Assembly for 2016-20. Continued easy monetary conditions are likely to encourage rising government debt and falling yields amid excess liquidity (see chart 2). The Finance and Budget Commission highlighted concerns over debt sustainability and government bailouts of SOEs in a report in October. However, progress with the government's privatisation is expected this year, which could reduce government debt requirements.

Chart 2: Vietnam Public Debt and Bond Yields



F is forecast. E is estimate for public debt.

Source: Bloomberg, World Bank

Inflationary pressures are likely to build this year as administered prices for education and health rise. Headline inflation rose to 5.2% yoy in January, a three-year high, but core inflation (1.9%) remains low. SBV is aiming for inflation under 4% this year. Pressure to tighten policy is likely to come later in the year, particularly as the Bank also seeks to keep the dong stable, a goal that is undermined by rising inflation as it is likely to encourage the population to convert dong into gold or US dollars. Foreign inflows have enabled FX reserves to rise to a record $40 bn (three months of imports), providing an improved buffer against depreciation pressure on the dong though. Overall, a neutral policy stance from SBV seems likely to be accompanied by policies prioritising dong stability given ongoing global uncertainty.

External accounts have improved over the past 12 months, with the current account surplus estimated to have expanded to 4.0% of GDP in 2016, up from 0.5% in 2015. The improvement was almost entirely due to the trade account, which moved from a 1.6% of GDP deficit to a 1.4% surplus over the period. Strength in trade is expected to continue this year, which should aid a further build up of FX reserves and support the dong.

The overall balance of payments has been aided in recent years by strong capital inflows, including FDI and portfolio flows. Stable macro conditions, including reduced inflation and healthy growth, and a 0% cap for onshore dollar deposits have crimped demand for US dollars. "Other" investment net outflows averaged under $1 bn in the first nine months of 2016 compared to $3.6 bn for the previous nine months. This backdrop has helped create a buffer against external shocks and puts Vietnam in a stronger position.

Market Strategy: Vietnam's market has underperformed FM over the past year and the market faces some headwinds this year including increased supply from the privatisation programme. At the same time, however, expected increases in foreign ownership limits should be supportive for sentiment. Moreover, valuations have fallen both in absolute terms and relative to FM. Given supportive economic fundamentals and attractive valuations, we keep our *overweight*, albeit slightly reduced due to external risks from the US.

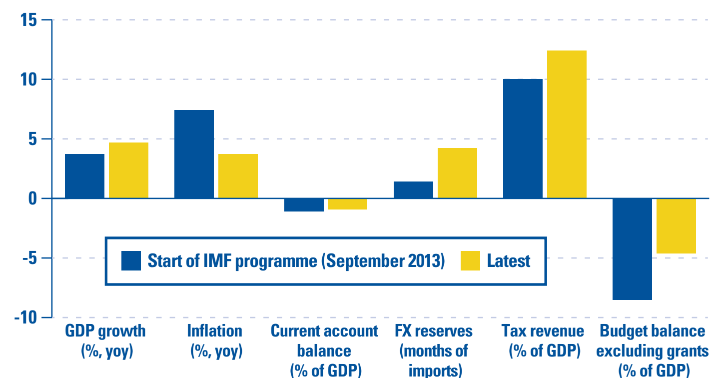
Pakistan

Overweight

Pakistan is on a firm footing after completing the IMF programme and is set to benefit from ongoing reforms and Chinese investment in CPEC.

Pakistan's economic fundamentals have improved significantly under the IMF's programme (see chart 3). The improvement spans a broad range of measures, including accelerated GDP growth, reduced inflation, current account and budget deficits, increased FX reserves and improved tax revenues. Overall, after completing the three-year programme in September the economy is in a much stronger position to progress with further reforms, including reducing in NPLs, raising exports and private investment, reducing the size of the informal sector and increasing private investment to bolster growth.

Chart 3: Pakistan Under the IMF



Source: IMF

GDP expanded by 4.7% yoy in FY 2015/16 (year to end-June), up from 4.0% in the previous 12 months. Activity has been aided by a lower oil price, rising infrastructure investment and monetary policy easing. A recovery in agricultural output is set to support a forecast 5.0-5.5% growth outturn in FY 2016/17.

