CITY OF LONDON
Investment Management Company Limited

Frontier Markets Semi-Annual Outlook

February 2019*

Overview

FM: Better Times Ahead

Frontier markets (FM) faced a number of headwinds last year, ranging from the economic to the political. Although this is not unusual for the asset class, it came against a backdrop of tightening global liquidity, which put further downward pressure on asset prices. Tightening by the Federal Reserve and other global central banks signalled the end of ultra-loose monetary policy. At the same time, the economic and political environment was not especially benign given that exceptional US growth was partly driven by the temporary impact of fiscal stimulus, China continued to slow and US-China trade tensions escalated significantly. This heightened concern that a policy mistake (excessive tightening) could occur at a vulnerable time for the global economy.

Argentina had been the poster child in 2017 for market-based reforms in FM, but was front and centre in 2018 for the wrong reasons. Concerns over debt sustainability and shrinking liquidity led to financial instability, with the peso falling by 56% peak to trough against the US dollar, before stabilising and rallying by 10% from the September low into year-end. It took extremely aggressive action by the central bank and an IMF program to ensure financial stability. President Mauricio Macri's administration have attempted to implement market-based reforms, but progress has been somewhat slow. As a result, market forces took over events when Macri asked the IMF to speed up its disbursements, precipitating a near 20% fall in the peso against the US dollar over two days.

However, Argentina was the exception rather than the rule in FM last year. GDP growth in major FM economies such as Vietnam, Bangladesh, Nigeria and Kenya accelerated in 2018 compared to 2017. Inflation has generally been low and controlled, while current account and budget balances are healthy and/or improving. Hence, despite the noise around FM, economic fundamentals have remained healthy.

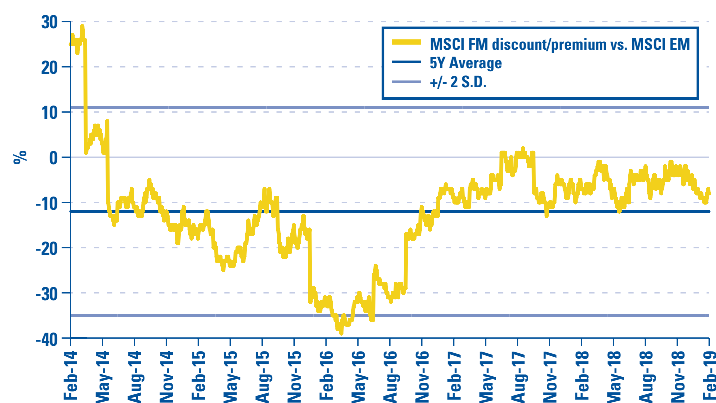
To some extent, last year's market narrative has reversed course in recent months due to: 1) a dialling back of the tightening rhetoric from the Fed; 2) stimulus measures from the Chinese authorities including tax cuts and monetary easing and 3) a détente in US-China trade relations. This has provided a benign backdrop for risk assets so far this year and should at least allow some time for FMs to implement reforms under less external pressure. This is particularly applicable to Argentina and could allow for continued financial stability this year.

Market Strategy

Market performance in FM was lacklustre last year. As with other global markets, the rally in MSCI FM in January (5.7%) gave way to declines for the rest the year and resulted in a loss of 16.4% for 2018 as a whole. This was the worst annual performance since 2011 and FM underperformed both developed (-8.7%) and emerging markets (-14.6%).

MSCI Argentina (-50.8%) was a key drag on MSCI FM's performance, with the losses somewhat justified by deteriorating fundamentals. However, many other FMs suffered losses despite improving economic fundamentals. These included Bangladesh (-14.7%), Vietnam (-12.7%) and Morocco (-7.5%). This has left FM valuations unchallenging, with the trailing P/E at a 9% discount to that of EM and only slightly narrower than the long-term average of 12% (see Chart 1). Overall, this backdrop suggests attractive investment opportunities within the asset class.

Chart 1: FM Valuations



Source: Bloomberg

We make the following changes to our allocation:

- **Downgrade Nigeria to *underweight*.** Difficult economic conditions and policy uncertainty in an election year are major headwinds;
- **Upgrade Bangladesh to *overweight*.** The market has become increasingly attractive given improving economic dynamics, reduced political risks and unchallenging valuations;
- **Downgrade Sri Lanka to *neutral*.** Growth is set to remain healthy, but a large amount of debt is due this year and political tensions remain after the constitutional crisis;
- **Upgrade Romania to *neutral*.** The "greed tax" adds policy uncertainty, but a political risk premium appears to be priced in and the measures are likely to be modified.

**The publication reflects asset performance up to January 31, 2019, and macro events and data releases up to February 11, 2019, unless indicated otherwise.*

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Latin America

Argentina

Neutral

Economic conditions are improving and the IMF program is on track, but political risks remain.

