CITY OF LONDON
Investment Management Company Limited

Emerging Markets Quarterly Outlook

July 2018*

Overview

Trade Conflict Looms Large for EM

Investors continue to carve out a new narrative for markets in the year ahead. While this shift remains more cyclical than structural for now, it features a few permanent elements. Where democracy reigns freely, the push towards an anti-establishment vote remains strong, be it in Italy or, most recently, in Mexico. Where elections are more managed, local strongmen are entrenching themselves further as is happening in China, Russia and Turkey.

The extraction from the liberal post-war world order has also found its expression in the withdrawal from the Iran nuclear deal (JCPOA) by the US and the escalating trade conflict. Indeed, with an administration mostly shorn of free trade advocates, the US has begun to engineer a 'reverse globalisation'. Unless the rest of the world is able to create an independent institutional arrangement, this threatens to cause a dramatic reduction in world trade (which is at a record high, despite sluggish growth).

In addition to the earlier steel and aluminium tariffs imposed universally, the US has so far applied a 25% tariff on $50 bn of imports from China ($34 bn of which are effective July 6) and threatened to apply a 10% tariff on a further $200 bn. It also threatened to impose 20-25% tariffs on $360 bn of auto imports (from China and the EU) and toyed with the idea of quitting the WTO.

The direct effects of these measures may be limited as many observers have pointed out, given the small size of the affected base relative to each economy. Estimates of the first order effects range from a drag on global growth of a mere 25bps in the mildest scenario to 1.5% in more severe scenarios. Once tit-for-tat retaliatory measures are taken into account, such estimates rise to a 3% drag on global growth. But the wider repercussions go further and none of them are positive. When faced with tariffs, exporters can react in one of three ways: raise prices and risk a decline in export volumes, reduce margins to absorb tariffs and remain competitive, or relocate production/redirect exports elsewhere and circumvent them. Raising prices could boost inflation in the importing country, especially when intermediary goods used in many sectors are affected. In turn, this would force the central bank, the Fed in particular, to raise interest rates, which would come at an awkward time. Higher rates and a shrinking trade deficit would probably drive the dollar up, further complicating the external environment for emerging markets (EM). But the policy reaction and the ensuing financial tightening are themselves only part of the consequences. More important will be the disruption wrought to global supply chains - not only in some highly integrated IT sectors in Asia, but also in the automotive and other sectors in the US – accompanied by the attendant job losses. Given the offshoring, component sharing and globalisation that have taken place over the past decades, such a development would be highly destabilising for all world economies. The imposition of non-tariff barriers such as quotas or restrictive specifications could further amplify these effects in a stealthier manner. Such policies are also highly symbolic and carry an important political signal, while affecting both business and consumer sentiment negatively.

Finally, the trend in interest rates is part policy normalisation, part cyclical and part structural. On the one hand, the Fed is keen to prepare for the advent of the next recession by restoring rates to neutral. It recently moved its 2018 median expectation from three to four hikes and anticipates tightening beyond the estimated neutral rate of 2.8-3.0%. On the other hand, inflation could rise in the face of lower unemployment (despite little evidence so far), higher fiscal deficits and the adverse effects of protectionist policies. Finally, the structural decline in long-term yields could reverse as the Fed's foresight is questioned under increasingly challenging conditions and external pressure.

Market Strategy

The cocktail of adverse developments in local politics, international trade and US rates does not bode well for emerging markets. Nor does it support a level of global risk appetite consistent with strong EM flows. Together with the significant depreciation in EM currencies in Q2, this will also put pressure on EM central banks to tighten their monetary policy stance.

On the other hand, despite such doubtless negative factors, EMs have benefited from a robust level of developed market demand recently, most notably the strong activity readings in the US. This puts the asset class at the intersection of two opposing forces, a fact that will likely cushion any correction. However, it also suggests that when the temporary boost to US activity fades, the adjustment in EM could become more marked. Our country allocation is broadly geared towards a less benign environment for risk assets, but recent changes also reflect idiosyncratic country factors:

- **Brazil**: We move Brazil to *underweight* as local discontent with the political establishment raises the risk of a radical candidate winning the October election, which would further impede much-needed reforms;
- **South Africa**: We reduce South Africa to *neutral* given plans for a controversial land reform, slowing growth, a widening external deficit and rand volatility;
- **Indonesia**: We shift Indonesia to *neutral* due to a widening external shortfall, exposure to commodities and sharp monetary tightening;
- **Malaysia**: We downgrade Malaysia to *neutral* on the back of higher fiscal risks due to the removal of the Goods and Services Tax (GST) and the re-imposition of fuel subsidies.

**The publication reflects asset performance up to June 29, 2018, and macro events and data releases up to July 6, 2018, unless indicated otherwise.*

Asia

China

Underweight

The PBoC is providing liquidity support as the economy faces a credit and investment slowdown, as well as rising trade tensions with the US.

Chinese GDP grew by 6.8% yoy in Q1 2018, which was better than expected and supported by both domestic and external demand. However, we have seen more headwinds for Q2. While external demand remained resilient in May, with goods exports up by 12.6% yoy and freight volume accelerating to 8.5% yoy, there has been renewed weakness in domestic demand. Industrial production moderated to 6.8% yoy in May (versus 7.0% in April). Fixed investments slowed significantly to 3.9% yoy (vs. 6.1% in April) as the slowdown in infrastructure investments more than offset the recovery in real estate investments. Private consumption has also shown signs of weakness as retail sales and passenger vehicle sales slowed to 8.5% yoy (vs. 9.5% in April) and 7.9% (vs. 11.2%), respectively. The Caixin manufacturing PMI also edged down slightly in June, though it remained in expansionary territory (above 50).

Credit growth continues to slow, even though policymakers have marginally pared back the pace of financial regulation. Broad credit growth, as measured by aggregate financing to the real economy adjusted for equity issuance and local government bond swaps, decelerated to 11.6% yoy in May, the lowest since 2006. Real estate financing is crowding out the financing of infrastructure investments and manufacturing, as real estate activities have been more resilient than other more productive sectors against the backdrop of a credit slowdown, weaker economic growth and widening corporate credit spreads. This does not bode well for productivity growth in the future.

CPI inflation remained well contained at 1.8% yoy in May, comfortably below the People's Bank of China's (PBoC) target of 3%, giving the central bank some leeway for its monetary policy despite the Fed's hiking cycle and the strong US dollar. Meanwhile, the producer price index accelerated to 4.1% yoy in May from the March trough of 3.1% on the back of rising commodity prices as well as the supply-side reform last year that reduced the production capacity of non-state entities. Strong PPI inflation supports the profit growth of (mostly state-owned) upstream industries such as mining and energy, while downstream industries are facing rising cost pressure.

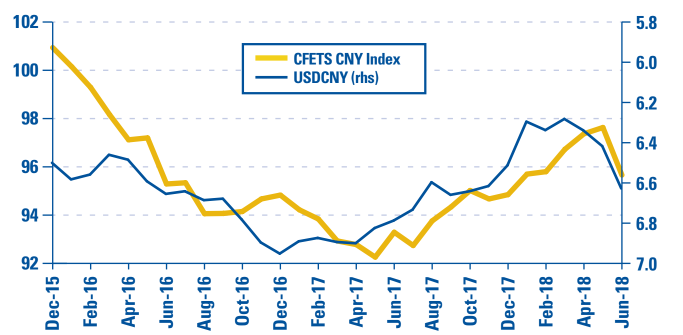
Trade tensions between China and the US rose in Q2, weighing on investor sentiment towards Chinese assets. The US administration approved the final list of $50 bn worth of Chinese goods subject to an extra 25% tariff, of which $34 bn became effective on July 6th and the rest will become effective in late July. China immediately retaliated by announcing the same amount of tariffs on $50 bn worth of US goods. China also indicated that what was agreed upon previously during the Sino-US trade negotiations in May, e.g. increasing Chinese imports of US agricultural goods, will be invalidated once the US actually implements the 25% tariff. The rhetoric has since become more aggressive, with President Trump indicating a potential 10% tariff on an additional $200 bn worth of Chinese goods and possible restrictions on Chinese investments in the US. Trade tensions so far this year show that what was implemented has been smaller than what Trump had initially threatened. The extra tariff on the $50 bn worth of Chinese goods per se is unlikely to have a substantial impact on overall Chinese economic growth. However, it is by no means clear that trade tensions between the two countries are going to end soon, given the still significant gap between what the US demands and what China offers.