In addition, investment is likely to be a key pillar of growth in the coming years. The investment drive has come via the government's propensity for infrastructure spending. Under PM Nawaz Sharif, several projects have been undertaken including a $1.2 bn project to build a 375km road joining Islamabad and Lahore. Some of these projects are of questionable value. The aforementioned road adds little economic value due to the existing Grand Trunk Road, a shorter, toll-free road. However, going forward it is the $46 bn (17% of GDP) China-Pakistan Economic Corridor (CPEC) that is set to boost growth, with $18 bn of projects already underway and related projects set to run until 2030. Some CPEC projects will address some long-standing problems such as the chronic electricity shortage, with 12 energy projects set to be completed by the end of FY 2017/18. Others will add economic value such as development of the seaport in Gwadar and the setting up 30 Special Economic Zones. In the long-term, this could raise Pakistan's growth potential.

However, the rise in infrastructure spending from CPEC is expected to come at a cost to external accounts as imports rise. Separately, remittances (7% of GDP last year) have been robust and supportive of the current account. There is a risk of reduced remittances from the US amid increased protectionism. However, remittances from the US have already been falling due to more stringent regulations and only account for 12% of the total. Remittances from Saudi Arabia and the UAE account for around half of the total and are rising, albeit at a slower pace. The risk here is that as the Gulf states reduce fuel subsidies and increase tax to adjust to a lower oil price, remittances slow further and even fall as expatriates' cost of living rises. On balance, rising imports, continued strength in the rupee eroding competitiveness (up 4.2% yoy in trade-weighted terms) and downside risks to remittances suggest the current account deficit is set to widen (forecast to be 2.2% of GDP in FY 2017/18, more than double that in FY 2015/16).

Meanwhile, fiscal policy has remained prudent and the government is expected to meet its budget deficit target of 3.8% of GDP for FY 2016/17. Revenue-raising measures have had a mixed impact on government finances. A tax amnesty on real estate investments, with a tax of 3% paid on declared holdings, was passed by the government in December. Although this will bring assets under the tax net, the initial tax is only expected to raise $75 mn in revenue. The policy will be reviewed in the budget for FY 2017/18. Conversely, the state privatisation programme is set to pick-up this year, with several sales targeted prior to end-June amid strong interest from Chinese investors.

Pakistan's foreign currency debt rating was affirmed at B ('stable' outlook) by Fitch in February. Although the country has public debt (64.8% of GDP) higher than the median for the B-rating (56.7%), this is mitigated by the expected fall in the budget deficit, aided by tax reforms and improved growth prospects. At the same time, funding costs have remained low and Pakistan has good access to international capital markets, illustrated by the issue of a $1.0 bn five-year dollar sukuk bond in October, its first in two years, at a historical low yield of 5.5%.

Market Strategy: The MSCI Pakistan will be upgraded to EM status in May, which is likely to keep investor flows into the market healthy. Its 5% dividend yield is attractive and its P/E discount to FM has widened by one percentage point over the past year to 14%. Given the healthy economic backdrop and ongoing structural reforms, we expect the market to outperform FM and keep our *overweight*.

Middle East and North Africa

Kuwait

Underweight

Growth is set to recover this year, but November's election raises policy uncertainty.

GDP growth in Kuwait is forecast to accelerate to 2.6-3.0% this year from an estimated 2.5% last year. Contributions are likely to come from both the oil sector, as reduced output from the OPEC agreement is more than compensated for by the higher oil price, and the non-oil sector, with growth in the sector accelerating by half a percentage point to 4.5% this year as PPP projects are pushed forward. Conversely, austerity measures are likely to limit consumption. Public sector wages are set to rise by 2.0% in fiscal year (FY) 2016/17 against inflation of 3.5% yoy in December, which would be the first real wage fall in several years amid subsidy cuts.

