Frontier Markets Semi-Annual Outlook

February 2018

Overview

Tighter for longer

The global economic expansion has become more synchronised over the past year and this has also been the case within frontier markets (FM). Growth has rebounded in some commodity-dependent countries, like Kazakhstan, amid a recovery in prices and rising output. Elsewhere, growth has accelerated as activity in various areas like agriculture (Morocco), domestic demand (Argentina) and foreign investment (Vietnam) has been robust. In contrast, economic output in Kuwait contracted in 2017 as it cut oil production as part of the OPEC agreement, but a recovery is expected this year as consumer confidence has rebounded and spending is set to accelerate as part of the National Development Plan.

Continued easy monetary policy and benign inflation in developed economies have helped to support this trend, but a reversal is underway. Rising inflationary pressures are starting to emerge as spare capacity falls, supporting further monetary tightening. The Fed is raising rates more aggressively than a year ago and shrinking its balance sheet and the European Central Bank is reducing its monthly asset purchases. Inflation in FM has been benign as a result of tighter monetary policy (Argentina, Nigeria) and slowing food inflation, which had accelerated due to weather-related disruptions (Morocco, Kenya), implying a dovish monetary policy stance overall.

However, tighter global financial conditions leave highly indebted FMs exposed to refinancing risk. Public debt as a percentage of GDP has risen significantly in many FMs. One example is Kenya, where public debt has risen by over 10% points over the past five years to 52.7% of GDP. Recurrent spending is also taking up an increasing share of the government's budget, so debt may prove less sustainable beyond the short-term. However, the rise in public debt in Vietnam has funded infrastructure-related spending amid rising urbanisation in the country. This is likely to raise economic activity and productivity as more people move to the cities.

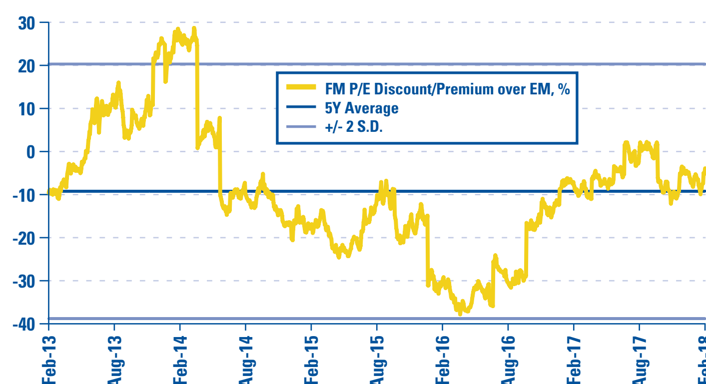
Meanwhile, external accounts in FM are being aided by the synchronised global expansion as external demand has been robust. FX reserves have been rising as a result of both rising export revenues and FDI. Thus, overall balance sheet dynamics are healthy and the asset class should be able to withstand tighter financial conditions, albeit with some exceptions like Kenya, which is increasingly reliant on short-term flows to finance its current account deficit.

At the same time, market-based reforms are continuing apace. Argentina continues to lead the way, with the government emboldened by its gains in midterm elections in October and is now pushing through reforms in areas ranging from the labour market to taxes. Morocco has also implemented measures to make its exchange rate more flexible, while Vietnam is set to ramp up its privatisation programme this year having gained momentum in H2 2017. Sri Lanka is pushing ahead with its reform agenda under IMF supervision. Such structural reforms augur well for medium-term growth prospects in FM.

Market Strategy

Tighter financial conditions are set to be a headwind for some FMs, but we expect the asset class to be resilient given strong and improving economic fundamentals. Valuations remain unchallenging, with the FM P/E trading close to its long-term average of a 9% discount to emerging markets (see Chart 1). The attractiveness of FM from an income perspective also remains, with a dividend yield of 3.0% against 2.3% for EM.

Chart 1: FM Valuations



Source: Bloomberg

Political risks last year were resolved favourably in the case of Argentina, which we keep at overweight amid ongoing reform momentum. However, political and economic problems have risen in Kenya after disputed election results, so we stay *underweight*. We make a few changes to our allocation:

- Political headwinds are likely in Nigeria, which we keep as an *underweight* given presidential and parlimentary elections in February 2019 as well as rising tensions in the Niger Delta.
- Tensions in Bangladesh may also rise in the build up to January 2019 parliamentary election. This, combined with rising twin deficits, lead us to downgrade the market to *neutral*.
- Economic vulnerabilities in Romania ranging from slowing growth to widening twin deficits mean we reduce our allocation to *underweight*.
- Reforms and improved growth are likely in Sri Lanka under the IMF programme and we raise our exposure to *overweight*.
- A recovery in activity in Kuwait is expected this year, with consumer and business sentiment improving and capital spending set to expand so we raise our allocation to *neutral*.

Authorised and regulated by the Financial Conduct Authority. Registered as an Investment Advisor with the SEC. Regulated by the DFSA. Registered Office: 77 Gracechurch Street London EC3V 0AS

Latin America

Argentina

Overweight

The midterm election victory for Cambiemos suggests an appetite for continued reform.