The economic crisis in Argentina has eased in recent months after a tumultuous Q2 and Q3 last year. Currency stability has returned after the peso reached a historical low against the US dollar in September. At that time, the currency had depreciated by 50% since April, but has since strengthened by 10%. This was aided by the IMF raising its credit facility from $50 bn to $56 bn in October and, after concluding its review in December, approving a $7.6 bn disbursement.

Latest GDP figures showed that that the country officially entered recession in Q3, with output falling by 0.7% qoq. This was a marked improvement from -4.0% in Q2 and was also reflected in yoy figures (-3.5% in Q3 from -4.2%). However, the improvement was driven by a contraction in imports (-10.2% yoy) that was comfortably above that of exports (-5.9%). Indeed, all other expenditure components declined by more than headline GDP: consumer spending (-4.5%), government spending (-5.0%) and investment (-11.2%). Consensus expects GDP growth to trough at -5.7% yoy in Q1 2019 and rebound to 2.5% growth in Q4 for a full-year turnout of -1.0%. The recovery is set to be driven by agriculture following the drought in 2018, which led to a 30% fall in production, and a rebound in consumer spending (approximately two thirds of GDP) as inflation falls.

The growth trajectory coincides with a likely peak in price pressures. Consumer prices rose by 47.6% yoy in December against 24.8% a year earlier and driven by higher imported prices. This is reflected in the magnitude of peso depreciation against the dollar (-50.5% in 2018 compared to -14.8% in 2017). Inflation on a sequential basis has already begun to fall, potentially signalling a peak. CPI rose by 2.6% mom in December, down from a high of 6.5% in September. Core prices also suggest easing inflationary pressures, falling from 7.6% mom to 2.7% over the same period. Consensus expects CPI to rise to 48.7% yoy in Q1 and fall to 27.4% by Q4.

The central bank (BCRA) has kept monetary policy tight and this should help to reduce inflation. This has been achieved through at least two channels as part of a new monetary policy framework under the IMF: 1) raising the key short-term interest rate (Leliq) to a peak of 73% in October and 2) keeping to the target of zero nominal growth in base money through June 2019 and 1% growth after this, instead of targeting inflation. Tight policy is likely to mean short-term economic pain, but support medium-term economic stability. It is likely to engender a recovery in household consumption as real wages begin to rise again.

Fiscal policy is also set to remain tight, with the government targeting a primary balance of zero this year compared to a 1.4% of GDP deficit in January to October 2018. However, the full-year 2018 deficit is projected to be 2.7% of GDP as the government paid bonuses to government workers and made provisions for child allowance and employment support programmes to help cushion the impact of the recession. The fiscal adjustment is set to come from a number of sources including: 1) export taxes (1.3% of GDP); 2) reduced transfers from central government to provinces (0.7%), 3) a fall in energy subsidies (0.3%) and 4) lower government spending (0.2%). The 2019 budget approved by Congress in November was in line with the primary fiscal balance target, but may be ambitious in an election year.

Meanwhile, the current account deficit is expected to more than halve from an estimated 4.7% of GDP in 2018 to 2.1% this year. Part of the adjustment comes from exports outperforming imports, a trend already in place. Thus, the trade deficit for 2018 fell to 0.8% of GDP from 1.3% in 2017. This was due to import contraction outpacing that of exports, whereas this year the recovery in agricultural output should support export growth in excess of imports. Downside risk to the balance of payments remain as capital account outflows may continue amid ongoing uncertainty.

One source of uncertainty is political, with the presidential and parliamentary elections in October. Polls suggest that President Macri and potential presidential rival, former president Cristina Fernández de Kirchner, each have around one third of support of the electorate. The second round of the presidential election is scheduled for November, if needed. Polls currently suggest that Macri would be victorious if he faced Kirchner in the second round, which seems likely at present as the moderate Peronist candidates are less likely to make it to the second round. There will also be provincial elections taking place from March to June in areas of importance for the energy sector such as Neuquen, which produces the majority of the country's natural gas. These elections could provide an early barometer of voter preferences.

Market Strategy: The MSCI Argentina underperformed MSCI FM by 0.6% in the six months to end-January, but this is much improved from the underperformance of 26.2% in the previous six months. Meanwhile, the MSCI Argentina's trailing P/E is at a 3% premium to FM, 0.8 of a standard deviation above its long-term average and up from a 13% discount at end-July. Stabilisation of financial conditions justifies the re-rating, but we believe that valuations do not sufficiently compensate for ongoing risks related to policy implementation and politics. We therefore stay at *neutral*.

Asia

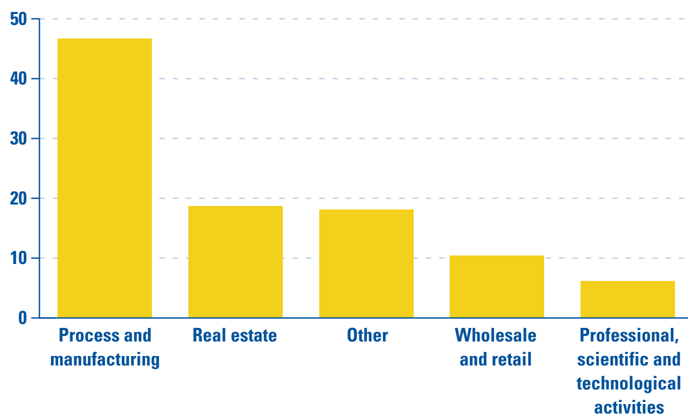
Vietnam

Overweight

Growth is set to slow, but economic fundamentals remain strong.