Kuwait remains the only Gulf country with a semblance of democracy. This means it is better placed, in theory, to quell unrest than regional peers as it gives the population a nominal say in the make-up of the country's parliament. Although the Al Sabah family rules, a 50-member National Assembly is determined by the electorate and the assembly has the power to block the Al-Sabahs' plans. However, in recent years it has approved government plans. Implemented projects rose to 80% in FY 2014/15 and 89% in FY 2015/16, from an average of 65% prior to this, driving an acceleration in non-oil growth.

Elections in November gave the opposition 24 seats amid voter discontent over reduced subsidies on fuel and other commodities. This raises policy uncertainty and makes fiscal reform less likely, though expansionary policy in terms of capital spending is expected to continue.

Fiscal accounts are thus likely to remain in deficit, projected to be $1.4 bn (1.2% of GDP) in 2017. Incidentally, elimination of subsidies for healthcare, housing, fuel and electricity would balance the budget this year. Although some subsidies may be cut, the remainder of the shortfall is likely to be covered via increased borrowing, with Kuwait planning its first issue of US dollar denominated debt in 1H to raise up to $10 bn (~10% of GDP). At the same time, the stabilisation of the oil price above the country's breakeven price of $50 combined with a strong balance sheet (e.g. SWF assets worth almost $600 bn) suggest that Kuwait's AA- sovereign debt rating is not under threat.

Market Strategy: Kuwait's rally (+14.1% ytd) has made it one of the world's best performing stockmarkets, though the reasons are more likely technical (e.g. reinvestment of tender proceeds) than fundamental. We view the rally as unsustainable as much needed reform is unlikely to be implemented. We keep our *underweight*.

Morocco

Overweight

Elections gave the PJD the most seats in parliament and reformist policies are expected to continue once a government is formed.

Economic growth in Morocco last year decelerated to an estimated 1.5%, a third of the rate of the previous year, as agricultural output (12% of GDP) contracted by double digits as a result of a drought. However, growth is expected to rebound, driven by agriculture, to 4.4% this year. At the same time, inflation remains unchallenging (1.8% yoy in December) and is expected to fall to 1.2% this year as food and energy price rises decelerate. Core inflation is also low (1.1%) and inflation expectations are well-anchored, so Bank-Al-Maghrib is likely to keep its key policy rate at the current record low of 2.25%.

Meanwhile, policy continuity is expected after October's election gave the ruling Justice and Development Party (PJD) the largest number of seats (125 out of a total of 395), gaining 18 seats from the 2011 election. Although talks to form a coalition are ongoing, the progressive leadership of the PJD is expected to prevail, allowing a continuation of reforms. For example, the country is aiming to attract long-term investment and has been successful in the recent past: FDI rose by 11% from 2010 through 2015 in contrast to regional falls over the period. The new investment law should support this trend, with the aim of creating free economic zones in all of Morocco's 12 regions and incentivising exports.

The current account deficit has narrowed in the past two years mainly as a result of the collapse in the price of oil (~14% of imports). Last year's shortfall was 2.9% of GDP, almost half that in 2014, when the oil price began its descent. The deficit narrowing has been aided by strong auto and textile exports and a recovery in tourism, both of which should compress the gap to 2.3% of GDP in 2017.

Morocco is seeking to reduce its reliance on fossil fuels and the government has been pushing for increased renewable energy use. It is aiming to raise electricity consumption from renewable sources to 42% of the total by 2020, thereby reducing vulnerability of the economy to oil price fluctuations. To this end, Morocco launched its first concentrated solar power (CSP) operation, Noor, last year which will be the world's biggest CSP facility. Two plants are set to go online this year and the facility is aiming to be fully operational by 2019.

Market Strategy: Morocco's market has outperformed FM steadily over the past 12 months, but the P/E premium over FM has narrowed from 75% to 53%. We believe this offers value, particularly given a reformist administration that is implementing its agenda. This augurs well for market returns in the short- and medium-term in our view, so we keep Morocco as a core *overweight*.

Sub-Saharan Africa

Nigeria

Underweight

Nigeria has numerous structural problems that are not being addressed, which could lead to stagnation.