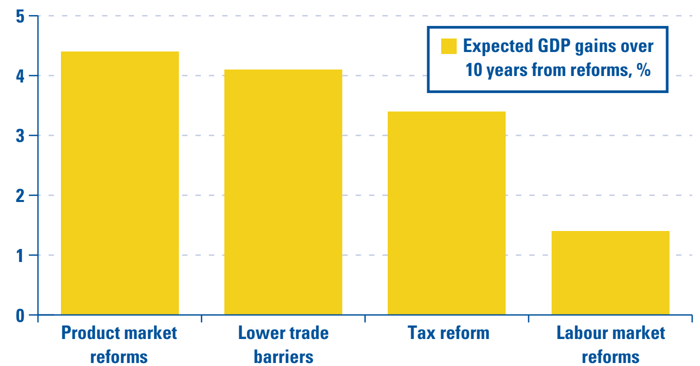
In midterm elections in Argentina in October the ruling Cambiemos ("Let's Change") coalition won 40% of the national vote and the opposition Unidad Ciudadana coalition won 21%. This meant that Cambiemos increased its representation in the lower house from 86 seats to 107 (out of a total of 257) and in the upper house from 15 to 24 (out of 72). There appears to be significant support among the electorate for President Mauricio Macri's reform agenda as the result comes after painful policies such as reduced subsidies and exchange rate liberalisation, which led to a surge in inflation. Future policy proposals may need to be watered down given Cambiemos' lack of a majority in either house, but the result was a clear boost to pursuing further market-based reforms.

However, the glow of the victory was short-lived. In December, the government's approval rating fell to 44%, the lowest since Cambiemos took office in December 2015 and 10% points down a year earlier. In the same month, there were violent street protests as the pension reform bill was passed by Congress. This reform changes the pension calculation from a twice-yearly one based on wages and taxes to a quarterly one adjusted by inflation plus 5% points and is expected to reduce government spending by 0.6% of GDP annually. This could mean that government meets its 3.2% of GDP primary deficit target this year (down from an estimated 3.9% in 2017). Given falling inflation, some retirees felt aggrieved, but lower payments next year are set to be offset by a one-off payment.

A tax bill was passed in December, including a 10% point reduction in the corporate tax rate over five years to 25%. Other reforms such as those related to the labour market are stalling, illustrating the difficult nature of reaching a consensus. In February, the government announced it would be scaling back planned labour reforms. This set of reforms included a labour amnesty for companies to move informal workers into the formal sector, thus broadening the tax base, and a reduction in social security payments for employers. After negotiations with unions and the opposition, the labour measures will be sent to Congress in two or three bills in March. Overall, reform progress has been positive and the sense of urgency to push ahead with them remains, suggesting momentum could continue.

Meanwhile, GDP has continued its recovery from the 2016 contraction (-2.3% yoy). Economic output rose by 4.2% yoy in Q3, the fastest pace since 2013 and was driven by robust domestic demand (8.4% yoy). Investment expanded by 13.9% yoy as construction accelerated. Growth is forecast to rise from an estimated 2.9% in 2017 to 3.3% this year and next, which would complete three consecutive years of growth for the first time since the crisis. In the medium-term, the OECD estimates that more structural reforms could raise GDP growth by 1.5% points annually.

Chart 2: Argentina GDP Gains Reforms, %



Source: OECD

Robust domestic demand is having an adverse impact on external accounts. In Q3, exports rose by 2.1% yoy after a 1.2% yoy contraction in Q2, but import growth accelerated from 9.1% in Q2 to 18.7%. As a result, the current account deficit has risen from 2.7% of GDP in 2016 to an estimated 4.0% in Q3 and is set to widen further to 4.5% this year. Exports are likely to be hampered by the 4.6% rise in the real effective exchange rate last year. The current account shortfall has been financed by debt, for which there has been robust demand, as illustrated by $9 bn of bond sales in January that were 2.4x oversubscribed and sold at record low yields (10Y bonds at 6%) and covered around a third of the government's funding needs and half of infrastructure spending for 2018.

Although inflation has receded significantly from 47.2% yoy in July 2016 following the peso depreciation to 24.8% in December 2017, it remains elevated in part due to ongoing subsidy cuts. The central bank (BCRA) set its inflation target at a more realistic 15% this year, up from the previous target range of 8-12%. This could allow room for easier monetary policy, with the Bank cutting its policy rate in December and January by a total of 75bps to 26.5%. However, BCRA is likely to tighten policy this year and, combined with a stronger peso and rising real rates, is set to bring inflation down below 20%.

Market Strategy: The MSCI Argentina rose by 72.3% in USD terms in 2017, its best performance in price terms since 2003. Returns were supported by continued reform implementation and signs of economic imbalances being addressed. Looking ahead, 2018 is likely to be another year of healthy returns, supported by similar factors to those in 2017. The market's forward P/E trades in line with FM against an average of a 12% premium since Macri's victory in 2015. We believe that the market offers good value and keep our *overweight*.

Middle East and North Africa

Kuwait

Neutral (↑)

Robust capital spending and improved sentiment are set to drive a growth rebound in 2018.

GDP growth in Kuwait in the oil and non-oil sector diverged in 2017, with overall economic output contracting by an estimated 2.1% yoy. Production cuts in the oil sector led to a 4.5% fall in output, but the 50% rise in the oil price since June should lead to a rebound in output this year. Capital spending related to the Kuwait National Development Plan led non-oil activity to expand by 3.0% in 2017 and this is set to continue in 2018. GDP is projected to rise by 2.1% yoy as both the oil (3.5%) and non-oil (1.1%) sectors expand. A recovery in household consumption, with the consumer sentiment index rising to its highest level since 2015, and a recovery in the real estate market should also be supportive.