Vietnam's economic growth has continued to accelerate. Activity expanded by 7.1% yoy in 2018 compared to 6.8% in 2017 and was again driven by strength in the secondary (8.9% yoy) and tertiary (7.0%) sectors. GDP growth is projected by consensus to slow this year to a still healthy 6.7%, the midpoint of the government's 6.6-6.8% target range. The manufacturing sector is likely to remain strong, with PMI rising to a historical high in November (56.5). At the same time, ongoing US-China trade tensions are driving increased foreign investment inflows. Realised foreign direst investment (FDI) rose by 9.1% yoy in 2018 to $19.1 bn, a sixth consecutive annual record high, led by Japan and South Korea. Processing and manufacturing accounted for 46% of FDI last year (see Chart 2) and this sector is set to support activity. Samsung, whose exports account for almost a quarter of Vietnam's exports, is set to release the Samsung Galaxy X in 1H and this is likely to provide a fillip.

Chart 2: FDI into Vietnam, % of 2018 Total



Source: FDI Intelligence, Ministry of Planning and Investment

Improved growth has not led to a marked rise in inflationary pressures thus far. In fact, headline CPI has nearly halved from a peak of 4.7% yoy in June to 2.6% in January. The fall in the oil price and a deceleration in food inflation has aided this trend. However, core prices have risen mildly to 1.8% in January against 1.2% a year earlier. Upside risks to inflation come from at least two sources: 1) a potential rise in electricity tariffs to cover the project costs of state owned Vietnam Electricity and 2) the 33% hike in the environmental tax on fuel implemented in January. These factors may also hamper household consumption and thus GDP growth. Overall, the central bank (SBV) looks likely to meet its 2019 inflation target of below 4.0% yoy.

SBV is targeting the same credit expansion this year as last (14% yoy) and aims to keep the dong stable, which should help to maintain financial stability. Moreover, improvements in non-performing loans mean that several banks are set to meet Basel II standards this year and this should help cushion any economic shocks. Credit growth in recent years has been substantial, with the credit outstanding rising to 131% of GDP last year, up 40% points from five years earlier. Macroprudential measures, including tighter lending standards for real estate and a required 5% point reduction in short-term lending to 40% of the total, should help to limit credit accumulation.

External accounts are set to improve, supported by robust exports and ongoing implementation of free-trade agreements like that with South Korea. The current account surplus is projected to rise to 3.2% of GDP this year, up a full percentage point from that estimated for 2018. Healthy overseas remittances are also supportive. The continued expansion in the US, from which 60% of remittances originate, augur well for a continuation of this.

Fiscal policy is set to tighten as the government seeks to keep its debt level below the 65% of GDP limit set by the National Assembly. The Ministry of Planning and Investment projected the level at end-2018 was 63.9% compared to 61.5% a year earlier. Last year's budget deficit is estimated at 4.6% of GDP and the government is aiming to reduce this by 0.3% points over the next three years. This should keep a cap on government borrowing, but the privatisation programme will likely need to accelerate from its lacklustre progress recently (e.g. 12 SOEs were equitized in the first 11 months of 2018 against a target of 85).

Market Strategy: The MSCI Vietnam's P/E is around double that of MSCI FM. This is one standard deviation above its long-term average of a 68% premium and a similar level to where it was six months ago. Over the period, the market underperformed FM only slightly, by 0.6%. We believe market valuations are not stretched given strong economic fundamentals, as well as prudent monetary and fiscal policy. Capital inflows as a result of ongoing US-China trade tensions mean that the market may be viewed as an effective hedge against these strains. We stay *overweight*.

Bangladesh

Overweight (↑)

Accelerating growth is supported by a broad-based expansion, pushing up price pressures and keeping the central bank hawkish.

Bangladesh has continued to post stellar growth, with GDP rising by 7.9% yoy in fiscal year 2017/18 (FY18 year to end-June 2018), up from 7.3% in the previous 12 months. The acceleration was broad-based, aided by healthy domestic demand, credit growth, exports and inward remittances. This continued in 1H FY19, with remittance inflows up by 8.0% yoy. GDP growth for FY19 is forecast by the central bank to be in the range of 7.5-8.2%.

Inflation has been on a steady decline, falling each month since February 2018. CPI rose by 5.4% yoy in December from 5.8% a year earlier. Falling food prices have helped, particularly as domestic production recovered from the 2017 floods. By contrast, core inflation has been gradually rising, at an 18-month high of 4.5% yoy in December. Bangladesh Bank's (BB) survey in December showed that 70% of participants expect inflation a year ahead to be above 6%. However, this was also the case a year earlier, so expectations may be upwardly biased. In any case, strong growth is likely to keep inflationary pressures elevated and the impact of a lower oil price on headline inflation may be muted given regulated fuel prices. Hence, BB is likely to have a hawkish stance.

