Frontier Markets equity:
One-on-one with the Portfolio Managers

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Key takeaways:

- Frontier Markets (FM) had a challenging 2018, driven by global factors and unique developments in individual countries
- They are experiencing a rebound in 2019 and we remain positive on the asset class with its strong growth and development trends
- Investors could benefit from adding FM as a diversifying source of returns to their portfolios

Ramzi Sidani
Lead Portfolio Manager

Talib Safee
Portfolio Manager

HSBC Global Asset Management

2018 was quite a tough year for FM equities. Are you more optimistic about 2019?

2018 was difficult for active equity managers, as performance overall was not driven by fundamentals. In particular, Emerging Markets (EM) and FM equities were caught in the eye of a perfect storm on the back of various concerns including:

- faster than expected US Federal Reserve (Fed) tightening
- a stronger US Dollar
- US-China trade tensions

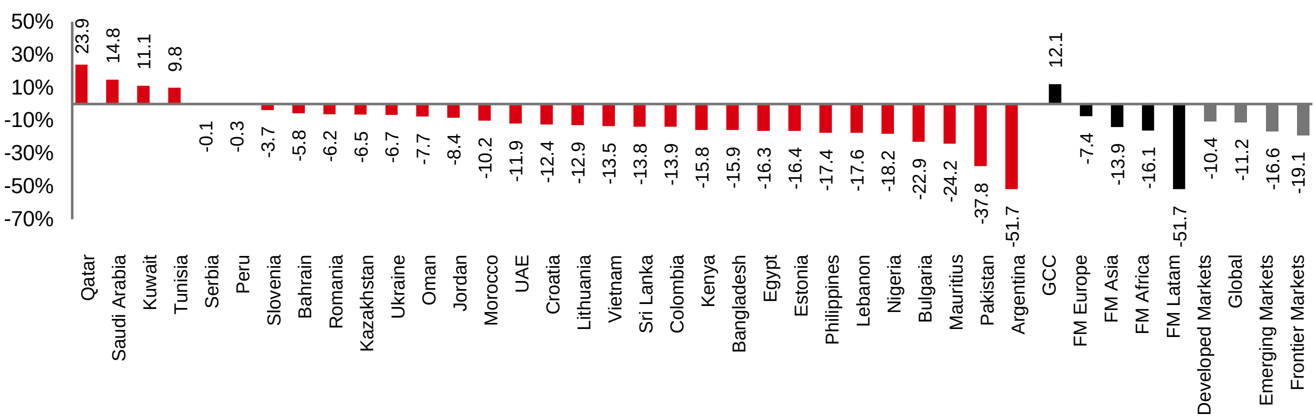
This was also exacerbated by the crisis in Argentina, which impacted general sentiment towards broader FM equities .

Most countries were in negative territory with the exception of Qatar, Saudi Arabia (a standalone country per MSCI and, therefore, excluded from our benchmark), Kuwait and Tunisia. Qatar's weight in the MSCI EM Index increased during the period and we saw passive flows propping the market. Saudi Arabia performed well, supported by non-fundamental events after MSCI announced the country's upgrade to EM status in June 2018 with implementation in 2019.

On the other end of the spectrum, Argentina was the worst-performing country in 2018, down by about -50% after being one of the best-performing countries in 2017.

Frontier Markets 2018 returns

(USD)



Source: Bloomberg. Price return of standard country MSCI indices in USD, as of December 31, 2018. Frontier Markets: MSCI Frontier Markets Index; Emerging Markets: MSCI Emerging Markets Index; Developed Markets: MSCI World Index, Global: MSCI All Country World Index (ACWI). Past performance is no guarantee of future results.

For us, the key detractors were our allocations to Argentina and Qatar.

Argentina

The country was the worst performer in 2018. We were slightly overweight relative to our benchmark in the first half of the year, which hurt us significantly. Sticky inflation and fears of a steeper Fed interest rate path put the financing program of Argentina at risk. The currency depreciated by around 20% in May and the country had to enter into an International Monetary Fund (IMF) program. At this stage, the IMF program in place gave us comfort that Argentina's financing needs for the next two years will be covered. Unfortunately, the sell-off in Turkish markets in August caused broader negative sentiment and the Peso depreciated further by around 30%. This resulted in the IMF increasing the size of its package. We became cautious on Argentina in the second half of the year. We retain our cautious stance and believe the presidential elections are going to be a decisive element in 2019.

Qatar

In 2018, Qatar was, and still is, our largest underweight. The main performance driver of the Qatari equity market had very little to do with fundamentals. We turned bearish in 2017 when the crisis with neighboring countries started, resulting in Saudi Arabia and the UAE imposing a blockade and closing down land borders and airspace. This significantly impacted the Qatari economy by increasing the cost of all raw materials and merchandise in the country, which led to capital leaving the country and the government slowing down its spending given this liquidity crunch.