Inflation has risen recently, from a low of 0.5% yoy in September to 1.1% in December, but remains low by historical standards. Utility price rises are expected to accelerate inflation, with CPI forecast to rise by 2.8% in 2018. However, the central bank will not necessarily mirror the Fed as it may want to keep credit growth healthy (estimated to be 8% this year).

The fiscal deficit is set to remain around 10% of GDP this year and next as government spending is set to rise. This puts more onus on the government to push through tax reforms to raise revenues. However, the proposed introduction of a value added tax and a corporation tax, estimated to reduce the deficit by 2-3% points of GDP, have stalled. Elsewhere, the authorities have shown more willingness to progress reforms in relation to capital markets. "New Kuwait 2035", which includes 164 development programmes and seven pillars for investment and improvement, has also reinvigorated business confidence. These trends are likely to facilitate more private sector involvement in the economy.

Meanwhile, the current account is estimated to have moved back into surplus in 2017 (0.1% of GDP), but may fall into small deficit in 2018 as the higher oil price is likely to be counterbalanced by rising imports amid increased capex. External buffers remain substantial, with the sovereign wealth fund's assets amounting 450% of GDP, much of which is held in liquid investments.

Market Strategy: Kuwait's P/E trades at a 3% discount to FM, one standard deviation below the five-year average of a 25% premium. This is also low when compared to the average of the period since the oil price began to fall (16% premium). Unchallenging valuation levels combined with an improving economic backdrop mean we upgrade our weight from *underweight* to *neutral.*

Morocco

Overweight

Morocco has continued to implement structural reforms, improving medium-term prospects.

Morocco's economic rebound in 2017 was driven mainly by agriculture (15% of GDP). GDP rose by an estimated 4.8% yoy against 1.2% in 2016. Agricultural activity expanded by 16.1% yoy after a 12.8% contraction in 2016, with the recovery aided by improved productivity since the launch of the "Maroc Vert" plan in 2008. A slowdown in economic activity to 3.1% is forecast for 2018 as agricultural sector growth normalises. Investment is also expected to be supported by the new Industrial Action Plan, which is set to create over 300K jobs through 2020, while joint ventures with foreign partners are also expected to boost activity.

Improved conditions in the agricultural sector are expected to reduce food prices, thereby keeping inflation low at 1.0% yoy for 2018 against 1.9% in December, allowing for continued accommodative monetary policy. At its December monetary policy meeting, Bank Al Maghrib kept its key rate at 2.25%, unchanged since March 2016. Fiscal consolidation should also help keep inflationary pressures low. The budget deficit is projected to fall from an estimated 4.1% of GDP in 2017 to 3.5% this year.

Fiscal decentralisation, reform of the civil service, more targeted social spending and improved SOE supervision will likely make spending more effective in the medium term. In the meantime, lower budget deficits are allowing for a reduction in government debt, which fell to 63.0% of GDP in 2017 from 64.7% in 2016.

External accounts are healthy and improving. The current account deficit is expected to fall from an estimated 4.4% of GDP in 2017 to 3.9% in 2018 amid accelerating exports as Eurozone growth rises and reduced food imports. Rising tourist numbers (10% yoy for January to November 2017) have also boosted foreign receipts. Although energy imports contribute to the deficit, some of this shortfall is being addressed by capacity buildout of renewable energy, from which the country aims to obtain 42% of its energy requirements by 2020.

Market-based reforms are also taking place, with a move towards a more flexible exchange rate regime announced in January. The dirham will be allowed to fluctuate within a 2.5% band, up from 0.3% previously, of the central bank's reference rate (60% euro, 40% USD). This will likely allow greater ability to absorb external shocks. The country also has a healthy level of FX reserves of approximately seven months of imports.

Market Strategy: Morocco's relative valuations are unchallenging, with the trailing P/E at a 43% premium to FM and in line with its five-year average. Given healthy fundamentals and ongoing structural reform, we see further upside and stay *overweight*.

Asia

Vietnam

Overweight

Growth is expected to remain strong this year and a ramp up in privatisations is set continue the move towards becoming a more market-based economy.

Economic growth in Vietnam picked up pace in 2H17, expanding by 6.7% yoy and up a full percentage point from that of 1H, driven by rising oil production and accelerating growth in the manufacturing sector. Private consumption also helped, with retail sales rising by a monthly average of 10.5% yoy in 2H against 9.6% in 1H. However, a partial reversal of these trends is likely to pare growth back to a forecast 6.6% this year, down from 6.8% in 2017. Industrial production rose by 20.9% yoy in January, a five-year high, and this bodes well for GDP growth (see Chart 3).

Inflation remains low, both in absolute terms and by historical standards. Consumer prices rose by 2.7% yoy in December, while core prices rose by just 1.3%, suggesting minimal underlying inflationary pressures. This compares to a 10Y average of 7.0% for the headline rate. Some of the fall in the past year has been due to lower prices of food (40% of the CPI basket) due to one-off factors. However, the fall in food prices in recent years also has a structural element as supermarkets are increasingly sourcing food directly from farmers, cutting out wholesalers who typically mark up prices by 20-40%.