The current account deficit widened by 1.2% points yoy to 3.2% of GDP in FY18. This was partly due to a flood-related surge in imports, which rose by 25% yoy. Import growth has moderated since to 5.7% yoy in December and this is set to continue given also a fall in oil import costs. Export growth has also been strong and ongoing US-China trade tensions could lead to production relocation in the garment sector, further supporting exports. As a result, BB projects a narrowing of the current account shortfall to 2.0% of GDP in FY19.

Parliamentary elections in December gave the ruling Awami League (AL) a landslide victory, winning 257 of 300 seats in the lower house after opposition parties boycotted the election. The party is tightening its grip on the country, which is effectively under one-party rule. However, the smooth running of the elections and policy continuity is a positive outcome. Fiscal policy has been prudent and progressive under AL, with the digitisation of parts of the tax system improving revenue collection. The budget deficit is forecast to be around 1.5% of GDP in FY19, less than half the level at the last election in 2014.

Market Strategy: The MSCI Bangladesh's trailing P/E is at a 54% premium to FM, half a standard deviation below the long-term average of 71%. Given improved economic dynamics, including narrowing twin deficits, and reduced political risk, we believe the market offers good value and raise Bangladesh to *overweight*.

Sri Lanka

Neutral (↓)

Growth is likely to be supported by consumption, but political uncertainty and large debt repayments are likely to keep downward pressure on the rupee.

Sri Lankan GDP slowed to 2.9% yoy in Q3, down from 3.8% a year earlier and 3.6% in Q2. The slowdown from Q2 was broad-based as agriculture, industries and services activity all decelerated. Consensus expects a growth acceleration to 3.7% yoy this year amid healthy real wage growth (household consumption makes up 62% of GDP), though this is still below the estimated potential of 4-4.5%.

Falling inflation has buoyed domestic conditions, with headline CPI falling from 5.9% yoy in August to 2.8% in December, the lowest since March 2016. Despite this, the central bank (CBSL) unexpectedly tightened policy in November, aiming to stem capital outflows amid a political crisis and to support the rupee, which had fallen by 10% against the US dollar since September. Downward pressure on the rupee is likely this year given the large amount of debt repayments, approximately $5.9 bn (6.4% of GDP).

Financing of the current account deficit may prove difficult given this backdrop. The shortfall is projected to widen to 3.0% of GDP in 2019 from an estimated 2.5% in 2018. Exports may slow as demand in key export markets decelerates, while imports are set to remain robust as investment activity continues apace. The external deficit is a key risk that has been heightened by debt dynamics and political volatility.

The political/constitutional crisis began in October, when President Sirisena replaced Prime Minister Wickremesinghe with former President Rajapaksa. Although Sirisena dissolved parliament, the Supreme Court subsequently ruled that the move was unconstitutional and reinstated Wickremesinghe. This led to a delay in the 2019 budget, which is expected to be presented in March. A prudent budget and continued reforms in line with the IMF programme are likely to be required in order to maintain financial stability

Market Strategy: The MSCI Sri Lanka outperformed MSCI FM by 2.2% over the past six months, with its trailing P/E narrowing from a 25% discount to FM to 10% over the period. This is two thirds of a standard deviation below the long-term average, so there is still value in the market. However, risks ranging from a large amount of debt coming due to political volatility leave us cautious and we downgrade Sri Lanka to *neutral*.

Middle East and North Africa

Kuwait

Overweight

Improved economic conditions are set to remain in 2019, despite the headwind of a lower oil price.

Kuwait's GDP growth rebounded strongly in 2018, expanding by an estimated 2.9% yoy after a 3.5% contraction in 2017. As usual, economic activity was driven by the oil sector, with output expanding by 3.0% yoy. Crude oil output rose by 2.4% yoy and exports by 1.9% in the first 10 months of 2018. Non-oil growth accelerated from 2.2% in 2017 to 2.8% in 2018. Growth is set to slow to a projected 2.2% in 2019 due to output cuts from the OPEC+ agreement. Non-oil output growth is expected to accelerate to 3.0% amid rising project awards.

Headline CPI rose by just 0.1% yoy in November. Falling real estate prices have been a key driver since housing makes up around a third of the CPI basket, while food prices have been falling. CPI inflation is projected to accelerate to a still moderate 2.0% in 2019 as housing and food prices rebound. The benign inflationary backdrop, combined with the dinar being pegged to a basket of currencies and not just the US dollar, has enabled the central bank (NBK) to tighten by less than the Fed. The latter has hiked by 225bps in the current cycle, whereas the NBK has raised rates by 100bps over the same period.