Trade tensions and slowing domestic demand have led to a significant shift in the PBoC's policy stance given that the former may weigh on the export sector, which has remained resilient so far. The State Council, which the central bank reports to, changed its liquidity goal to "reasonably ample" from "reasonably stable" in June. The central bank quickly followed by cutting the required reserves ratio (RRR) of major Chinese banks by 50bps, releasing CNY700 bn ($105 bn) of liquidity into the financial system. Consensus expects another two RRR cuts for the rest of the year.

The Chinese yuan depreciated versus the US dollar and the currencies of its major trading partners in June following the central bank's move to an easing bias. While the yuan depreciation against the US dollar (-5.5% in Q2) looks steep, we have not observed significant distress in the currency market. For instance, the spread between the onshore USDCNY and offshore USDCNH remains less than 1bp, compared to more than 11bps in the aftermath of the yuan devaluation in 2015. The Chinese sovereign CDS has risen in June, but is still less than half the level in 2015.

Market Strategy: MSCI China lost 3.5% in USD terms in Q2, outperforming EM equities by 4.5% points. Weaker domestic demand and rising trade tensions have weighed on Chinese equities and the yuan. We expect neither of them to reverse significantly in the near term. The P/E ratio of the MSCI China trades at 13% premium to that of MSCI EM, compared to the five-year average of 14% discount. Therefore, we remain *underweight* Chinese equities. Chinese A shares, which have a P/E at a 5% premium to EM compared to a long-term average of 20%, look to be a better value than other Chinese equities.

Chart 1: Trade-Weighted CNY and USDCNY



Source: China Foreign Exchange Trade System

South Korea

Overweight

The Bank of Korea may increase its policy rate in H2 2018 on the back of gradually rising inflation.

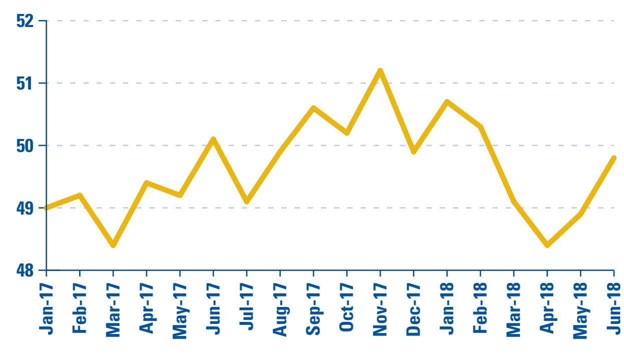
Korean GDP grew by 1.0% qoq seasonally-adjusted in Q1 2018, versus -0.2% in Q4. The expansion was driven by accelerating government spending, private investment and exports. A rebound in tourism from China was also supportive. Yet, domestic demand may moderate back to trend for the rest of the year. First, private investment is likely to slow on the back of decelerating manufacturing and construction activities. Equipment investment fell 3.2% mom in May, the third consecutive monthly decline, while construction investment also contracted. Second, private consumption may have decelerated in Q2 on the back of slower employment growth. Indeed, consumer goods sales growth decelerated to 4.6% yoy in May from 5.5% in April, dragged down by a contraction in automobile sales. In contrast, there are signs of recovery in external demand following temporary setbacks in early Q2. Exports (excluding the volatile ship building sector) accelerated to 13.8% yoy in June. Also, the June manufacturing PMI rose to 49.8 from the trough of 48.4 in April. Export orders rose to 52.1, the highest level since October 2013. The Bank of Korea's business survey and the Federation of Korea Industry's survey also points to a stronger outlook for the export sector. Consensus expects 0.7% qoq growth in Q2 (vs. 1% in Q1) and 2.9% growth for the year 2018 (vs. 3.1% in 2017).

The Bank of Korea maintained its policy rate of 1.5% at its May meeting, unchanged since November 2017 and in line with consensus. Since then, however, cost pressures have been building. Import prices rose 2.7% mom in May following a 1.0% rise in April, on the back of rising energy prices. The producer price index continued its upward trend since the beginning of the year, rising by 2.2% yoy in May, a full percentage point above the January outturn. While headline CPI inflation was at 1.5% yoy in June – still below the 2% target – supply-side pressures may push up consumer prices in H2 2018. Indeed, consensus expects headline inflation to converge to the 2% target towards the end of the year and this could prompt the central bank to hike the policy rate in Q4.

Political and geopolitical events have affected Korea and its asset markets so far this year. Leaders from the US and North Korea held an unprecedented summit in Singapore in June, 65 years after the ceasefire that ended the Korean War. The Korean won had been resilient versus the US dollar leading up to the summit, but has depreciated since then. While the US and North Korea signed a joint in principle statement in favour of North Korea denuclearisation, the "complete, verifiable, irreversible" terms initially demanded by the US – as well as the implementation details for denuclearisation - were left out. Hence, the sanctions on North Korea are likely to stay in place, with uncertainties remaining around the path towards denuclearisation. That said, the summit – and more broadly the de-escalation of US-North Korea tensions – has had a notable impact on South Korean politics. President Moon Jae-in's approval rate reached 83% in May following the summit talks between the South and North Korean leaders, the highest since he took office a year ago. On the back of the President's popularity, the ruling Minjoo party achieved victory in the June local and by-elections and increased its presence in the National Assembly. The party won a record of 14 out of 17 major metropolitan and provincial government elections. It won 11 seats in the by-elections, increasing its parliamentary share from 41% to 43%. The election victory by the ruling party increases the chance of additional fiscal stimulus, such as increases in social security payments, which in turn may support private consumption.

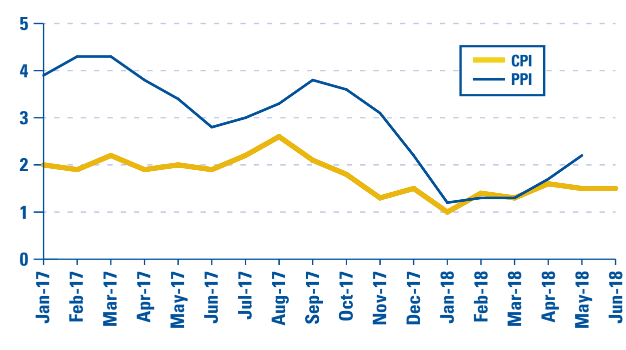
Market Strategy: South Korean equities lost 9.2% in USD terms in Q2, underperforming EM equities by 1.2% points. The Korean P/E ratio trades at a 30% discount to the MSCI EM P/E, compared to a historical average of a 16% discount. We remain *overweight* Korean equities for several reasons. First, monetary conditions remain quite accommodative as government bond yields remain near historical lows and the tightening path looks gradual. Second, rising Chinese tourist numbers and an improved relationship between the two countries are set to support earnings in the consumer sector (e.g. auto and cosmetics). Third, we see signs of export recovery after temporary setbacks in early Q2. Fourth, equity valuations remains cheap despite the IT-led rally last year. Risks to our call include rising trade tensions between the US and the rest of the world, which may affect open economies such as South Korea. Also, the IT sector's earnings may decelerate this year as memory prices have resumed their fall after a sharp rise in 2017.

Chart 2: South Korea Manufacturing PMI



Source: Markit

Chart 3: South Korea Inflation, % yoy



Source: Bank of Korea

Taiwan

Neutral

Growth is set to ease to trend in H2 due to moderating global trade growth.