Low price pressures and a stable currency enabled State Bank of Vietnam (SBV) to cut its key policy rate by 25 bps to 6.25% in July 2017, the first change since 2014. Nevertheless, with CPI set to accelerate to 3.8% this year as fuel, electricity and food prices rise, monetary policy from SBV could turn hawkish given that the Federal Reserve is also tightening policy.

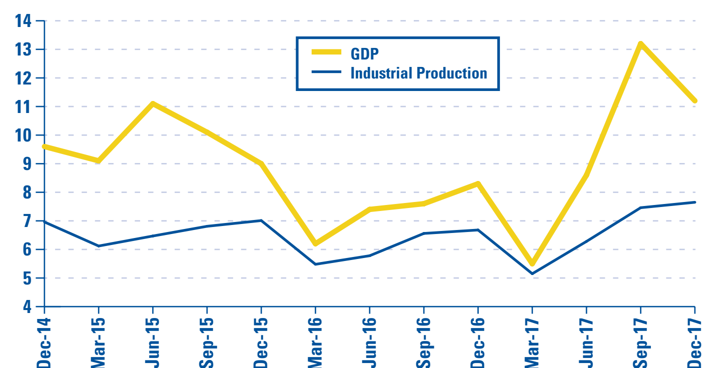
The manufacturing sector (15% of GDP) is a key growth driver and is being boosted by investment from South Korean companies, with Samsung alone accounting for 20% of Vietnam's exports. Samsung's halting of production of its Note 7 smartphone was a key drag on exports and economic growth in 1H. Rising foreign investment is a trend that is set to continue due to Vietnam's comparative advantages including: 1) low cost labour (US$2.38/hour against US$4.99/hour for China) that is well educated and 2) geographical proximity to China and key shipping routes means production can be easily integrated into the global supply chain. Buoyant manufacturing exports, which account for nearly half of total exports, augur well for external accounts. Robust domestic demand should also result in a strong expansion in imports, but the trade balance is expected to remain in surplus. This is forecast to drive a 1.1% of GDP current account surplus in 2018, down slightly from 1.3% in 2017.

Robust FDI inflows and overseas remittances, up 16% yoy in 2017, have pushed FX reserves to a historical high of $54.5 bn. Locals are also increasingly converting USD holdings into Vietnamese dong as confidence in the currency rises amid low and controlled inflation. This provides an improved buffer against external shocks. A further boost in the medium-term is set to come from free trade agreements, like the one pending with the EU that is expected to be approved later in 2018. The revised Trans-Pacific Partnership (TPP) following the US withdrawal in 2017, is due to be approved in 1H and includes Australia, Canada, Japan, Malaysia and Mexico. The new agreement, known as the TPP 11, was approved by member states in January and is due to be signed in March.

Foreign inflows have also risen as the government's privatisation programme has begun to pick up pace. In November, the government announced plans to sell up to 54% of brewer Sabeco. Other measures, such as allowing a book building for IPOs and reduced restrictions on strategic partners, should expedite the process. The government is aiming to make divestment from 181 SOEs and 64 IPOs, more aggressive than last year's targets. Early signs are positive, with the IPO of PV Oil, a unit of PetroVietnam, in January 2.3x oversubscribed.

Progress on privatisation is expected to help limit public debt, which is has risen to 61.3% of GDP and closing in on the 65% constitutional limit. The budget deficit is expected to remain at 3.7% of GDP this year, consistent with the National Assembly's target for 2016-2020 of less than 3.9%. Government revenues are benefitting from robust FDI and related taxes, as well as rising income tax as an increasing proportion of the workforce is being employed by the private sector. The 7.0% increase in public sector wages this year and rising interest payments on Official Development Assistant loans as Vietnam moves into its first year of "transitional support" are likely to offset revenue gains

Chart 3: Vietnam Activity, % yoy



Source: Bloomberg

Market Strategy: The MSCI Vietnam's P/E trades at a 91% premium to FM, 1.1 standard deviations above its long-term average (52%). However, given strong fundamentals and ongoing market-based reforms, we view valuations as reflecting the quality of the market, so we keep our *overweight*, albeit at a reduced level.

Bangladesh

Neutral (↓)

Growth is set to remain healthy, but the 2019 election and rising twin deficits are significant risks.

GDP growth in Bangladesh has remained strong at around 7.2% for fiscal year 2017 (FY17, year to end-June 2017). Exports are set to continue to drive growth as global demand stays healthy and the rebound in the oil price should aid a recovery in remittances from the GCC. This, combined with double digit credit growth, is forecast lead to a growth out turn for FY18 similar to the previous 12 months, with the government targeting 7.4%.

Inflation rose from 5.0% yoy in December 2016 to 5.8% a year later as a result of food inflation due to floods. However, underlying inflationary pressures fell, with non-food inflation nearly halving over the period from 7.1% to 3.9%. Bangladesh Bank (BB) is targeting 5.5% inflation for FY18, but the Bank is likely to remain diligent given upward price pressures from robust domestic demand and credit expansion, rising oil prices and the depreciation of the taka (5% yoy vs. USD). This was illustrated in January when BB said it would take steps to limit "over exuberance in lending".