External accounts have recovered back to significant surplus after the 2014-16 oil price collapse led to a deficit for the first time since 1992. A current account surplus of 15% of GDP is estimated for 2018 amid a significant rise in oil exports and lacklustre capital goods imports. However, this trend is expected to reverse this year given oil output cuts, a lower oil price and a rise in infrastructure-related imports amid increased projects. The surplus is projected to fall this year, but remain substantial at 10% of GDP.

Fiscal accounts have also improved. The budget deficit fell by 5% points yoy to 9% of GDP in fiscal year 2017/18 (year to end-March) and is projected to narrow to 0.5% in 2018/19. The lower oil price is set to be mirrored by reduced government expenditure 2019/20, producing minimal deficit widening to 1.0%. The fiscal position is markedly better than these figures imply given sovereign wealth assets of $600 bn and return on these assets of an estimated 12% of GDP.

Market Strategy: Kuwaiti stocks were supported by improved flows due to an upgrade to the FTSE EM index and this should continue in 1H19 given the potential upgrade to MSCI EM in 2020 (decision to be announced in June 2019). The lifting of certain foreign ownership limits last year makes the upgrade more likely. Given healthy economic conditions and unchallenging valuations – MSCI Kuwait's trailing P/E is at a 42% premium to FM, against a historical average of 34% - we stay *overweight*.

Morocco

Overweight

Accelerating growth is supported by low and falling inflation, while external balances are set to improve this year.

GDP growth in Morocco was healthy in the first three quarters of 2018 (3.2%, 2.4% and 3.0% yoy). The quarterly average of 2.9% yoy was down from 3.8% in the same period of 2017, when growth was elevated by a sharp rebound in agricultural output from the 2016 drought. Growth was broad-based and this is expected to have continued in Q4, leading to a full-year outturn of 3.2%. GDP is projected to expand at a similar rate (3.3%) in 2019. Job creation and falling unemployment (to 10.0% in Q3 2018 from 10.6% a year earlier) has occurred in both urban and rural areas, which should lead to benign social conditions and healthy household consumption.

Falling inflation is also likely to be growth supportive. CPI rose by just 0.1% yoy in December, down from 1.9% a year earlier, as improved agricultural conditions pushed food prices lower. Core CPI has been stable at around 1.0%, which has helped to keep inflation expectations contained. A survey by the central bank (BAM) showed that inflation was expected to be 1.9% yoy over the next two years. The benign backdrop has allowed BAM to keep its key policy rate at 2.25%. This is expected to continue this year, with the Bank projecting CPI inflation of 1.0% for 2019.

Meanwhile, the rise in the cost of energy imports and slowing growth in key export markets (Eurozone) has worsened external balances. The current account deficit widened to an estimated 4.4% of GDP in 2018 from 3.6% in 2017. The lower oil price (-10% yoy) and improved car exports are set to narrow the shortfall back to 3.7% this year. At the same time, capital inflows are likely to remain healthy. FDI is projected to amount to 3.4% of GDP this year as the country reaps the rewards of infrastructure investment and reforms over the past decade. The country has risen from 128th in 2009 to 60th in 2019 in the World Bank's Ease of Doing Business ranking.

The budget deficit is projected to remain at 3.7% of GDP this year. Reduced grants from the GCC are set to reduce non-tax revenues, but this will be partially offset by a 2.5% solidarity tax on corporates. However, upside risk to the deficit stem from increased subsidies, social spending and public investment, particularly given the government's optimistic 2019 growth projection of 3.8%.

Market Strategy: The MSCI Morocco trades at a 70% premium to MSCI FM, which is 1.1 standard deviations above its long-term average of 53%. The value in the market is much reduced from a year ago when the premium was 44%. However, still strong fundamentals justify the valuation in our view and we keep our *overweight*.

Sub-Saharan Africa

Nigeria

Underweight (↓)

Growth is set to remain tepid this year, with election-related disruptions likely to weigh on activity.

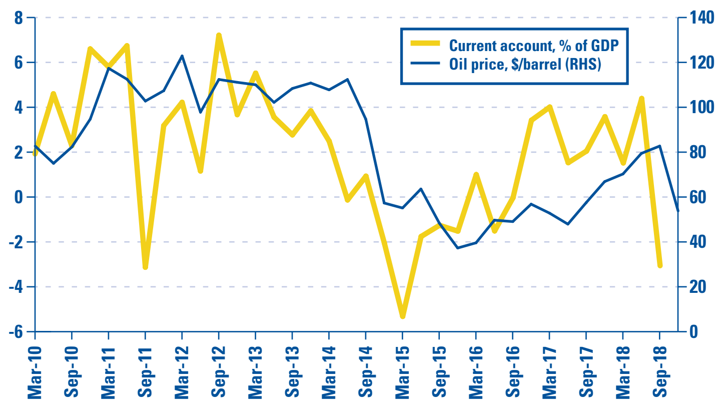
Economic activity in Nigeria remained lacklustre in the first nine months of 2018, despite the oil price rising by 24% over the period. GDP expanded by 1.5-2.0% yoy each quarter from 1Q to 3Q. Growth in Q3 (1.8% yoy) was dragged lower by contractions in the energy sector due to ongoing militant disruptions and by real estate amid delays in budget implementation that slowed construction projects. Growth in the agricultural sector, which accounts for a quarter of the economy, was also lacklustre (1.9% yoy) as output was hampered by unrest in the north of the country.