GDP in Nigeria has continued to shrink, posting a 2.2% yoy fall in Q3 after a 2.1% fall in Q2 and 0.4% in Q1. However, non-oil sector output was flat after falling in 1H, aided by a 4.5% expansion in agriculture. Nigeria is expected to return to growth this year, but the government's 7% target for 2020 seems ambitious at present. Indicative of the country's decline in recent years, Nigeria's GDP has fallen behind South Africa and it is now the second-largest economy in Africa.

Meanwhile, the Central Bank of Nigeria (CBN) view monetary policy as having become largely ineffective at addressing current economic issues. At its monetary policy committee meeting in January, the CBN left both the key rate (14.0%) and cash reserve ratio (22.5%) unchanged. CBN Governor Godwin Emefiele said that weak growth and high and rising inflation (18.6% yoy in December) was due to structural factors beyond the confines of monetary policy such as high energy prices, unpaid salaries and an FX shortage.

Despite this, central bank policy has been lacklustre with regards to the currency. CBN announced the floating of the naira in June and has since tried to keep the exchange rate close to ₦315/US$. However, this rate does not reflect the level at which transactions take place since the shortage of and high demand for dollars have reportedly pushed the black market rate as high as ₦490. Weekly dollar sales by the central bank have been insufficient to satisfy demand, which is high due to the country's import requirements (~10% of GDP) and FX reserves (6% of GDP) are too low to cover this. The dysfunctional state of the market has dented the CBN's credibility. Moreover, although activity is lacklustre, higher interest rates could help attract foreign investors and tackle high inflation.

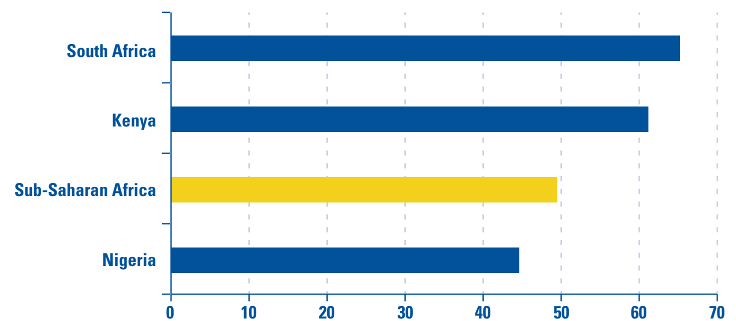
The government has also been at fault and at times ham fisted. In November, the State Security Service, Nigeria's intelligence agency, arrested money changers in various Nigerian cities and forced many to sell dollars at ₦400. This has led several money changers to halt operations, while those with US dollars are hoarding them in the hope of an improved rate.

To some extent, the shortage of dollars was out of the control of the authorities as the collapse of the price of oil led to lower dollar revenues (the sector accounts for 98% of Nigeria's FX revenues). At the same time, militants in the Niger Delta began sabotaging oil pipelines, thus reducing production. However, the latter factor could have been tackled by the government via negotiations. A series of policy errors and lack of credibility over the naira floatation is preventing the currency market from finding an equilibrium, which is stalling economic activity. Without a change in the situation, there is a risk of 'lost years' (i.e. stagnating output).

The impact could be worse over the long-term given major structural issues that are yet to be addressed. For example, firms often cite electricity problems and power outages as the biggest obstacle to business performance. Moreover, resultant losses to businesses are worse and a higher percentage of firms have their own generators than in other countries. The government is still trying to clean up its electricity distribution companies, riddled with debt, and gas pipeline vandalism is also hampering output. In this sense, the African Development Bank's $1 bn loan to finance Nigeria's budget deficit and its statement that the loan portfolio would rise to $10 bn by 2019, including investments in energy projects, is welcome.

Corruption is also a major and often cited problem, with PwC estimating that Nigeria's GDP could have been 22% higher in 2014 if the corruption level equated to that of Ghana. Again, this problem is more significant than in other countries. The Enterprise Survey showed that 24% of managers in Nigeria said bribes are required to get things done compared to 15% in South Africa, 10% in Brazil and 5% in China. President Muhammadu Buhari's anti-corruption drive has been largely based on a few high profile cases, with little by way of policies to tackle endemic corruption. These factors partly explain Nigeria's consistently poor ranking in the World Bank's Ease of Doing Business (169th out of 190 countries) and lacklustre performance relative to regional peers (see chart 4).