Taiwanese GDP growth slowed from 3.3% yoy in Q4 to 3.0% yoy in Q1. While domestic demand remained strong, net exports were a drag on growth: imports accelerated to 5.6% yoy in Q1 (vs. 1.8% in Q4), while exports were unchanged at 6.0% yoy. There have been mixed signals on economic momentum in Q2, but on balance growth may not decelerate as fast as expected. On the one hand, the manufacturing PMI continued its downward trend this year, reaching 53.4 in May, the lowest since October 2017, before edging up slightly to 53.5 in June. On the other hand, export orders recovered in May, reaching 11.7% growth yoy (or 4.7% mom), after a soft patch in Q1. Tech export orders also accelerated in Q2, growing by 7% yoy in May and 4% in April, versus an outright contraction in Q1. Industrial production also surprised to the upside, growing by 7.1% yoy in May and 8.8% in April. Consensus expects 3.1% yoy growth in Q2 and 2.7% for full-year 2018, as decelerating global trade growth is set to weigh on the open economy in H2.

The Taiwanese central bank maintained its policy rate at 1.375% in June, unchanged since June 2016. The economy is decelerating, though still running above trend. As the Fed gradually raises the Fed Funds rate this year, the interest rate gap between the US and Taiwan is set to widen, weighing on the Taiwanese dollar. However, the currency remains quite resilient on the back of a strong trade surplus and vast FX reserves. Therefore, the recent USD strength is likely to have limited impact on Taiwanese inflation. Indeed, both the headline and core CPI inflation remained moderate at 1.3% yoy in June. The central bank expects average headline and core inflation to be on average 1.4% and 1.2%, respectively, this year.

Sino-US trade tensions are another uncertainty facing Taiwan, in addition to the trajectory for US interest rates and the US dollar. Taiwan is significantly involved in the tech supply chain led by China. Indeed, the Taiwanese value added in China's exports to the US amounts to 1.8% of Taiwanese GDP, the highest ratio among all EM economies.

Market Strategy: Taiwanese equities lost 6.3% in USD terms in Q2 2018, outperforming EM equities by 1.6% points. Taiwan's P/E ratio is similar to that of EM, compared to a historical average of a 10% premium. On the one hand, Taiwanese assets seem relatively resilient to US dollar strength, and tech export orders are recovering. On the other hand, decelerating global trade growth and rising trade tensions between China and the US are set to weigh on Taiwanese equities and thus we remain *neutral*.

Malaysia

Neutral (↓)

While the new government might bring positive changes in the long term, we see headwinds to the near term growth and fiscal outlook.

The opposition Pakatan Harapan (Alliance of Hope), led by former Prime Minister Mahathir Mohamad, delivered a surprise victory and won a parliamentary majority in the May 2018 general election, beating the Barisan Nasional that had led the government since Malaysia's independence in 1957. While the new government may have a positive impact in the long term, for instance by reducing red tape and corruption, the economy faces uncertainties in the short term. First, the removal of the GST and the re-imposition of fuel subsidies may help contain inflation - which is already near a historic low – and support private consumption. However, it increases fiscal risks (the GST brought in tax revenues worth 3% of GDP last year) and in turn increases the public and corporate borrowing costs. Second, the new government has just suspended a handful of Chinese-backed projects in railways and oil pipelines, which are worth $23 bn in total, or 7% of Malaysian GDP. This may weigh on capex spending and near-term economic growth.

The Malaysian economy experienced a broad-based deceleration across both the private and public sector in Q1, with GDP growth recorded at 5.4% yoy, compared to 5.9% in Q4. The biggest downward shifts came from private investment and government spending, whereas private consumption was resilient due to low inflation. A few economic measures have deteriorated moderately in Q2. First, manufacturing PMIs were in contractionary territory (below 50), dragged down by new orders and output, signalling a sluggish manufacturing sector. Second, slowing global trade growth and a strong US dollar have started to weigh on the external balances of the economy. The trade balance declined from MYR14.7 bn in March to MYR8.1 bn in May. FX reserves fell from $110 bn in April to $105 bn in June despite a trade surplus, signalling capital outflows. Consensus expects the GDP growth to slow to 5.5% in 2018, compared to 5.9% in 2017.

Headline CPI inflation came in at 1.8% yoy in May, and core inflation remained unchanged at 1.5%. While the central bank does not have a formal inflation target, both inflation measures are near historical lows. Consensus expects no change in the policy rate of 3.25% for the rest of 2018.

Market Strategy: Malaysian equities lost 11.4% in Q2 2018, underperforming EM equities by 3.5% points. The P/E ratio trades at an 18% premium over that of EM, compared to a long-term average of 26%. The surprise election result brings new uncertainties to the fiscal and economic outlook, and hence we reduce our exposure from *overweight* to *neutral*.

Indonesia

Neutral (↓)

Growth remains healthy and policymakers are vigilant as financial stability is a key priority.

GDP growth in Indonesia in Q1 was resilient at 5.1% yoy, compared to 5.2% in Q4, and was largely driven by strong investment growth. Capex has continued to expand, independently of credit provision. Investment growth accelerated from 4.8% yoy in Q1 2017 to 8.0% in Q1 2018, while commercial credit growth decelerated from 8.7% yoy to 8.2% over the period. This is likely to support a moderate acceleration in GDP growth this year to 5.3%, compared to 5.1% in 2017.

Household consumption will likely benefit from a 69% yoy rise in government bonuses to civil servants. In order to fund this, the government may reduce capex, while a higher oil price will also likely raise government revenues. Overall, the 2018 budget deficit is projected to remain similar to 2017, at around 2.6% of GDP.

Inflation has remained broadly stable, with headline CPI in a range of 3.2-3.4% yoy so far this year, close to the central point of Bank Indonesia's (BI) 2.5-4.5% target range for 2018. However, the central bank grew concerned over financial stability after a near 7% fall in the rupiah from January to May despite its intervention in the FX market. BI commenced the tightening cycle at its scheduled May meeting by raising its key rate by 25bps. New BI Governor Perry Warjiyo subsequently announced an emergency meeting, at which the Bank raised its key rate by a further 25bps to 4.75%. In June, Warjiyo stated that the Bank's focus was "economic stability, primarily the stability of rupiah exchange rate". Further rate rises are expected in H2, which is likely to keep pace with that of the Fed at the very least. Monetary policy is also likely to focus on macroprudential measures in order to ensure financial stability.

Increased oil prices (60% yoy) and robust import demand are set to widen the current account deficit to 2.1% of GDP this year compared to 1.7% in 2017, despite a weaker rupiah. Hence, it is imperative to prevent excessive outflows in order to maintain financial stability, a key goal for both BI and the government.

Market Strategy: The MSCI Indonesia underperformed EM by 4.7% points in Q2. The P/E is now just at an 18% premium compared to a five-year average of 28%. However, a rising external deficit, a high exposure to commodities and sharp monetary tightening lead us to downgrade Indonesia to *neutral*.

Philippines

Neutral

Economic growth is set to remain healthy, but widening twin deficits are likely to put downward pressure on the peso.

Philippine GDP expanded at a healthy 6.8% yoy pace in Q1, up from 6.5% in Q4, but below the government's target range of 7-8%. The key drivers were government consumption (13.6% yoy) and investment (12.5%), while export growth (6.2% yoy) lagged imports (9.3%). Market consensus is for 2018 growth to match that of 2017 at 6.7% yoy, driven by domestic demand.

Private consumption was a laggard in Q1 (5.6% yoy) and this is likely due to accelerating inflation, with consumer prices up by 4.6% yoy in May compared to 2.9% a year earlier. This is above the 2-4% target range of the central bank (BSP) and was driven higher by food and transport costs. Core inflation has also accelerated by over 2% points over the past 12 months to 5.2% yoy in June. BSP has thus tightened monetary policy, raising its reverse repo rate by 25bps to 3.5% at its June meeting (having started the tightening cycle in May with the same rise). More hikes are likely in H2 as the monetary authorities are concerned over inflationary pressures building given rising inflation expectations and minimum wage increases.

In contrast, fiscal policy is set to remain expansionary, with the budget deficit projected to widen from 2.2% of GDP in 2017 to 2.8% in 2018. A longer-term positive is that a higher proportion of expenditure is being put towards capex (30% compared to an average of 20% for 2011-17). However, government financing needs have risen and domestic liquidity conditions have tightened as a result, so the BSP has reduced the reserve requirement ratio and is expected to ease further. The increase in public debt would reverse the post-crisis trend of reduction and may raise financial stability risks.