Tepid growth is also expected this year. Consensus forecasts a 2.5% yoy expansion, an acceleration from 1.9% in 2018, but this is likely to prove somewhat optimistic and the IMF projects growth of 2.0%. Activity is likely to be weighed down by uncertainty around presidential and parliamentary elections on February 16, while the oil price is down 15% yoy. Even if the oil price rallies, Nigeria is unlikely to reap the full benefit since supply disruptions are set to remain high. Moreover, while the composite PMI remains comfortably in expansionary territory (above 50) at 54.0 in January, it has fallen from 59.1 in May.

Meanwhile, inflation was stable in 2H 2018, in a narrow range of 11.1-11.4% yoy and down from a peak of 18.7% in January 2017. The deceleration was aided by favourable base effects as the July 2017 devaluation fell out of the calculation. However, CPI is still above the upper bound of the central bank's (CBN) 6-9% target range and monetary policy is therefore likely to remain restrictive. Upside price risks are centred around food prices given a high likelihood of an El Nino event this year. The CBN has kept its key rate at 14.0% since July 2016, with the fall in CPI pushing the real rate up to 2.6% in December against -1.4% a year earlier. This, combined with the Fed dialling back its tightening rhetoric, could reduce capital outflows. However, the Bank is likely to remain vigilant around the election as unrest or violence could lead to outflows.

The economic downturn since the oil price collapse in 2014-15 and subsequent lacklustre growth led to a current account surplus (2.0% of GDP estimated for 2018). This has been due to import compression amid lacklustre domestic demand, while exports have benefited from the recovery in the oil price. This year, rising imports are set to contrast with lacklustre exports, of which oil makes up 80%. Lower oil export revenue is likely to hamper the current account balance (see Chart 3) and shrink the surplus to a projected 1.0% of GDP. This may lead to renewed downward pressure on the naira, with lower oil prices also set limit FX reserve accumulation.

Chart 3: Nigeria Current Account Balance and the Oil Price



Source: CBN, Bloomberg

Fiscal accounts are healthier than a few years ago, aided by improvements in tax collection such as digitisation of parts of the process. Government revenue was 8.2% of GDP in the first nine months of 2018 compared to 5.5% in 2015. Revenues this year are likely to be hampered by a lower oil price and limited production due to both agreed OPEC+ production cuts and potential vandalisation in the Niger Delta. The figures presented for the 2019 budget were found to have inconsistencies and this has delayed its approval. In any event, the risk of fiscal slippage is significant, particularly in an election year, and leaves upside risk to the consensus projection of a 3.3% of GDP deficit in 2019.

The general elections are set to be a two-horse race between the incumbent All Progressives Congress (APC) and the opposition People's Democratic Party (PDP). President Buhari of the APC is running on a campaign based on his achievements in office to date. However, these are minimal: the Centre for Democracy and Development suggests he has only delivered seven of the 222 pledges made when he was a candidate in the 2015 election. As economic conditions have deteriorated Atiku Abubakar of the PDP is running on a platform to "Get Nigerians Working Again". Unemployment trebled since Buhari took office to 23.1% and Abubakar has also suggested privatisation of state-owned companies. Whatever the outcome, the government faces difficult conditions including tepid economic activity, reduced oil revenues and social unrest. The latter includes clashes between herdsmen in northern Nigeria and vandalisation in the Niger Delta. There is also the risk of social unrest as the electorate are disillusioned with politicians and recent state elections suggest ongoing vote buying.

Market Strategy: The MSCI Nigeria's trailing P/E is at a 46% discount to MSCI FM, two standard deviations below its long-term average of 22%. However, despite this, the market underperformed FM by 13.4% over the period. Some of this may be explained by the oil price fall, but much of the underperformance occurred while the oil price rallied between August and October. Given the lacklustre economic backdrop and policy uncertainty in an election year, we believe the market is a value trap and reduce our allocation to *underweight*.

Kenya

Underweight

Healthy growth and controlled inflation belie the country's vulnerability to external shocks.

Kenyan GDP rose by 6.0% yoy in Q3, up from 4.7% a year earlier and the full-year 2018 outturn is also estimated to be 6.0%. A combination of a recovery in the agricultural sector and the favourable base effect of suppressed activity during the 2017 elections have aided growth figures. Consensus expects growth to slow to 5.8% this year. The composite PMI augurs well for healthy growth as it was in expansionary territory (above 50) at 53.6 in December, while the KASI Consumer Confidence index was in positive territory throughout Q4.