Chart 4: Percentile Ranking in 2017 World Bank Ease of Doing Business*



**Percentile based on world rankings since 2005.*

Source: World Bank

There is an increased risk of social unrest, especially given that 70% of the population live below the poverty line, the deteriorating economic backdrop and Buhari's unexplained month-long absence, with no return date specified, after receiving medical treatment in London. The president's glacial pace of reform means that it was hard to tell that he was absent, but protesters in Lagos and Abuja complained about their "missing president".

Market Strategy: Nigeria's market underperformed FM significantly over the past 12 months, but the P/E discount to FM (35%) is close to that a year ago. Ongoing structural problems leave the economy vulnerable to stagnation, so absent reforms we keep our *underweight*.

Kenya

Underweight

Uncertainty over this year's presidential election is set to remain amid continued economic headwinds.

Kenya's presidential election on August 8th could yet be closely contested, despite a January poll showing that President Uhuru Kenyatta has a 22 percentage point lead over opposition leader Raila Odinga of the Orange Democratic Movement. In any case, more important is likely to be the passing of the election peacefully. To this end, the country has put in place processes to avoid the election violence that marred the 2007 election. These include the president appointing new Commissioners to the Independent Electoral and Boundaries Commission in December, which were widely accepted by all parties, and establishing a National Cohesion Commission.

Typically, economic growth slows in Kenya in an election year, but 2013 was an exception amid a peaceful election. Latest growth figures showed a slowdown to 5.7% yoy in Q3 from 6.2% in Q2. This was driven by a deceleration in the agriculture sector (around a quarter of output) as activity grew by 3.9% compared to 5.5% in the previous quarter. The ongoing drought in Kenya could act as a drag in Q4 2016 and Q1 2017, but should dissipate in 2H.

Rising government spending in the run up to the election is also likely to compensate for lacklustre private credit growth after the Banking Act was put into law in September, capping lending rates at 4.0% above the central bank's policy rate and putting a floor on deposit rates of 70% of the key rate. This has led to a narrowing of the lending-deposit rate spread by six percentage points to 5.8% and a resultant slowdown in private credit growth to 4.3% yoy in December from 17.8% a year earlier.

Consumer price rises have been accelerating since April (5.0% yoy) and was 7.0% in January, close to the upper bound of Central Bank of Kenya's (CBK) 5.0 +/- 2.5% range. The Kenyan shilling has weakened against countries such as China and India (half of Kenya's imports are from these two counties), suggesting further upward pressure on CPI. Conversely, an expected growth slowdown in 1H and election uncertainty is likely to keep the CBK on hold.

Meanwhile, the twin deficits are set to remain. Risks to the government's estimate of a 7.0% of GDP budget deficit for FY 2016/17 are to the downside given that it is predicated on an optimistic growth forecast (6.2%) and we are in an election year. At the same time, reduced agricultural exports, shilling strength against key export partners and higher oil prices are set to lead to a 6.5% of GDP current account shortfall this year.

Market Strategy: Kenyan equites underperformed FM by double digits over the past 12 months, with the P/E below its long-term average and at a discount to FM, compared to a premium a year ago. However, we expect lacklustre performance until the election is resolved and keep our *underweight*.

Europe

Romania

Neutral

Protests against the newly elected government erupted due to attempts to decriminalise corruption-related charges, but growth should remain healthy amid loose fiscal policy.

The largest protests in Romania's history erupted in Bucharest in February after the government passed an emergency decree that decriminalises several offences, a move seen by critics as an attempt to allow the release of officials incarcerated for corruption. The move has led to expressions of "deep concern" from international institutions such as the European Commission.

These political and social issues come less than two months after Romania's legislative election in December gave the Social Democrat Party (PSD) 46% of the vote in both the upper and lower houses, up from 34-36% in the 2012 election. The PSD formed a coalition with the Alliance of Liberals and Democrats in order to carry a majority in both houses. Having been returned to power just a year after a nightclub fire led to the collapse of the PSD government, the current administration was mindful of being toppled again. The pressure led the government to remove the decree. We view the government being held to account as a positive, particularly since other countries in the region are moving towards more populist and autocratic rule (e.g. Hungary, Poland, Bulgaria).

