FIS GROUP

February 2016

2016 OUTLOOK for Frontier Markets

Tina Byles Williams
Portfolio Manager
CIO & CEO

Adam Choppin
Analyst
Manager Research & Investment Strategy

MARKET OUTLOOK

SUMMARY

Similar to most other major global markets, 2015 was also largely a year to forget on the frontier. The few bright spots of meaningfully positive local returns (Argentina and Romania) were largely overwhelmed by further currency weakness relative to the U.S. Dollar. Looking ahead for 2016, we see a global sense of skittishness and thin growth leadership as extending to the frontier markets as well, though their lesser lack of integration and correlation with global markets will separate some markets more than others. To that end, the asset concentration within the small universe of global frontier markets managers is our top concern across frontier markets for 2016. Thus at the broadest level, we recommend underweighting global frontier markets vis a vis other clearer opportunities in Japanese equities, but see some genuine opportunities in the frontier universe relative to emerging markets. Otherwise our views here largely reflect our recommendations for medium-term allocations within the frontier universe. As in emerging markets, we expect U.S. dollar strength to continue, and indeed may even be exacerbated by local currency weakness in selected markets (e.g. Nigeria). Saudi Arabia and the rest of the GCC are making headlines for their regional confrontations, both hot and cold, fiscal struggles and influence in the oil market, but also for some peculiar reforms to the stock market. Nigeria is both cheap and expensive in different parts, and could be poised for a truly volatile 2016. Indeed much of the big African stocks seem expensive compared to their European, Asian, or Latin American counterparts, and these stocks seem poised at best for stagnation in 2016 and possibly a significant de-rating. But the universe is not without its bright spots and we see very positive macro fundamentals and micro market catalysts in Argentina, Vietnam, and Frontier Europe (ex Kazakhstan).

Frontier Regions / Countries	-		N		+		Page Ref.
GCC (Saudi, Kuwait, etc.)		●		● (variance)		Though the market may rebound some this year as oil prices recover from a bottoming out, at this stage we view these markets' as unlevered plays on oil, or in other words an inferior way to bet on oil. Valuations are not bad, but also not compelling and we don't see an oil price rebound sufficient to ignite meaningful growth or improved earnings across the markets. Tactical overweight for a modest oil recovery, but otherwise underweight vs. oil.	8
Africa (Kenya, Morocco, Nigeria, etc.)		●		● (variance)		Kenya, Morocco, and Nigerian consumer sectors are all overbought and are more likely to stagnate or de-rate in the coming year than see much upside. But Nigerian financials appear quite reasonably priced and poised for an upward correction, especially after a capitulation by the Nigerian Central Bank on the presently artificially high exchange rate.	10
Frontier South Asia			●			Bangladesh, Pakistan, and Sri Lanka all portend strong economic growth, but apart from Pakistan, valuations are underwhelming and Pakistan appears too uncertain politically or micro-economically for a top-down call on the market.	8
Argentina					●	New and improved macro-economic governance should lead to a steady re-normalization of the market over the next few years, while valuations appear reasonable.	3
Vietnam				●		10 years of strong economic growth have not been reflected in the stock market, but new regulatory and structural catalysts offer a change in access and relevance.	6
Frontier Europe				●		(ex Kazakhstan) Improving Eurozone growth and sentiment will soon trickle out of the euro area into the cheaper, faster growing markets in Eastern Europe, especially Romania. Kazakhstan portends further currency weakness in a world of cheap oil.	7

● Strategic (6-12 months+)   ● (variance) Variance from some sctors/small markets *(See notes/write-up)*