Consumption is likely to support growth amid moderate inflation of 4.7% yoy in January, just below the mid-point of the Treasury's 2.5-7.5% target range. Inflation had accelerated from 3.7% in April to 5.7% in September following an 8% tax on fuel. The fall in the oil price in Q4 has pushed down price pressures, but monetary policy is likely to remain neutral. The central bank (CBK) kept its key policy rate unchanged at 9.0% at its January meeting, with the last change a 50bps cut in July, stating that further cuts would stoke inflationary pressures as the economy is operating at capacity.

The current account deficit is forecast to narrow from 5.6% of GDP in 2018 to 5.3% this year. This is set to come largely from reduced oil import costs and improved agricultural exports. The wide deficit and falling FX reserves leave the economy vulnerable to external risks. FX reserves have fallen from 6.4 months of imports in April to 5.3 in January.

The government projects the budget deficit will narrow to 5.0% of GDP in fiscal year 2019/20 (year to end-June 2020) from 6.3% in 2018/19. Spending is set to rise and requires a 5.0% of GDP rise in borrowing, the majority of which will be external debt. Elevated external debt could become a problem for Kenya given tightening global liquidity. The Capital Markets Authority suggested that more debt should be shilling denominated, while CBK Governor Patrick Njoroge has said that the government should look to renegotiate its debt (56.5% of GDP) to reduce the cost of servicing it.

Market Strategy: MSCI Kenya underperformed MSCI FM by 6.2% over the past six months as the post-election rally faded in 2H 2018. Economic vulnerabilities are still a concern and we believe market valuations do not fully reflect this. The trailing P/E is at a 15% discount to FM, around one standard deviation below the long-term average. In addition, downside risks to currency stem from wide twin deficits, with the IMF stating that the shilling was overvalued by 17.5%. We stay *underweight*.

Europe

Romania

Neutral (↑)

Growth is set to remain healthy, but populist measures announced leave policy uncertainty.

GDP in Romania expanded by 4.4% yoy in Q3, above market expectations of 3.7% and up from 4.1% in Q2. Growth was driven by household consumption (4.4% yoy), which accounts for around two-thirds of GDP. However, investment and net exports detracted from value added. These trends are likely to continue, contributing to a slowdown in growth towards potential. This translated to a slowdown from an estimated 4.0% yoy in 2018 to a forecast 3.5% this year.

Inflation in 2019 is expected to fall back to the upper bound of the central bank's (NBR) 1.5-3.5% target range. Part of the fall from 4.6% in 2018 is due to favourable base effects, while the lagged impact of monetary tightening should dampen price pressures. The NBR raised its key policy rate by 75bps to 2.5% in 2018. However, after leaving the policy rate unchanged at its February meeting, the Bank was dovish as it expects inflation to slow during the first three quarters of 2019, while government policy uncertainty is a downside growth risk. The NBR is likely to use its FX reserves (~five months of imports) to keep the leu stable, rather than raise the policy rate amid slowing growth and controlled inflation.

The government announced an emergency decree in December, including a so-called "greed tax" on banks and gas and electricity companies, as well as a cap on gas and electricity prices for households, effective from the start of 2019. Its impact on the budget is expected to be minimal and the deficit this year is forecast to widen slightly to 3.5% of GDP as slower growth and VAT reimbursements reduce revenues. The situation is fluid, but there were signs in January that the measures could be watered down.

External shortfalls are set to remain wide. The current account deficit is projected to be 4.0% of GDP this year, in line with that estimated for 2018. The slowdown in economic growth may suppress imports and reduce the trade deficit, while lower oil prices should also help. However, the measures in the emergency decree were populist in nature and risk reducing foreign capital inflows, which in turn could make financing the current account shortfall more of a challenge.

Market Strategy: MSCI Romania underperformed MSCI FM by 15.3% in the past six months, all of which came after the "greed tax" announcement. Valuations remain unchallenging, with the MSCI Romania's trailing P/E at a 43% discount to that of MSCI FM, 1.1 standard deviations below its long-term average, so a political risk premium appears to be priced in. Given healthy growth, controlled inflation and a prudent central bank, we raise Romania to *neutral*.

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KEY ECONOMIC AND FINANCIAL INDICATORS *(All data shown are as at end-January 2019 unless otherwise stated)*