Prior to the election, the PSD had campaigned on a platform of fiscal easing, with many favourable policies mooted to entice the electorate. For example, a 16% rise in the minimum wage, further public sector salary increases (+10% in 2016) and a one percentage point cut in VAT to 18% in 2017 were proposed. There is a risk that the budget deficit (estimated at 2.9% of GDP in 2016) could rise above the 3% EU limit this year, though spending cuts in areas such as infrastructure could be made to avoid this. Fiscal stimulus is expected to support GDP growth of 4.5% in 2017, compared to an estimated 5.0% in 2016. Domestic demand is likely to be a key support, but net exports may act as a drag as EU growth slows and Romanian import demand remains strong.

Monetary policy has remained ultra loose, with the key policy rate at a historical low (1.75%) since May 2015, during which time there has been deflation (-0.5% yoy in December). In 2016, this was largely due to the VAT cut in January and once this drops out of the calculation, inflation is expected to return and accelerate closer to mid-point of the National Bank of Romania's (BNR) 2.5% +/- 1% target range. Although tightening is unlikely to commence before H2, it is likely to prove a growth headwind and a counterbalance to the fiscal expansion.

Market Strategy: After a strong 2016, valuations are not attractive, with the P/E above its long-term average, but supportive economic conditions should keep returns respectable, so we maintain a *neutral* weight.

Michael Hart & Lyndon Barreto, CFA, February 2017

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KEY ECONOMIC AND FINANCIAL INDICATORS *(All data shown are as at end-January 2017 unless otherwise stated)*