However, a key risk for policy prudence is the parliamentary election scheduled for January 2019. The ruling Awami League under Prime Minister Sheikh Hasina are likely to win given that the party has 274 out of 350 seats in parliament and exerts strong over the media, with criticism of the government increasingly suppressed. The opposition Bangladesh Nationalist Party are in a weak position and its leader Khaleda Zia was convicted of corruption and sentenced to five years in jail in February. One risk is that this suppression leads to social unrest and causes disruption to activity. Meanwhile, the budget deficit is likely to widen as spending rises in the lead up to the election, even though the government projects a deficit for FY18 and FY19 unchanged versus FY17 at 5.0% of GDP.

External accounts have deteriorated due to a combination of slowing export growth due to taka strength, robust import growth amid strong domestic demand, falling remittances as a result of a slowdown in the GCC and rising costs of sending money due to increased regulatory requirements. This pushed the current account into a deficit (0.7% of GDP) in FY17, which is set to widen further to 1.2% in FY18. Downward pressure on the currency is thus set to remain, but healthy FX reserves (seven months of imports), mean the taka will likely fall gradually.

Market Strategy: Valuations for the MSCI Bangladesh are unchallenging, with the trailing P/E trades at a 47% premium to FM, below the five-year average of 62%. However, risks around the election, a potentially widening budget deficit and deteriorating external accounts pose significant downside risks to the currency. We thus reduce our weight from *overweight* to *neutral*.

Sri Lanka

Overweight (↑)

Reforms under the IMF programme are improving the country's outlook.

Growth in Sri Lanka last year, estimated at 4.7%, was driven by consumption and investment, which more than compensated for a negative trade contribution. The latter was due to strong imports amid lacklustre agriculture exports due to adverse weather conditions. Strong domestic demand is expected to lead to a similar growth outturn for 2018, but economic reforms could begin to bear fruit next year and push growth up to 5.0%.

Bad weather pushed up consumer prices, which rose by 7.1% yoy in December up from 4.5% a year earlier and likely hampered growth last year. However, with weather-related problems set to dissipate this year, inflation is expected to fall back to 4.5% and will likely to be growth supportive. This would be in line with the 4-6% inflation target range proposed under the "Flexible Inflation Targeting" to be implemented by the central bank by 2020. However, the Bank is likely to keep a hawkish tilt, after a 25 bps hike in March 2017, due to robust credit growth.

Meanwhile, the three-year IMF programme that began in 2016 is progressing well, with reforms being undertaken. The Inland Revenue Act (IRA), due to be implemented from April 2018, is a significant reform as it makes the tax system more efficient and allows for more broad-based revenue collection. The government expects the IRA to add 0.5% of GDP to revenues and the IMF forecast it could raise up to 2.0% of GDP in the medium term. This should allow for a stabilisation of and eventually a decline in government debt, which has risen by 10 percentage points in the past five years to 80% of GDP. Further progress on privatisations, one of the the IMF's recommendations, would help alleviate pressure on the government's SOE liabilities (11.9% of GDP).

The current account deficit is set to fall to 2.0-2.5% of GDP this year and next, from an estimated 3.0% in 2017. Last year's deficit widened due to rising food and fuel imports amid the floods. Revenues from tourism and remittances were lacklustre, the latter due to the slowdown in the GCC (over 60% of inward remittances to Sri Lanka come from the region). As agricultural production recovers, external accounts are set to benefit. FDI is likely to remain robust amid continued infrastructure investment from China, which should ease pressure on external accounts and the rupee. FX reserves also have risen to $6.5 bn (3.8 months of imports), from $5.1 bn a year earlier, providing a stronger buffer against external shocks.

Market Strategy: Valuations for the MSCI Sri Lanka are attractive, with the P/E at a 29% discount to FM and close to two standard deviations below the five-year average (23% premium). Given the healthy growth backdrop and reform momentum under IMF supervision, we view the market as attractive and upgrade our weight to *overweight*.

Sub-Saharan Africa

Nigeria

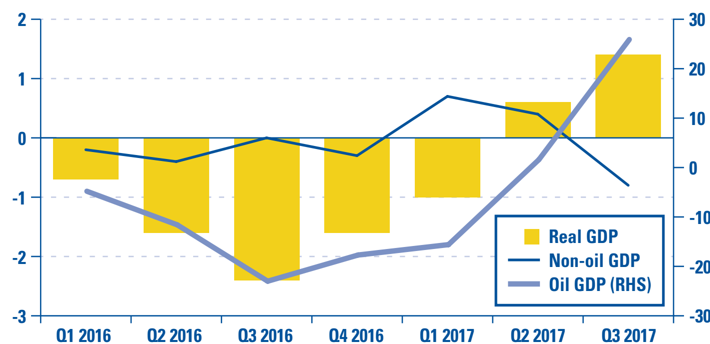
Underweight

The economic recovery has gained momentum, but risks to growth are rising due to tensions in the Niger Delta and elections in 2019.

Nigeria's economy has begun to recover from the oil-related recession in 2015-16. After five consecutive quarters of negative yoy growth, GDP rose by 0.7% in Q2 and double that rate in Q3. This has been driven by a recovery in oil prices and production, with output surging 25.9% yoy. Oil output in the Niger Delta rose to 2.0mn barrels/day in Q3, in line with the 2014-15 average and up from a low of 1.4mn a year earlier amid stability in the region, with no major attacks in the Delta region since January 2017 as militants agreed to a truce in August 2016.