The current account is expected to post a deficit of 1.0% of GDP this year, up from 0.7% in 2017. This is likely to be driven by a widening trade deficit due to rising capital goods imports associated with government spending and a broad-based contraction in exports. External accounts may be supported by remittances (+12.7% yoy in April) given the 7% fall in the peso against the US dollar so far this year.

Market Strategy: The MSCI Philippines underperformed EM by 4% points in Q2. This has taken some froth out of the market and the P/E is now at a 39% premium to EM compared to a long-term average of 57%. Net positioning by EM investors shows the largest underweight since 2011. However, twin deficits are a headwind for the peso and therefore US dollar returns, so we stay *neutral*.

Thailand

Overweight

Growth is expected to accelerate and inflation to rise, while external accounts remain robust.

Economic growth in Thailand remains strong, with Q1 GDP expanding by 4.8% yoy, from 4.0% in Q4. The expansion was broad-based and driven by both external and domestic demand. The latter had lagged in H2 2017 as agricultural incomes were suppressed by low soft commodity prices, so the rise in prices this year should support primary sector income and consumption. These trends are expected to drive an acceleration in GDP growth to 4.2% in 2018, which would be the strongest outturn since the 2012 post-floods rebound.

Inflation has been rising recently, moving to 1.5% yoy in May compared to zero a year earlier and 0.4% as recently as February. The disinflationary impact of food prices has begun to dissipate as supply has fallen. Price rises have also started to broaden and accelerating domestic demand is likely to raise inflationary pressures. Core inflation has accelerated modestly to 0.8% yoy in May, up 0.3% points from a year ago. The central bank attributed the rise to a "build-up in demand-pull" inflation. Headline inflation is expected to remain manageable, with consensus projecting a 1.3% rise in 2018 and 1.5% in 2019 compared to the central bank's 1-4% target range.

Rising price pressures alone are unlikely to change the Bank's neutral monetary policy stance. Instead, the Bank of Thailand is more likely to move towards a tightening bias in H2 if financial stability concerns rise. Some members of the monetary policy committee suggested at the April meeting that "the policy interest rate would partly help prevent these risks from further developing and broadly affecting financial stability". One member voted to raise rates at the June meeting, when the key rate was left unchanged at 1.5%.

However, Thailand has robust external accounts, unlike some other EMs. The current account surplus is expected to remain around 10% of GDP this year. Higher oil prices are a downside risk, but will likely be outweighed by strong revenues from tourism. This and substantial FX reserves (~9 months of imports) should support the baht in H2.

Market Strategy: MSCI Thailand's 7.0% point underperformance versus EM in Q2 more than wiped out the outperformance of Q1. The market's P/E now trades at a 12% premium to EM, compared to a five-year average of 18%. Although the election has been pushed back again to May 2019, the outcome is unlikely to change policies significantly as the military is set to remain in control and keep infrastructure spending plans in place. This backdrop, combined with strong fundamentals, prompts us to remain *overweight*.

India

Overweight

Growth has accelerated, but rising inflation and widening deficits suggest further tightening in H2.

Gross Value Added (GVA) growth in India has continued on an upward trajectory, accelerating to a seven-quarter high of 7.6% in Q1 from 6.0% a year earlier. Investment and public sector activity were key drivers, rising by 14.4% yoy and 13.3%, respectively. Net exports were a drag as export growth slowed and import expansion remained strong. Consensus expects a rebound in growth for fiscal year 2018/19 (year to end-March 2019, FY19) to 7.3% compared to 6.6% in FY18, supported by rising activity in rural areas due to rising income given increased subsidies.

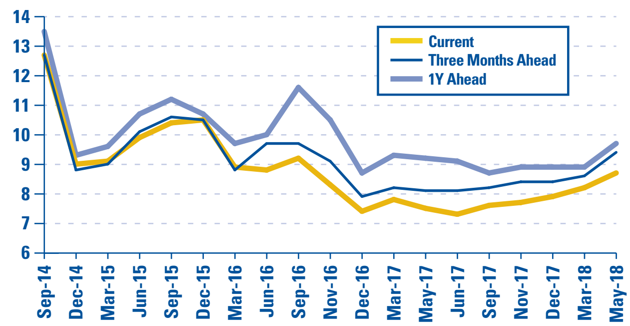
However, growth momentum is questionable. The Q1 outturn was aided by favourable base effects as the impact of demonetisation weighing on Q1 2017 activity faded. This was also the case for the subsequent quarter, so Q2 growth this year should benefit too. Therefore, a key test of underlying growth will be in H2 when these base effects fade. Manufacturing and services PMIs have fallen this year, with the former in contractionary territory in May. Finally, it is uncertain whether the government will sustain its investment drive, while private sector involvement has been minimal.

Inflation has similarly been impacted by the low comparison base in H1 2017. Headline and core CPI rose by 4.9% yoy and 5.4% in May respectively, compared to 2.2% and 3.8% a year earlier. Inflationary pressures are both demand-led by strong growth as well as cost-push due to rising input costs (e.g. higher oil price). Inflation expectations have also risen significantly (see Chart 4) since growth bottomed in Q2 2017. The Reserve Bank of India (RBI) survey of households in May showed inflation one-year ahead is expected at 9.9%, up from 8.6% forecast in March.

This backdrop prompted the RBI to raise the repo rate by 25bps to 6.25% at its June meeting. It also raised its inflation forecasts and stated that it was committed to "achieving the medium-term target for headline inflation of 4% on a durable basis". Minutes from the June meeting showed that the RBI is concerned over rising core inflation, with the government's minimum support price policy for agricultural producers cited as a key upside risk. The Bank is thus likely to hike at least once more in H2.

Meanwhile, rising oil prices have widened the trade deficit. Since the oil price bottomed in 2016, the 12-month shortfall has widened from 4% of GDP to 6%. This trend is expected to continue and is projected to widen the current account deficit from 1.9% of GDP in FY18 to 2.5% in FY19. Although this is low compared to that during the taper tantrum (4.8%), the current account surplus excluding oil and gold has declined from 4.6% of GDP in H2 2014 to 2.2% in H2 2017.

Chart 4: Median Household Inflation Expectations, % yoy



Source: RBI

Concerns over fiscal slippage are also likely to rise. Revenues are a concern as collection from the Goods and Services Tax are running 16% below government projections. The government's divestment programme has been lacklustre, with the failure to receive any offers for a 76% stake in Air India partly indicative of investor mistrust in the government's ability to step back from involvement in state companies. Expenditure faces upside risks, particularly given the general election in 2019 and the falling popularity of the ruling National Democratic Alliance (NDA), the coalition led by Prime Minister Narendra Modi's Bharatiya Janata Party. A poll in May showed that the NDA would get 274 seats of 545 in the lower house, down from 314 currently and only a two-seat majority. The 3.4% of GDP budget deficit projected for FY19 could thus rise closer to 4.0%.

Widening twin deficits mean the rupee is likely to remain under pressure in H2. The currency fell by 7.2% against the US dollar and 5.2% on a real effective basis in H1. This poses a risk to financial stability and may require action from the central bank. However, India's position compared to the 2013 'taper tantrum' is much better. Inflation was much higher then (close to 10%) and the RBI did not have an official inflation target. The changes compared to 2018 mean the pressure on the currency is likely to be less pronounced (the rupee depreciated by 27.9% against the US dollar during the taper tantrum).

Market Strategy: The MSCI India outperformed EM by 7.4% points in Q2, despite the rupee falling by 5.1% versus the dollar over the period. The trailing P/E is at a 60% premium to EM compared to a five-year average of 49%. Yet, the improvement in fundamentals since the 2013 taper tantrum and the limited exposure to US trade sanctions mean that India is less exposed to the adverse factors affecting emerging markets. We retain our *overweight* allocation for now.

Latin America

Brazil

Underweight (↓)

The uncertain election outlook, a pent-up need for reform and the adverse impact of the recent strikes come at the wrong time for the Brazilian economy.