		Macroeconomic Data													Market Performance					Forecast
		% change on year ago				Latest 12 months														
	Frontier Market	Annual GDP Growth YoY	Quarterly GDP Growth QoQ*	Industrial Production Growth YoY	Consumer Price Index YoY	Trade Balance	Current Account	Foreign Reserves 2017 Latest	Foreign Reserves 2016 Year Ago	Currency vs $ 2017 Latest	Currency vs $ 2016 Year ago	Sovereign Rating S&P	Budget Balance % of GDP 2017F	Short-Term Interest Rates	% S&P Frontier 150 Index***	Stock Market Index (S&P Frontier 150 Index) US$	Change since 12/31/16 US$	Change since 12/31/16 Local	Trailing P/E	6 month Currency vs $ +/-
		%	%	%	%	$ Bns	$ Bns	$ Bns	$ Bns					%	Jan. 31, 2017	Jan. 31, 2017	%	%		
Over Weight	PAKISTAN	5.7	n.a.	2.3	3.7	-26.7	-3.6	0.0	0.0	104.76	104.95	B	-4.5	4.63	14.42	4938.98	1.22	1.64	11.8	+
Over Weight	MOROCCO	0.4	n.a.	0.8	1.8	-18.1	-8.7	23.7	20.7	9.97	9.88	BBB-	-3.0	3.34	8.66	1177.30	11.10	12.20	20.7	+
Over Weight	ARGENTINA	-3.8	-0.8	-2.3	14.3**	2.1	-15.7	46.6	25.4	15.90	13.93	B-	-5.5	18.59	14.46	2145.61	19.62	20.20	31.5	-
Over Weight	VIETNAM	6.2	n.a.	8.3	4.7	-4.8	6.4	37.2	30.6	22595.00	22375.00	BB-	-5.5	4.80	7.39	310.62	4.54	3.72	17.6	-
Over Weight	BANGLADESH	7.1	n.a.	2.5	5.0	-10.0	2.0	30.3	25.8	79.22	78.53	BB-	6.9	5.91	3.44	1702.45	7.06	8.28	23.7	-
Over Weight	PANAMA	4.8	n.a.	n.a.	1.5	-5.0	7.1	3.6	3.1	1.00	1.00	BBB	-3.6	2.18	2.57	5152.97	7.33	7.33	22.9	uc
Neutral	BAHRAIN	3.9	n.a.	n.a.	2.3	2.9	n.a.	2.7	3.1	0.38	0.38	BB-	-11.6	1.50	1.75	3612.26	26.31	26.29	9.3	uc
Neutral	BOTSWANA	4.5	-3.2	n.a.	3.0	0.6	1.6	7.7	9.0	0.10	0.09	A-	n.a.	1.77	0.27	887.00	-6.25	-6.25	9.1	-
Neutral	CAMBODIA	7.0	n.a.	n.a.	3.4	n.a.	169.7	8.3	6.6	4032.00	4047.15	n.a.	n.a.	1.45	0.71	848.14	-4.86	-6.36	n.a.	-
Neutral	COTE D'IVOIRE	9.2	n.a.	n.a.	1.3	n.a.	n.a.	0.0	0.0	614.51	609.01	BB-	-3.2	3.50	0.80	995.23	-1.91	-4.26	n.a.	-
Neutral	GEORGIA	2.4	n.a.	4.2	1.8	-7.7	-1.8	2.6	2.3	2.68	2.45	BB-	n.a.	n.a.	1.25	1143.84	3.19	16.11	19.9	-
Neutral	JORDAN	1.8	n.a.	-3.3	0.8	-13.6	-3.3	13.0	15.9	0.71	0.71	BB-	-3.1	1.75	3.05	832.98	0.25	0.32	12.2	-
Neutral	KAZAKHSTAN	0.4	n.a.	1.8	8.5	11.0	-6.8	19.4	19.8	325.02	360.10	BBB-	-1.8	15.00	3.73	113.79	25.43	21.55	7.0	-
Neutral	MAURITIUS	4.0	n.a.	n.a.	2.3	-1.2	-3.7	4.3	3.8	35.53	36.08	n.a.	n.a.	4.80	1.26	2369.14	4.50	3.26	7.8	-
Neutral	OMAN	1.8	n.a.	-1.2	1.1	3.2	4.1	21.3	16.9	0.39	0.39	BBB-	-11.8	0.95	2.29	2509.60	-3.59	-3.59	8.4	uc
Neutral	ROMANIA	4.3	2.4	1.5	-0.5	-7.6	-22.2	34.8	35.2	4.20	4.15	BBB-	-3.4	0.45	3.32	946.86	5.07	1.64	15.9	-
Neutral	SLOVENIA	2.7	4.0	7.4	0.5	1.2	2.9	0.2	0.3	1.08	1.09	A	-2.0	0.29	1.14	893.92	0.72	-1.70	11.3	-
Neutral	SRI LANKA	4.1	n.a.	-3.4	5.5	-7.8	n.a.	4.3	6.6	150.45	144.08	B+	-5.0	10.46	1.27	2973.92	-2.78	-2.33	11.1	-
Under Weight	KUWAIT	1.8	n.a.	n.a.	3.5	13.3	5.9	30.0	26.2	0.30	0.30	AA	-6.9	+1.3	17.10	1506.44	13.06	12.82	14.9	-
Under Weight	KENYA	5.7	7.2	n.a.	7.0	-8.7	-3.5	7.9	7.1	103.80	102.40	B+	-6.6	6.94	3.28	2486.11	-10.91	-9.76	9.4	-
Under Weight	NIGERIA	-2.2	36.0	n.a.	18.6	-2.9	-1.4	28.1	28.2	304.75	199.05	B	-2.7	10.23	7.00	796.53	1.62	-1.43	9.7	-
Under Weight	UKRAINE	2.0	2.0	4.5	12.4	-0.5	-1.4	11.9	12.4	26.97	25.55	B-	-3.1	9.92	0.82	597.80	30.43	30.38	3.8	-

*Note: S&P credit rating shown is long-term foreign currency rating. * % change in GDP on previous quarter, annual rate. **Month-on-month figure. Unofficial estimates suggest annual inflation is 40-50%.*

****MSCI FM 15% Country Capped Net TR Index. Data are the latest available, but in certain cases relate to periods more than one year ago.*

Source: Bloomberg, City of London Investment Management

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