The oil sector accounts for 10% of GDP and its exemption from OPEC cuts means the country could continue to benefit from the higher oil price. This is set to drive accelerated GDP growth of a forecast 2.6% yoy this year, up from an estimated 0.8% in 2017. Nevertheless, oil output faces significant downside risks from the Niger Delta Avengers after it ended its ceasefire in November and in January stated that it would attack operations of deep sea multinationals. Non-oil sector growth has been lacklustre and contracted by 0.8% yoy in Q3, led by manufacturing (-2.9% yoy). Output in the services sector (48.3% of GDP) posted a broad-based 2.6% yoy contraction.

Chart 4: Nigeria's Economic Growth, % yoy



Source: World Bank, PWC

Demand for services has likely been hampered by still-elevated inflation. CPI rose by 15.4% yoy in December against 18.5% a year earlier. As a result, the Central Bank of Nigeria (CBN) tightened policy, with the Bank withdrawing liquidity from the market. Governor Godwin Emefiele said in November that he expected inflation to "moderate so rapidly" by Q1 2018 that the CBN would ease. However, price pressures are set to remain amid ongoing problems in the north east, which is a large food producer, and the incomplete pass through of higher oil and electricity prices and so, monetary easing may not be forthcoming in 1H.

Meanwhile, the CBN's monetary policy committee did not meet as scheduled in January after the Senate failed to approve the president's nominees amid disagreements on other policy issues such as the budget. This shows that political differences are beginning to impact policy implementation, though the members are expected to be confirmed prior to the next meeting in March.

External accounts are likely to remain in surplus as a result of recovering oil exports and weak import demand. The current account surplus is forecast to be 1.0% of GDP in 2018 down from estimated 1.9% in 2017. The introduction of the Investors and Exporters Foreign Exchange window in April 2017 helped to alleviate pressure on importers and, combined with rising oil export proceeds, led to increased foreign reserves, providing a support against external shocks. FX reserves stood at $40.6 bn (14 months of imports) at the end of January, up from $28.1 bn a year earlier, but improving import demand and a potential disruption to oil exports may lead to a reduction this year.

Fiscal policy is set to remain expansionary and the budget deficit is likely to remain around the same level as 2017, estimated at 3.0% of GDP. However, as with monetary policy, political gridlock has hampered progress and is only likely to worsen with presidential and parliamentary elections less than a year away. Various MPs are seeking to fund projects in their constituencies prior to the February 2019 elections, with a third of spending in the 2018 budget to be allocated to infrastructure investment. The Economic and Financial Crimes Commission's case against Senate President Bukola Saraki for false declaration of assets is also a cause of friction that could hold up the approval of the budget.

President Buhari and his government have nevertheless made some progress with its reform agenda. In January, the Senate approved the first pillar of the Petroleum Industry Bill (PIB). Specifically, the Petroleum Industry and Governance Bill (PIGB), which clarifies "the rules and procedures that govern the oil and gas sector" and will create four new entities that will have powers including conducting bidding and awarding licenses for exploration. This is significant progress as it is the first time that both the upper and lower house have passed the same version of a bill related to the PIB. The other sections include the Petroleum Industry Fiscal Bill, which could make it more attractive for foreign companies to invest. These reforms could improve the outlook for the oil and gas sector in Nigeria, help remove structural deficiencies and raise the country's growth potential.

Market Strategy: The MSCI Nigeria's P/E trades at a 19% discount to FM, just below the five year average of 16%. However, given rising political risks going into the February 2019 elections and significant downside risks to activity from tensions in the Niger Delta, we stay *underweight*.

Kenya

Underweight

Growth is set to accelerate this year, but wide twin deficits remain an unaddressed weak spot.

Kenya's economic growth is likely to pick up in 2018 following a tumultuous 2017 due to the political calendar. Specifically, the August presidential and parliamentary elections, the rerun of the presidential election in October and associated violence and uncertainty helped push Q3 GDP growth down to 4.4% yoy. However, the end of the election season is likely to lead to improved business and consumer confidence. The agricultural sector is also recovering from the droughts in 2H16 and 1H17, which is expected to raise GDP growth from an estimated 5.0% in 2017 to 5.6% in 2018.

Inflationary pressures due to the droughts have subsided, with CPI rising by 4.5% yoy in December down from a peak of 11.7% in May. This year, inflation is set to face downward pressure from rising food production, but upward pressure due to higher oil import costs. Overall, consumer price rises are likely to remain close to the midpoint of the Central Bank of Kenya's 2.5-7.5% target range, with a rise of 5.4% forecast for 2018. As a result, the central bank is unlikely to change its policy rate.

The recovery in food production is also set to improve the current account deficit, which had widened to 6.4% of GDP in 1H17. A reduction in food imports is expected to boost the trade balance. However, rising oil and infrastructure-related imports are likely to offset this and the current account balance is expected to widen towards 7.0% of GDP in 2018. The wide shortfall is problematic in that it is increasingly being financed by short-term flows, whereas FDI has been subdued (0.6% of GDP).

Fiscal policy is set to be less expansionary than that of 2017, when the elections led to increased spending. The budget deficit is forecast to fall from an estimated 8.5% of GDP in 2017 to 7.2% this year. Government spending has risen to 27.4% of GDP, up from 23.7% five years ago. It has thus become a more important growth driver and in the absence of a matching rise in revenue collection means that the deficit is likely to remain wide. This is also raising credit risk, with recurrent spending takes up 90% of government revenues. Thus, spending on other areas like infrastructure requires increased debt, which could crowd out private credit. Public debt in the past five years has risen by over 10% points to 52.7% of GDP.