Brazil remains in the thrall of the upcoming presidential elections in October. With none of the main party candidates scoring high in the polls, chances for the victory of a radical candidate remain high. Former President Lula started his 12-year jail sentence in April, but submitted yet another appeal request to the Supreme Court in June. This was to be ruled on by the Second Panel (three judges) on June 26, but the judges referred the appeal to the full court, which is in recess until August. Lula remains the most popular candidate with 30% of voter support, but time is running out for him as the registration process for candidates closes on August 15. It remains unlikely that Lula would be freed or that he would be allowed on the ballot.

The latest poll (Ibope) suggests that in a scenario without Lula, Jair Bolsonaro leads with 17%, followed by Marina Silva with 13%, Ciro Gomes with 8%, Geraldo Alckmin (6%), and PT candidate Fernando Haddad (2%). But the most important category remains that of the undecided, which constitute 33%. This likely reflects continued support for and uncertainty over the fate of Lula amongst the electorate. It is likely to diminish once Lula declares his support for a candidate, which could see the transfer of 12-15% points of his support base. Aside from the still unlikely success of Geraldo Alckmin, a presidency of the former Green Party leader (now REDE) Marina Silva would represent the most market-friendly outcome amongst the remaining candidates.

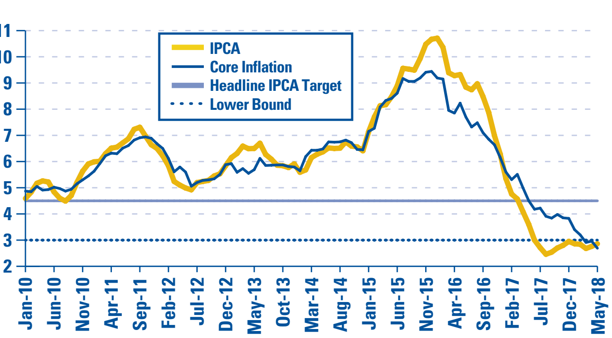
GDP expanded by 1.2% in Q1, down from 2.1% yoy in Q4. However, economic growth accelerated on a sequential basis, from 0.2% qoq in Q4 to 0.4%. It marked the fifth consecutive quarter of expansion and was led by private consumption growth. Retail sales growth has remained strong since and industrial production bounced back to 8.9% yoy in April after languishing for some months. However, since then both the external environment and domestic conditions have deteriorated. Tightening global financial conditions (rising rates, weakening equity markets and a stronger dollar) affected Brazil disproportionately given its enormous fiscal challenges. Domestically, a popular strike by truckers who demanded lower diesel prices led to fuel and food shortages in parts of the country. The government and Congress belatedly responded with tax cuts, fuel subsidies, toll reductions and market protection for independent truckers. The total cost of these measures is estimated at around BRL 13.5 bn (0.2% of GDP). The central bank has slashed its growth forecast for this year from 2.6% to 1.6% as a result of the strikes.

More important than the fiscal impact is the signal this sent about the reform process: that it had essentially ended, after Congress had already failed to pass the much-needed pension reform. As a result, markets took a dim view of the outlook and the real depreciated by 15% in Q2. The central bank intervened in the currency market, ramping up its FX swaps by $10 bn to $42 bn in total. It offered an additional $25 bn for one week and another $10 bn the next, but left the total stock still significantly short of the historical high of $115 bn in 2015. The central bank also emphasised that it would not resort to rate hikes to respond to currency weakness, only insofar as second round effects on inflation expectations would become evident.

The strike and the supply disruptions may yet push up prices, but the impact was limited in May, with the IPCA recording a 2.9% yoy gain, in line with the 2.7% and 2.8% yoy recorded in March and April respectively. On the whole, inflation remains benign, with underlying inflation at historically low levels. In its Q2 Inflation Report, the BCB forecast inflation at 4.2% yoy in Q4 2018 and at 4.1% yoy in the same quarter for the next two years (assuming a constant FX rate of 3.70 and a SELIC rate of 6.5%). This remains well within the inflation target of 4.5% for this year and of 4.25% for 2019. If this scenario materialises, BCB is indeed likely to keep the SELIC rate at 6.5% well into 2019 (having left it unchanged in June). COPOM members recently reiterated that the economy "prescribed accommodative monetary policy." Any earlier tightening would require a rise in inflation expectations due to the impact of the trucker strikes or additional currency weakness.

While markets are jittery about Brazil, its external accounts remain solid. The current account deficit has recorded less than 0.5% of GDP year-to-date and will likely be helped further by the weaker currency. It is expected to end the year at less than 1% of GDP. Meanwhile, investment flows remain strong, with FDI running at a rate of 2.5% of GDP. Foreign reserves remain a solid $382 bn, equivalent to 27 months of imports.

Chart 5: Brazil Inflation, % yoy



Source: IBGE, BCB, Bloomberg

Market Strategy: After a strong Q1, the Brazilian market underperformed the MSCI EM by 18.4% points in Q2 as an uncertain election outlook combined with diminished reform prospects. As the 87% support for the strike showed, public disenchantment is high, raising the risk of a radical victory at the election and further undermining reform prospects. We thus move our allocation to *underweight*.

Mexico

Overweight

AMLO's landslide victory implies higher fiscal risks, but the outcome of the NAFTA renegotiation is not necessarily worse under his presidency.

The presidential election in July gave Andrés Manuel López Obrador (AMLO) a landslide victory, winning support with his promise to reduce corruption and drug-related violence. AMLO's victory - winning 53% of the popular vote - was expected given his 20-point lead in pre-election polls. The strong showing of the National Regeneration Movement, or Morena, in the Congressional election and the nine gubernatorial elections was more surprising. Morena and its coalition partners are set to gain a simple majority in both the Chamber of Deputies (Lower House) and the Senate (Upper House) and have won at least five out of the nine gubernatorial races this year. Hence, AMLO is set to become the first president since Ernesto Zedillo in 1994 to control both chambers of Congress.

AMLO is likely to face limited constraints by Congress, particularly when it comes to fiscal and industrial policies. That said, the constitutional reforms that were passed under his predecessor Peña Nieto are likely to remain in place as Morena has not reached a two-thirds majority in the Congress. In addition, AMLO may not be an outright populist and could defy the market as he and Morena have an eye on other gubernatorial elections over the coming years.

Nevertheless, an AMLO presidency could undertake notable changes in fiscal and industrial policies for the energy sector. First, he may increase spending on social welfare, wages and education. It is still unclear how the planned increase in fiscal spending will be financed, which suggests higher fiscal risks. However, the higher fiscal deficit is only likely to appear in the 2020 budget, as 90% of the 2019 budget has been earmarked. Second, AMLO has a nationalist attitude towards energy reform and is likely opposed to foreign investment in the oil sector. Private auctions for oil fields are likely to be suspended under his leadership. Rollback on the energy reform could adversely affect the country's oil production capacity in the long term, but may have limited impact on growth in the next 12-18 months, as most of the oil fields being auctioned have not yet gone into production. Third, AMLO could risk making NAFTA negotiations more difficult given his combative personality. However, it is worth noting that he has moderated his tone on this issue recently as more than 70% of Mexicans are in favour of NAFTA. The market is likely to react positively if AMLO appoints the mooted economist Jesús Seade Kurilead – who has a solid background in the GATT and the WTO – to lead the negotiations.

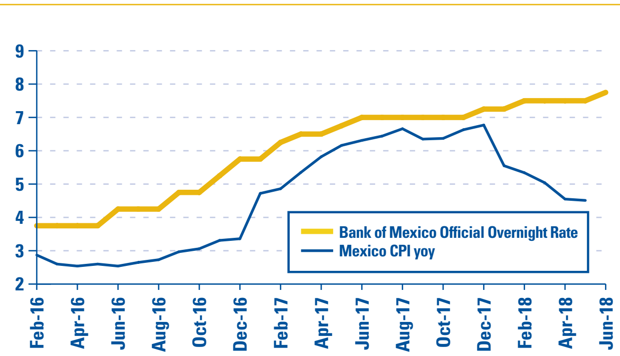
The Mexican economy grew by 1.1% qoq (or 1.3% yoy) in Q1 2018, accelerating from the 0.9% quarterly growth in Q4, as industrial production continued to rebound after the earthquake late last year. Services also accelerated and grew by 1.2% qoq (or 3.1% yoy) over the same period. Growth in Q2 likely eased back to trend around 0.5% qoq or 2.5% yoy for several reasons.