	Frontier Market	Annual GDP Growth YoY	Quarterly GDP Growth QoQ*	Industrial Production Growth YoY	Consumer Price Index YoY	Trade Balance	Current Account	Foreign Reserves 2019 Latest	Foreign Reserves 2018 Year Ago	Currency vs $ 2019 Latest	Currency vs $ 2018 Year ago	Sovereign Rating S&P	Budget Balance % of GDP 2019F	Short-Term Interest Rates	% S&P Frontier 150 Index**	Stock Market Index (S&P Frontier 150 Index) US$	Change since 12/31/18 US$	Change since 12/31/18 Local	Trailing P/E	6 month Currency vs $ +/-
		Macroeconomic Data: % change on year ago				Latest 12 months									Market Performance					Forecast (Bloomberg)†
		%	%	%	%	$ Bns	$ Bns	$ Bns	$ Bns					%	Jan. 31, 2019	Jan. 31, 2019	%	%		
Over Weight	VIETNAM	7.1	n.a.	7.9	2.6	-4.8	12.5	56.3	38.1	23190.00	22710.00	BB-	-4.7	4.70	13.83	427.63	1.92	1.93	17.6	-
Over Weight	BANGLADESH	7.3	n.a.	30.4	5.4	-22.0	-8.7	30.0	31.3	83.66	83.23	BB-	7.5	6.21	4.69	1662.49	7.96	7.91	17.6	-
Over Weight	MOROCCO	3.0	n.a.	0.2	0.1	-21.4	-3.9	22.0	23.8	9.52	9.13	BBB-	-2.6	3.05	9.86	1165.74	-0.17	-0.77	19.3	-
Over Weight	KUWAIT	-3.5	n.a.	n.a.	0.4	33.2	-4.9	34.8	31.4	0.30	0.30	AA	5.6	1.75	15.34	1778.98	2.48	2.23	14.9	+
Neutral	ARGENTINA	-3.5	-2.8	-13.3	47.6	-3.8	-35.2	66.4	62.4	37.30	19.37	B	-3.4	43.67	17.58	2597.20	22.16	20.10	10.8	+
Neutral	BAHRAIN	1.6	n.a.	n.a.	2.0	-0.3	n.a.	1.4	3.6	0.38	0.38	B+	-6.8	3.60	3.83	2700.94	11.64	11.67	9.7	uc
Neutral	CAMBODIA	6.9	n.a.	n.a.	2.6	n.a.	172.6	12.3	10.8	4029.22	4016.23	NR	n.a.	1.40	2.57	1905.49	14.12	13.31	n.a.	-
Neutral	COTE D'IVOIRE	7.7	n.a.	n.a.	0.7	n.a.	n.a.	0.0	0.0	569.50	533.20	B+	-3.2	6.60	0.47	760.65	4.77	4.38	n.a.	-
Neutral	GEORGIA	3.8	n.a.	-3.2	1.5	-5.8	-1.3	3.1	2.8	2.66	2.48	BB-	n.a.	n.a.	1.67	1178.86	6.99	6.19	17.9	-
Neutral	JORDAN	2.0	n.a.	-5.6	3.7	-13.6	-3.7	12.9	13.0	0.71	0.71	B+	-3.0	4.00	2.99	802.68	0.58	0.48	10.9	-
Neutral	KAZAKHSTAN	4.1	n.a.	0.1	5.2	27.4	-1.2	15.8	17.5	383.14	322.49	BBB-	-0.4	15.00	2.12	120.03	13.21	13.17	6.7	+
Neutral	LEBANON	1.5	n.a.	n.a.	4.0	-15.0	n.a.	41.3	43.6	1511.10	1510.50	B-	-8.1	4.75	0.54	817.87	-5.43	-5.39	6.7	-
Neutral	MAURITIUS	3.2	n.a.	n.a.	1.8	-2.1	-44.9	5.7	5.3	33.90	32.32	n.a.	n.a.	3.55	1.53	1015.88	1.10	0.37	8.5	-
Neutral	OMAN	1.9	n.a.	0.9	0.8	13.2	-10.8	13.8	16.8	0.38	0.38	BB	-3.9	2.55	2.00	2127.98	-3.54	-3.54	7.0	uc
Neutral	PANAMA	3.6	n.a.	n.a.	0.2	-5.7	8.9	1.1	2.8	1.00	1.00	BBB	n.a.	2.2	2.84	5116.70	18.37	18.37	11.7	uc
Neutral	ROMANIA	4.4	7.6	5.2	3.3	-7.6	-58.3	36.5	38.7	4.15	3.73	BBB-	-3.5	2.91	3.87	1002.28	-13.77	-12.53	5.7	+
Neutral	SRI LANKA	2.9	n.a.	4.3	3.7	-11.6	n.a.	7.7	6.7	176.65	154.13	B	-5.0	10.85	1.16	2663.34	1.46	1.93	10.4	-
Under Weight	NIGERIA	1.8	36.2	n.a.	11.4	18.7	6.4	43.2	40.6	362.00	360.50	B	-3.3	10.15	7.10	920.59	-5.09	-5.48	6.0	-
Under Weight	KENYA	6.0	3.7	n.a.	4.7	-11.2	-45.9	9.2	8.6	100.40	101.90	B+	-6.6	7.57	4.63	3815.50	13.26	12.04	9.9	-
Under Weight	UKRAINE	2.8	1.6	-3.5	9.8	-0.5	-1.4	19.8	15.6	27.53	27.87	B-	-2.5	13.98	1.39	572.91	22.49	22.02	3.8	+

*Note: S&P credit rating shown is long-term foreign currency rating. * % change in GDP on previous quarter, annual rate.**S&P/IFCG Extended Frontier 150 Net Total Return Index. Data are the latest available, but in certain cases relate to periods more than one year ago. †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.*

Source: Bloomberg, City of London Investment Management

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