Market Strategy: The MSCI Kenya trades at a 5% discount to FM, comfortably below the five-year average of a 10% premium. Market performance picked up after the October rerun and the index is above the level reached prior to the annulment of the presidential election. However, weak balance sheet dynamics are a significant risk to USD returns and we stay *underweight*.

Europe

Romania

Underweight (↓)

Economic growth is set to slow as inflation rises and the twin deficits widen, raising vulnerabilities.

Romania's economy has continued to post stellar growth, with GDP rising by 8.8% yoy in Q3 after 6.1% in Q2 and 5.7% in Q1. The latest figure is around three times the estimated potential growth rate of 2.5-3.0% and the expansion is being driven by private consumption. This has been supported by strong real wage growth, which was 10.2% yoy in November. However, GDP growth is expected to slow this year to 4.1%, from an estimated 6.5% in 2017, as inflation begins hamper consumption.

Price pressures have already begun to rise. CPI rose by 3.3% yoy in December, up from deflation of -0.5% a year earlier, due to leu depreciation and higher oil and administered prices. As the favourable base effects of the Q1 2017 tax cuts fade, CPI is set to rise above the upper bound of the National Bank of Romania's (NBR) 1.5-3.5% target range in 1H. As a result, at its January meeting the NBR raised its key policy rate by 25bps to 2.0%, the first rise since the financial crisis, and followed with the same at its February meeting. More hikes are likely, with Governor Isarescu sounding hawkish after both meetings as recent inflation data has been above NBR forecasts.

Meanwhile, the twin deficits are set to widen further this year and this could weaken the leu, particularly since the central bank stated at its November meeting that it aims to reduce interest rate volatility and would accept increased leu volatility to achieve this if necessary. The current account deficit is forecast to widen from an estimated 3.1% of GDP in 2017 to 3.5% in 2018 as rising exports amid improved Eurozone growth are likely to be offset by robust import demand.

Although the 2017 budget deficit is estimated at 3.0% of GDP, the limit under the EU Stability and Growth Pact, it was only one-off measures such as special dividends from state-owned companies that prevented it from moving above this level. In November, the European Commission warned Romania that an annual 0.8% of GDP reduction would be needed to avoid triggering "excessive deficit procedures" whereby corrective actions are required. If measures are not undertaken after several warnings, Romania could then face economic sanctions. The 2018 budget was signed into law in January and projects the deficit to be 3.0% of GDP. However, this is based on growth remaining robust at 5.5%, 1.4% points above private sector forecasts.

Market Strategy: The MSCI Romania's P/E relative to FM is 1.5 standard deviations below its five-year average. However, with growth set to slow, inflation accelerating and the twin deficits widening, we see further downside risk and downgrade Romania from *neutral* to *underweight*.

The information contained herein is obtained from sources believed by City of London Investment Management Company Limited to be accurate and reliable. No responsibility can be accepted under any circumstances for errors of fact or omission. Any forward looking statements or forecasts are based on assumptions and actual results may vary from any such statements or forecasts.

KEY ECONOMIC AND FINANCIAL INDICATORS *(All data shown are as at end-January 2018 unless otherwise stated)*