First, private investment and capital imports decelerated given the uncertainties around NAFTA and the July election. Non-oil intermediate import growth, which positively correlates with the manufacturing cycle, moderated to an annualised rate of 5% in Q2. Second, external demand continued to ease in line with global trade deceleration, with factory shipments growing at an annualised rate of 1.6% in Q2, significantly lower than the 15% growth in Q1. Still, consensus expects moderate acceleration in GDP growth to 2.2% in 2018 (vs. 2.0% in 2017), as private consumption continues to recover on the back of declining inflation and low unemployment.

Inflation has declined steadily to 4.5% yoy in June from the peak of 6.8% at the end of last year. It represents a remarkable achievement by the central bank and comes despite the recent US dollar strength and uncertainties around NAFTA that weighed on the peso and pushed up import prices. While the latest inflation figure is still above Banco de Mexico's inflation target of 2-4%, the central bank expects it to fall towards 3.8% by the end of the year, partly due to its tight monetary policy. Indeed, the central bank hiked the policy rate by 25bps to 7.75% at the June meeting, the second hike this year and the highest interest rate since 2009. The central bank has made it clear that it will act quickly and firmly if there is any substantial currency depreciation that leads to higher inflation expectations.

Market Strategy: Mexican equities lost 3.6% in US dollar terms in Q2, outperforming EM equities by 4.4% points, as the benefit from Mexico's limited exposure to the Chinese slowdown offset the rising poll ratings for Morena over the period. Mexican equities and the peso corrected the day after the election, as the market priced in higher fiscal risks following Morena's surprising victory in Congress. But while there is a risk that the central bank may hike the interest rate again at its August meeting – a headwind to Mexican equities – we remain *overweight* Mexican equities for several reasons. First, the election result is mostly in line with expectations and has not led to substantial peso depreciation, which reduces the chance of further rate hikes. Second, the potentially higher fiscal risks associated with the new government are unlikely to be realised until the year 2020. Third, among the major EM economies Mexico is one of the most resilient to a slowdown in Chinese investment due to its limited trade relationship with China and low base metal exports.

Chart 6: Mexican Policy Rate and Inflation Rate %



Source: Bank of Mexico

Emerging Europe and Africa

Russia

Overweight

> *Despite the recent imposition of additional sanctions, the economy continues to recover on the back of strong oil prices, while inflation remains benign.*

While President Putin has entrenched himself firmly in the country's political landscape, the economy has been through a volatile quarter. This was prompted by the imposition of additional sanctions on Russian oligarchs and their companies by the US in mid-April, which triggered a variety of market reactions, ranging from a 10% drop in the ruble in one week, to a 24% jump in the world price of aluminium (Rusal being one of the companies targeted) and a 12% loss in USD terms in the Russian stock market, reminiscent of the market reaction in the wake of Russia's annexation of the Crimea in 2014.

But against these political embarrassments and microeconomic challenges stands an economy that benefits from elevated oil prices, a weaker exchange rate, strong foreign demand and a boost to sentiment via the football World Cup. In Q1, real GDP gained 1.3%, up from 0.8% yoy the previous quarter. Growth was boosted by strength in the construction sector. Industrial output, led by manufacturing, also remains strong, recording gains of 3.9% and 3.7% yoy in April and May respectively. The manufacturing PMI slipped below 50 in May due to base effects, but has been consistently above it otherwise and is likely to have bounced back in June. The services PMI has remained in the 53-55 range over the past quarter. Retail sales growth has remained strong, with the latest reading at 2.5% yoy, while unemployment remains moderate at 4.8%. GDP estimates point to growth of 1.7% for the full year, but remains tentative given the data revisions currently underway.

Amidst this recovery, a key source of concern is the strength of wage growth, which remains high in real terms, even though it slowed successively from 11.3% yoy in March to 9.9% yoy in May. Yet, while far in excess of productivity growth, consumer price inflation remains benign. While the risk of FX pass-through remains, soaring gasoline prices were matched by very low food prices, containing CPI at 2.4% in May and at 2.3% yoy in June. The central bank has left rates unchanged, arguing that the government's decision to raise the VAT rate by 2% points in 2019 would warrant a slower move towards the neutral rate, estimated at 6-7%.

Market Strategy: After a strong Q1 (8% points outperformance), Russian markets remained resilient against outside forces and delivered a return of 1.2% points greater than the MSCI EM in Q2. Yet, with a P/E of 6.6 it remains the cheapest EM market and its 51% discount is in line with the historical average. Strong oil prices, economic recovery and low inflation lead us to maintain our *overweight* allocation.

Turkey

Underweight

Erdogan assumes the newly-created Executive Presidency, but Turkey's economic model is beginning to feel the strain.

President Recep Erdogan secured a second term as president in the June national election, obtaining 53% of the vote in an election was unlikely either free or fair, with external organisations expressing concerns over this. The outcome was better-than-expected as his victory was anticipated only in the second round given the rising support for an invigorated and more unified opposition. However, he will for the first time assume an Executive Presidency under the new constitution, which will make him both head of state and head of government. The role of Prime Minister, which Erdogan occupied between 2003 and 2014, has been abolished. The AK party gained 42.5% of the vote or 293 seats in the 600-member parliament. It will command a majority together with its coalition partner, the Nationalist Movement Party (MHP).

Such a concentration of power clearly compounds the risk of policy error. This relates both to Erdogan's white-elephant projects and populist measures (such as promised bonus payments to pensioners in June and August) as well as his views on inflation and interest rates. The latter triggered a sharp decline in the lira which has lost 19% against the US dollar since the start of the year. In turn, this has contributed to rising inflation, with CPI registering 15.4% in June from 12.2% in May.

The central bank responded to the developing crisis with a belated 300bps rate hike in May and followed this up with a further 100bps at the next meeting (to 17.75%) and a simplification of its policy framework (restoring the one-week repo rate to its erstwhile place as the key policy rate).

The strength of the FX pass-through to inflation can at least partly be explained by the strength of domestic demand. In Q1, Turkey's GDP gained 7.4% yoy in real terms, up slightly from 7.3% yoy in Q4 2017. However, it is likely that post-election fiscal tightening (following the splurge in H2 2017) and possibly further monetary tightening will increasingly weigh on consumer and business sentiment, inhibiting growth. The silver lining is that if financial conditions stabilise, a weaker exchange rate and decelerating domestic demand growth would help rein in Turkey's large current account deficit which runs at close to 6% of GDP.

Market Strategy: Following the presidential election, there is a chance of a relief rally in Turkish markets. However, this will likely be short-lived as economic fundamentals remain weak and risks associated with Erdogan's presidency are rising. While the market is cheap with a P/E of 7.0 (a 47% discount to the MSCI P/E), we maintain our *underweight* allocation.

Romania

Underweight

Slowing growth and rising inflation at a time of widening twin deficits leave Romanian assets vulnerable.

Romanian GDP decelerated to a lower-than-expected 4.0% yoy in Q1, against a market expectation of 5.5% and down from 6.7% in Q4. The slowdown was driven by household consumption and investment growth, both of which more than halved from the Q4 pace. Slowing growth and tighter monetary conditions pushed the European Commission's Economic Sentiment index for Romania in April to its lowest level since October 2014, capping four consecutive months of declines. This backdrop is likely to hamper household consumption (62% of GDP) and thus overall economic growth this year. GDP growth is projected to slow to 4.5% in 2018 from 6.8% in 2017.

Consumer-price inflation has accelerated significantly, with the headline figure rising for nine consecutive months to a five-year high of 5.4% yoy in May. This is significantly above the official 1.5-3.5% target range. Core prices have also been rising and were at a four-year high of 2.2% in May, up from -0.1% a year ago. The National Bank of Romania (NBR) has raised its key policy rate by 75bps this year to 2.5%. However, the glacial pace of tightening compared to the sharp rise in inflation has left real rates at a historical low of -2.9%. Thus, monetary conditions remain loose and pose upside risks to inflation, which the NBR project will fall back within target by next year as 2017 tax rises fall out of the calculation and economic growth slows.