Nevertheless, in 2018 the government decided to counter some of outflows by increasing the Foreign Ownership Limit (FoL) across most listed companies. This resulted in the Qatar's weight increasing in the MSCI EM Index, which meant passive funds had to add to their flows to cover this rise in weight. This pushed valuations up to expensive levels in our view, as highlighted by the chart below. It shows the price-to-book ratio (P/B) of Qatar National Bank, the largest bank in the country and our largest detractor in Qatar, which was at almost a 5-year high toward the end of 2018.

Qatar National Bank Trailing P/B

Source: HSBC Global Asset Management, Bloomberg, as of 31 December 2018. For illustrative purposes only. Past performance is no guarantee of future results.

2019 has started on a more positive note. Markets have been supported by a more dovish stance from the Fed and progress being made on trade talks. It is important to note that fundamentals are back in the driver's seat, which is when our investment process demonstrates its full potential.

One of the attractive characteristics of FM is its low correlation to other asset classes such as DM and EM equities. However, this correlation actually increased in 2018. Why is that and is it here to stay?

The correlation between FM and EM increased from less than 0.40 at the beginning of 2018 to over 0.60 during most of 2018. However, we are seeing this correlation normalizing in 2019, at closer to 0.50 now. Let's dissect what happened in 2018 and the reasons behind the anomaly.

The correlation between Argentina and EM was quite high. Argentina relied heavily on international debt markets, so it was hurt by the deteriorating environment and lower liquidity. Additionally, given Argentina's weight in MSCI Frontier Markets Index, the impact on FM of its high correlation to EM was pronounced. If we strip out Argentina, the correlation between FM and EM would have been much lower. Today, Argentina relies less on international debt markets as it received funding from the IMF for this year and the next.

What is your outlook for FM equities? What changes have you made to your portfolio?

We remain positive on the asset class. FM are at similar stages of development as EM were at about fifteen years ago and the secular economic development trends remain intact. This is in addition to low penetration of basic goods and services. Overall, this should support long-term expansion and help drive corporate profit growth. Also, valuations continue to look attractive relative to other asset classes, such as EM and DM, especially given profitability and earnings growth expectations.

We have not made any significant changes in our portfolio recently. Egypt continues to be our largest country position and overweight, and Qatar is our largest underweight.

Spotlight on Egypt

We turned positive on Egypt at the beginning of 2018. The country started implementing structural reforms in 2016, liberalized its currency and received funding from the IMF—all supporting economic development.

To provide some context, let's look at the political environment that Egypt has gone through in recent years and the reforms that have taken place.

The country experienced a period of political turmoil until President Al-Sisi was elected in 2014. In 2011, the Arab Spring saw the resignation of Hosni Mubarak as President, turning power over to the military. In June 2012, the Muslim Brotherhood's candidate Mohamed Morsi became Egypt's first freely-elected president. However, the Morsi government encountered fierce opposition after its attempt to pass an Islamic-leaning constitution and the country went through a period of chaos as Morsi announced a decree granting himself significant powers. In July 2013, Morsi was removed, with Constitutional Court Chief Justice Adly Mansour becoming interim president. In May 2014, Al-Sisi was elected in a presidential election and in October 2015, parliamentary elections led to an assembly packed with Al-Sisi supporters.

In 2016, the government started implementing a bold and transformational reform program focused on spurring the economy, enhancing the country's business environment and setting the stage for balanced and inclusive growth. The first wave of reforms focused on rebalancing the macro-economy, including passage of the value-added tax (VAT) law, reduced energy subsidies, the wage bill and the liberalization of the Egyptian Pound. The second wave of reforms focused on improving governance and the investment climate, including the Civil Service Reform Law passed in October 2016 and policies to remove investment barriers and attract local and foreign investments. In November 2016, the IMF approved a 3-year $12billion bailout loan agreement with Egypt, designed to help the country out of its deep economic crisis.

Those reforms and the gradual restoration of stability and confidence have started to show positive impact. GDP growth has been accelerating to above 5%, and inflation has been decreasing after peaking at 30% in 2017. This has provided scope to the Central Bank for easing, as highlighted by the recent interest rate cut of 100 basis points (bps) in February 2019.

In our view, Egyptian valuations look attractive relative to other EM markets with stronger consensus earnings growth. We continue to find attractive investment opportunities there.

Could you give us an example of a company you have invested in?

Egypt has an attractive demographic profile with a population of roughly 100 million, which continues to grow. One of our holdings with exposure to the domestic growth and the Egyptian consumer is Juhayna Food industries. Juhayna is the largest dairy company in Egypt, operating in three segments: milk, yogurt and juice. They have about 60% of the market share of the milk segment and are the second largest when it comes to yogurt and juice.

Juhayna has been growing volume at double digits and we believe it can continue to deliver sustainable and growing returns. The company is well-positioned to benefit from the consumer spending recovery that has been taking place in a market still dominated by loose milk (fresh milk that is not pasteurised). In Egypt, about 50% of the milk market is loose milk. We believe that the conversion from loose milk to packaged milk should continue with packaged milk reaching at least 70% of market share in the medium-term. This trend has also been materializing in Vietnam.

Furthermore, it is operating in a market where 85% of the distribution in Egypt is done through the traditional distribution network and where Juhayna has the second largest distribution network behind Pepsi. This provides a high barrier to entry for competitors.

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