Weight	Frontier Market	Macroeconomic Data: % change on year ago: Annual GDP Growth YoY	Quarterly GDP Growth QoQ*	Industrial Production Growth YoY	Consumer Price Index YoY	Latest 12 months: Trade Balance	Current Account	Foreign Reserves 2017 Latest	Foreign Reserves 2016 Year Ago	Currency vs $ 2018 Latest	Currency vs $ 2017 Year ago	Sovereign Rating S&P	Budget Balance % of GDP 2018F	Short-Term Interest Rates	Market Performance: % S&P Frontier 150 Index***	Stock Market Index (S&P Frontier 150 Index) US$	Change since 12/31/17 US$	Change since 12/31/17 Local	Trailing P/E	Forecast (Bloomberg)†: 6 month Currency vs $ +/-
		%	%	%	%	$ Bns	$ Bns	$ Bns	$ Bns					%	Jan. 31, 2018	Jan. 31, 2018	%	%		
Over Weight	SRI LANKA	3.3	n.a.	6.0	7.1	-9.6	n.a.	6.5	5.1	154.25	150.63	B+	-4.8	11.54	1.20	3278.72	7.64	13.38	10.6	-
Over Weight	ARGENTINA	4.2	3.6	0.3	24.8	-7.5	-25.8	62.0	46.9	19.46	15.77	B+	-5.5	21.00	16.56	3635.61	10.74	15.38	21.7	-
Over Weight	MOROCCO	3.8	n.a.	0.2	1.9	-19.2	-6.8	22.8	23.8	9.15	10.00	BBB-	-3.0	3.11	9.69	1344.51	6.40	4.02	21.9	-
Over Weight	VIETNAM	6.8	n.a.	20.9	2.7	-4.8	2.8	39.2	34.8	22710.00	22594.00	BB-	-3.7	4.86	18.39	518.97	13.37	13.38	17.6	-
Over Weight	PANAMA	5.4	n.a.	n.a.	0.5	-3.6	7.5	2.7	3.4	1.00	1.00	BBB	n.a.	2.21	3.48	7295.99	4.35	4.35	16.9	uc
Neutral	BAHRAIN	3.6	n.a.	n.a.	1.4	-0.3	n.a.	3.4	1.5	0.38	0.38	B+	-10.0	2.13	3.47	2704.73	3.92	3.92	7.2	uc
Neutral	BANGLADESH	7.3	n.a.	30.4	5.8	-15.3	-4.6	31.3	30.3	82.90	78.33	BB-	6.9	5.70	4.61	1843.63	-2.69	-2.54	22.3	-
Neutral	CAMBODIA	6.9	n.a.	n.a.	2.7	n.a.	171.1	10.9	8.3	4015.00	4027.00	NR	n.a.	1.49	1.45	1229.07	5.56	5.05	n.a.	-
Neutral	COTE D'IVOIRE	8.3	n.a.	n.a.	0.7	n.a.	n.a.	0.0	0.0	526.45	613.92	BB-	-4.1	6.60	0.57	1046.34	-0.65	-4.23	n.a.	-
Neutral	GEORGIA	4.7	n.a.	6.2	4.3	-5.3	-1.4	2.8	2.6	2.46	2.67	BB-	n.a.	n.a.	1.93	1634.91	5.27	1.02	22.0	-
Neutral	KAZAKHSTAN	4.3	n.a.	5.4	6.8	17.6	-7.5	17.8	19.4	322.58	322.01	BBB-	-1.6	15.0	3.86	175.96	-0.26	-3.02	10.0	-
Neutral	KUWAIT	-2.1	n.a.	n.a.	1.1	21.1	5.9	30.1	30.0	0.30	0.30	AA	-7.7	1.82	12.39	1582.89	3.54	2.80	14.9	-
Neutral	LEBANON	1.8	n.a.	n.a.	5.0	-15.0	n.a.	43.6	42.5	1508.50	1514.05	B-	-8.9	3.31	1.07	1051.51	5.79	5.59	8.5	-
Neutral	OMAN	0.0	n.a.	-1.2	1.7	4.4	-12.3	16.8	19.4	0.39	0.39	BB	-9.8	1.0	1.92	2296.90	0.20	0.18	8.0	uc
Under Weight	NIGERIA	1.4	35.9	n.a.	15.4	9.6	7.4	40.6	28.1	360.50	315.25	B	-2.7	11.24	9.40	1343.31	18.54	18.70	11.3	-
Under Weight	ROMANIA	8.8	10.6	9.5	3.3	-7.6	-38.6	38.7	34.8	3.72	4.20	BBB-	-3.6	1.78	4.36	1298.86	13.86	9.30	7.9	-
Under Weight	KENYA	4.4	1.6	n.a.	4.8	-10.4	-45.9	6.9	7.9	101.30	103.75	B+	-7.2	7.82	4.29	4174.72	9.50	8.28	13.9	-
Under Weight	UKRAINE	2.1	0.8	-0.5	13.7	-0.5	-1.4	15.6	11.9	27.71	27.10	B-	-2.8	9.06	1.36	645.74	7.16	6.19	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

CITY OF LONDON
Investment Management Company Limited

Contacts

Macroeconomic Analysis

Michael Hart, London Office
Phone: 011 44 207 711 1558
Fax: 011 44 207 711 0774
E-Mail: michael.hart@citlon.co.uk

Lyndon Barreto, CFA, London Office
Phone: 011 44 207 711 1551
Fax: 011 44 207 711 0774
E-Mail: lyndon.barreto@citlon.co.uk

Mike Liu, CFA, London Office
Phone: 011 44 207 860 8318
E-Mail: mike.liu@citlon.co.uk

London Office
77 Gracechurch Street
London EC3V 0AS
United Kingdom
Phone: 011 44 20 7711 0771
Fax: 011 44 20 7711 0772
E-Mail: info@citlon.co.uk

Philadelphia Office
The Barn, 1125 Airport Road
Coatesville, PA 19320
United States
Phone: 610 380 2110
Fax: 610 380 2116
E-Mail: info@citlon.com

Seattle Office
Plaza Center
10900 NE 8th Street, Suite 1519
Bellevue, WA 98004
United States
Phone: 610 380 2110

Singapore Office
20 Collyer Quay
10-04
Singapore 049319
Phone: 011 65 6236 9136
Fax: 011 65 6532 3997

Dubai Office
Unit 2, 2nd Floor
The Gate Village Building 1
Dubai International Financial Centre
P.O. Box 506695, Dubai, United Arab Emirates
Phone: 011 971 4 249 8402
Fax: 011 971 4 437 0510

Website

www.citlon.co.uk

Important Notice

City of London Investment Management Company Limited is authorised and regulated in the UK by the Financial Conduct Authority, registered as an Investment Advisor with the United States Securities and Exchange Commission and regulated by the Dubai Financial Services Authority.

While City of London Investment Management Company Limited has used reasonable efforts to obtain information from reliable sources, no representations or warranties as to the accuracy, reliability or completeness of third party information presented herein is made.

This document is not an offer to buy or sell securities and should not be construed as investment advice. Past performance is not a guide to future returns. The value of an investment and any income from it can go down as well as up and investors may not get back the original amount invested. From time to time, City of London Investment Management Company Limited may implement Fair Value Pricing to value underlying holdings within a portfolio. Such circumstances are outlined in the firm's Fair Value Pricing Policy document which is available upon request.