Meanwhile, imports have continued to expand at a faster pace than exports this year, by 3.1% yoy and 1.7% in April, respectively. This has pushed the annualised current account deficit for January to April to 3.3% of GDP, compared to 2.7% for the same period in 2017. In addition, foreign travel by Romanians is rising, reducing net international receipts. These factors are expected to widen the current account deficit from 3.1% of GDP in 2017 to 4.0% this year, which would be the widest level since 2012.

Fiscal concerns remain high and the budget deficit is expected to widen beyond the EU's 3% of GDP limit this year, to 3.5% from 2.9% in 2017. The deficit of 0.7% of GDP in the first four months of this year was the first in that period since 2014 as revenues rose at half the pace of expenditures, which were pushed higher by public sector wage increases. Rising capex is set to increase the deficit significantly in H2.

Market Strategy: Romania's market is relatively cheap in an EM context, with the P/E trading at a 40% discount (1.1 standard deviations below the long-term average). However, we view this as a value trap due to numerous economic woes and stay *underweight*.

South Africa

Neutral (↓)

Recent economic woes illustrate the significant task ahead for Ramaphosa to reform the country.

President Cyril Ramaphosa has outlined plans to redistribute land without compensation and raise black ownership in mining companies by 4% points to 30%. These policy pronouncements are seen as somewhat regressive, with the former potentially impinging on property rights. This could damage sentiment towards South Africa and Moody's have stated that the policy and uncertainty around it may result in a "pronounced fall in investment". However, with research suggesting that nearly two thirds of South Africans are of the opinion that land reform can play a significant role in addressing inequality, the policy is likely to be implemented in some form. Moreover, a change in policy direction in this area could jeopardise the president's healthy approval rating (65% in May) and adversely impact the ANC's showing in the 2019 general election.

Ramaphosa's other reform policies are facing their first stumbling blocks. New management at Eskom are seeking to reduce costs, but the goal of freezing wages has not come to fruition. Unions are seeking a 9% pay increase from Eskom after a 5% raise was offered and a strike led to blackouts in June. The government has also faced setbacks in its corruption crackdown, with the National Prosecuting Authority losing High Court cases to seize assets from the Gupta family. However, we view these developments as short-term setbacks and the direction of travel is ultimately towards reduced corruption and increased efficiency of state-owned enterprises. In the medium-term, we would expect the policy agenda to raise the economy's growth potential.

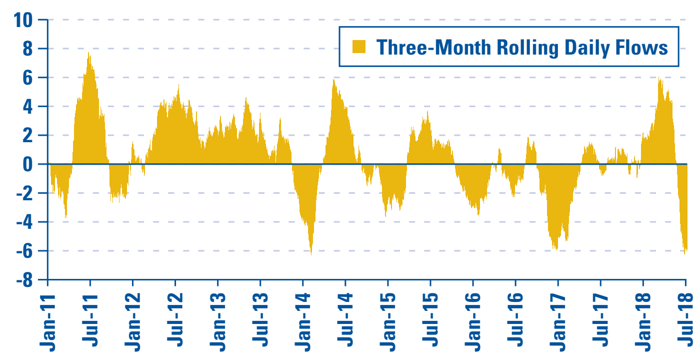
Economic growth in Q1 contracted by 2.2% qoq saar, a significantly sharper decline than the 0.5% expected. Activity was weighed down by the agricultural sector (-24.2%), mining (-9.9%) and manufacturing (-6.4%). A rebound is expected in Q2 as agricultural output recovers from the drought in Q1. However, data has so far disappointed elsewhere, with manufacturing production contracting by 0.6% mom and mining by 2.0% in April. The SACCI Business Confidence index also fell for a fourth consecutive month to its lowest level since October. However, while the composite PMI fell to a neutral level of 50.0 in May, new orders remained in expansionary territory for a fifth consecutive month and this bodes well for output in H2. Overall, GDP is forecast to accelerate to 1.6% this year and 2.0% in 2019, from 1.3% last year.

Inflation has remained within the central bank's 3-6% target range since April 2017, with both headline and core CPI rising by 4.4% yoy in May. However, the 8.9% fall in the rand on a real effective basis in Q2 is likely to raise the South African Reserve Bank's (SARB) inflation projections, which currently forecast CPI to rise by 4.9% in 2018 and 5.2% in 2019. The 1% point increase in VAT implemented in April and rising administered prices mean that inflation risks are tilted to the upside. Although a hike is not expected yet, sustained weakness in the rand could lead to a tightening in H2.

Meanwhile, external accounts have deteriorated. The current account deficit widened substantially to 4.8% of GDP in Q1 from 2.9% in Q4. This was driven by the trade balance, which moved from a 1.5% of GDP surplus to a 0.5% deficit. Around a third of the fall is estimated to have come from a freight derailment in January that impacted iron ore and coal exports. This one-off effect is expected to reverse in Q2. However, there are a few factors that suggest a deteriorating external trend, including the higher oil price and rising interest and dividend payments to foreigners. The current account deficit is projected to widen to 3.1% of GDP this year compared to 2.4% in 2017.

Capital inflows are required to plug the shortfall and yet there were record bond outflows in H1, which combined with equity flows totalled of $2.5 bn (see Chart 7). Concerns over worsening external accounts and tightening global liquidity have already led to significant rand weakness, with the currency declining by 15.9% against the US dollar in Q2. Continued outflows may lead to policy adjustments to curtail these flows and could push the SARB to hike in H2.

Chart 7: Net Foreign Equity and Bond Purchases, $bn



Source: South Africa Stock Exchange

The budget deficit is forecast to fall from 4.4% of GDP in 2017 to 3.6% in 2018, but slowing GDP growth and the associated slowdown in tax revenues leave upside risks to current estimates. Public sector wage agreements reached in May resulted in a 7% wage rise this year and a rise 1% point above inflation in both 2019 and 2020. This is nearly double the 4% rise the Treasury had accounted for in the 2018 budget in February. Expenditures may therefore need to be curtailed in H2 in order to limit public debt expansion, with the aim of preventing a credit rating downgrade (to non-investment grade) from Moody's and additional outflows from the bond market.

Market Strategy: The MSCI South Africa underperformed EM by 3.9% points in Q2, but this was entirely due to the currency. In local terms, the market outperformed by 9.9% points and earnings are likely to be bolstered by rand weakness given that companies with offshore earnings account for the majority of the index. However, valuations are not attractive, with the trailing P/E at a 59% premium to EM compared to a 5-year average of 36%. Given ongoing economic and policy difficulties, downside risks remain for the rand, affecting equity returns in US dollar terms. Hence, we downgrade our allocation from *overweight* to *neutral*.

KEY ECONOMIC AND FINANCIAL INDICATORS

	Emerging Market	Macroeconomic Data: % change on year ago: Annual GDP Growth*	Industrial Production*	Consumer Price Index*	Latest 12 months: Trade Balance*	Current Account Balance*	Foreign Reserves 2018 Latest	Foreign Reserves 2017 Year ago	Currency vs $ 2018 Latest*	Currency vs $ 2017 Year ago	Short-Term Interest Rates*	Sovereign Rating S&P	Market Data: Performance: % S&P/EM Frontier Super Composite BMI	Stock Market Index S&P/EM Front. Super Comp. BMI US$	Change since 12/31/17 US$	Change since 12/31/17 Local Currency	Forecast (Bloomberg)†: 2018 P/E Forecast*	EBIT Margin 2018 Forecast*	6 month Stock Market Index Estimate (Front. Super Comp. BMI) US$*	3 month Currency vs $ +/-*
		%	%	%	$ Bns	$ Bns	$ Bns	$ Bns			%		Jun. 29, 2018	Jun. 29, 2018	%	%		%		
Overweight	THAILAND	4.8	3.2	1.4	29.2	47.0	204.07	175.81	33.18	34.01	1.0	BBB+	2.32	1161.22	-10.46	-8.97	14.3	11.9	1205	+
	MEXICO	1.3	3.8	4.5	-11.5	-26.5	167.42	166.56	20.17	18.22	8.2	BBB+	2.65	424.77	-2.37	-1.94	16.7	15.1	437	-
	RUSSIA	1.3	3.7	2.4	0.1	44.3	366.62	326.66	63.44	59.35	6.0	BBB-	3.55	479.92	1.08	8.37	6.0	17.4	485	-
	SOUTH KOREA	2.8	0.9	1.5	82.9	69.2	389.27	368.93	1119.89	1150.22	1.7	AA	14.87	537.37	-8.25	-4.49	8.4	12.8	551	+
	INDIA	7.7	4.9	4.9	-158.1	-48.7	387.66	356.22	68.71	64.85	6.3	BBB-	10.62	1062.25	-8.76	-2.09	17.9	13.7	1120	+
Neutral	ARGENTINA	3.6	-1.2	26.2	-11.3	-33.8	44.68	40.94	28.93	16.62	30.0	B+	0.50	506.60	-34.28	0.72	9.9	25.1	520	+
	BAHRAIN	3.4	n.a.	2.8	n.a.	n.a.	2.81	2.33	0.38	0.38	3.0	B+	0.11	139.62	7.10	7.47	n.a.	n.a.	143	uc
	CHILE	4.2	3.6	2.0	10.2	-3.1	36.30	38.00	657.46	662.54	2.7	A+	1.18	533.88	-10.32	-5.06	15.9	15.6	549	+
	COLOMBIA	2.8	10.5	3.2	-5.5	-9.8	45.20	45.21	2941.01	3044.88	4.9	BBB-	0.51	6539.56	7.90	6.18	15.3	22.5	6729	-
	CZECH REP.	4.2	1.4	2.2	19.5	1.9	143.46	137.66	22.45	23.01	1.0	AA-	0.15	943.05	0.52	5.35	15.1	n.a.	991	+
	EGYPT	4.2	5.6	11.4	-37.0	-9.3	38.87	23.77	17.93	17.90	16.8	B	0.20	1638.92	11.01	11.65	11.6	n.a.	1787	+
	GREECE	2.3	1.0	0.6	-22.3	-2.7	1.96	1.63	1.16	1.14	0.1	B+	0.38	31.75	-7.15	-4.73	22.1	22.9	32	-
	HUNGARY	4.4	3.8	2.8	9.2	4.6	28.94	25.96	284.45	271.94	0.4	BBB-	0.23	497.23	-15.18	-7.44	9.8	n.a.	511	+
	INDONESIA	5.1	-3.5	3.1	3.0	-20.9	118.70	117.47	14394.00	13417.00	5.8	BBB-	1.87	1306.47	-14.64	-9.86	14.5	23.9	1354	+
	KENYA	5.7	n.a.	4.3	-11.0	-45.9	7.32	7.45	100.90	103.80	8.2	B+	0.14	790.08	9.09	6.77	14.6	22.1	824	-
	KUWAIT	1.8	n.a.	0.4	57.2	-4.9	34.02	31.22	0.30	0.30	1.3	AA	0.49	80.24	7.42	7.75	13.5	n.a.	82	+
	MALAYSIA	5.4	4.6	1.8	28.5	12.5	104.90	94.57	4.05	4.30	3.2	A-	2.38	391.76	-5.42	-5.58	15.9	20.3	412	+
	MOROCCO	3.2	9.6	3.2	9.6	-3.9	22.77	23.82	9.51	9.69	3.1	BBB-	0.24	610.15	-4.15	-2.72	18.4	26.9	630	-
	NIGERIA	2.0	n.a.	11.6	15.7	10.4	45.28	28.70	362.00	315.25	10.7	B	0.21	206.21	5.08	5.52	8.1	17.6	223	-
	PAKISTAN	5.4	4.3	4.2	-36.8	-15.2	11.17	17.71	121.72	104.85	4.6	B	0.20	749.28	-6.78	2.60	9.4	n.a.	788	-
	PERU	3.2	3.3	1.4	7.3	-2.9	62.03	60.65	3.29	3.25	0.3	BBB+	0.38	2128.23	4.44	4.55	14.0	n.a.	2198	-
	PHILIPPINES	6.8	19.8	6.8	19.8	-1.9	69.72	72.47	53.47	50.62	3.8	BBB	1.09	763.92	-20.04	-14.51	16.7	21.7	791	+
	POLAND	5.2	5.4	1.9	-1.1	-0.9	106.51	104.49	3.79	3.74	1.6	BBB+	1.04	322.16	-19.12	-12.83	11.3	14.7	332	+
	QATAR	1.4	n.a.	0.5	36.3	6.3	23.26	33.72	3.65	3.70	2.4	AA-	0.53	239.28	10.02	9.99	11.6	n.a.	246	uc
	SLOVENIA	4.6	6.0	2.1	0.8	3.8	0.33	0.32	1.16	1.14	0.3	A+	0.06	453.52	4.49	7.47	11.1	12.8	468	-
	SOUTH AFRICA	0.8	1.1	4.4	3.6	-47.7	43.16	39.38	13.90	13.23	6.7	BB	5.85	755.97	-15.03	-5.97	16.4	12.9	772	-
	SRI LANKA	3.2	4.3	4.4	-10.3	n.a.	6.64	4.53	158.40	153.55	11.3	B+	0.06	265.74	-5.48	-2.52	9.6	12.0	275	-
	TAIWAN	3.0	7.1	1.6	60.8	84.8	457.28	440.25	30.57	30.55	0.6	AA-	11.60	280.38	-0.63	1.80	13.6	7.9	282	+
	UAE	0.8	n.a.	4.2	80.9	27.5	88.62	87.49	3.67	3.67	2.5	AA	0.62	118.01	-2.81	-2.80	8.7	n.a.	120	uc
	VIETNAM	7.1	12.3	4.7	5.0	15.6	55.87	37.47	22985.00	22720.00	4.8	BB-	0.31	218.97	2.18	3.31	25.6	19.0	230	+
Underweight	CHINA	6.8	6.8	1.8	393.0	115.1	3110.62	3053.57	6.67	6.79	1.1	A+	28.13	921.32	-1.32	-1.05	12.7	12.9	969	+
	BRAZIL	1.2	-6.6	2.9	64.2	-13.0	373.67	367.89	3.91	3.30	6.2	BB-	5.50	585.49	-17.80	-4.80	10.9	19.0	602	+
	ROMANIA	4.0	5.7	5.4	-15.8	-43.6	39.19	37.97	4.02	4.03	3.0	BBB-	0.11	123.92	9.73	12.74	8.0	27.8	129	-
	TURKEY	3.1	6.2	12.2	-87.1	-57.1	81.31	85.95	4.62	3.56	17.8	BB-	0.80	320.21	-28.83	-14.01	6.6	13.9	329	+
	OUT OF INDEX																			
	SAUDI ARABIA	1.2	n.a.	2.3	87.3	7.8	477.56	551.46	3.75	3.75	2.5	A-	0.00	133.84	18.29	18.29	14.5	n.a.	125	uc

Note: All data shown are as at 29 June 2018 unless stated otherwise. UC is unchanged (currency versus US dollar). S&P sovereign rating shown is long-term foreign currency rating. UAE sovereign rating shown is for Abu Dhabi. Data for countries in the Middle East and North Africa region are the latest available, but in certain cases relate to periods more than one year ago. The 34 countries shown in the table accounted for 98.9% of the S&P/EM Frontier Super Composite BMI on 29 June 2018. An additional 22 countries accounted for the remaining 1.1% of the index on the same date. These countries, which can be accessed via City of London's Frontier Markets strategy, are: Bangladesh, Botswana, Bulgaria, Cote d'Ivoire, Croatia, Cyprus, Ecuador, Estonia, Ghana, Jamaica, Kazakhstan, Latvia, Lebanon, Lithuania, Mauritius, Namibia, Panama, Slovakia, Trinidad & Tobago, Tunisia, Ukraine and Zambia.
†Any forecasts are based on Bloomberg consensus forecasts, where available, and assumptions. Actual results may vary from any such statements or forecasts. Past performance is no guarantee of future results.
**Key Criteria*
Source: Bloomberg, City of London Investment Management

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