TABLE 1 MSCI Frontier Markets Index

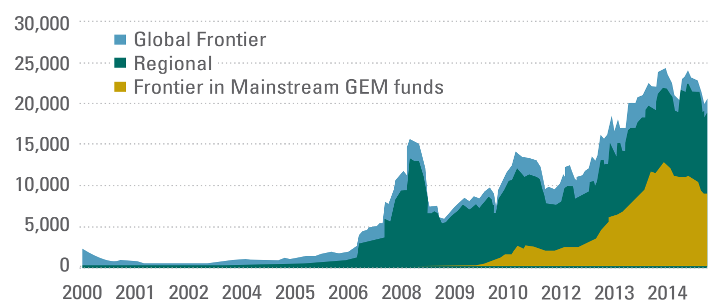
	Weight	2015 USD Return	2015 Currency Return	2015 Contrib.	ADTV	Mkt Cap	DY	P/B	P/E (LTM)	P/E (NTM)	# Sec.
	100.00	**-13.86**	**-5.20**	**-13.86**	**2,359,978**	**4,262**	**4.65**	**3.08**	**15.9**	**14.4**	**141**
Middle East	32.58	-13.51	-2.51	-4.45	1,066,991	6,066	4.92	1.28	12.9	12.7	29
Kuwait	22.37	-16.39	-3.50	-3.65	1,155,293	7,621	5.09	1.34	13.8	13.3	8
Oman	5.15	-9.38	-0.01	-0.54	1,549,723	1,856	5.49	1.34	9.0	9.1	10
Lebanon	3.06	3.76	0.00	0.06	42,510	1,955	2.51	0.88	12.5	15.2	4
Bahrain	1.26	-21.34	0.24	-0.30	66,811	965	6.22	0.74	10.2	7.4	4
Jordan	0.75	-2.33	-0.20	-0.03	56,899	4,782	1.87	0.94	13.8	10.6	3
Africa	28.72	-16.94	-9.07	-4.84	5,714,261	3,565	4.89	5.58	19.4	19.0	38
Nigeria	14.34	-19.89	-8.01	-2.94	9,247,333	3,267	5.42	6.23	23.4	22.7	18
Morocco	6.76	-10.28	-8.65	-0.71	97,250	5,815	4.68	4.50	16.9	16.6	10
Kenya	5.70	-16.06	-11.46	-0.85	3,595,203	2,846	3.85	6.37	14.4	13.6	5
Mauritius	1.25	-17.95	-14.04	-0.25	2,775,575	1,036	5.00	1.12	8.5	7.3	3
Tunisia	0.67	-15.09	-8.34	-0.11	10,377	654	3.53	1.99	13.9	13.1	2
Central Asia	13.34	-15.63	-4.11	-2.26	833,158	2,048	5.31	3.13	12.8	12.1	25
Pakistan	8.87	-13.08	-3.94	-1.29	996,330	2,224	6.69	2.10	9.5	9.0	17
Bangladesh	2.47	-17.18	-0.70	-0.46	507,539	2,230	2.50	6.85	23.1	20.0	5
Sri Lanka	2.00	-22.08	-9.02	-0.51	619,555	1,230	3.60	2.64	12.8	14.3	3
Eastern Europe	10.70	-16.25	-21.44	-1.82	410,333	4,716	5.52	2.60	22.2	7.8	27
Romania	3.19	1.80	-11.20	-0.01	1,470,345	2,207	3.90	1.03	29.5	11.0	5
Kazakhstan	2.56	-46.20	-54.93[1]	-1.48	202,021	11,385	8.61	12.39	54.2	3.3	3
Slovenia	2.39	-4.24	-10.36	-0.10	5,532	1,771	4.95	1.31	11.4	10.6	4
Croatia	1.51	-6.51	-10.25	-0.11	6,920	1,910	3.71	1.41	10.3	8.6	3
Estonia	0.46	11.67	-10.51	0.04	248,548	521	3.35	1.26	9.3	9.6	2
Serbia	0.22	-31.71	-10.61	-0.08	4,769	695	--	0.47	5.1	4.8	3
Lithuania	0.15	-4.62	-10.37	-0.01	25,007	435	6.02	2.83	15.9	13.8	2
Bulgaria	0.12	-35.32	-10.83	-0.06	9,643	191	--	0.70	11.7	9.6	3
Ukraine	0.10	-12.32	-28.82	-0.02	86	280	7.18	0.43	1.8	1.6	2
South America	10.59	-0.70	-66.12[1]	-0.28	626,759	3,506	1.61	1.74	8.0	9.0	8
Argentina	10.59	-0.70	-66.12[1]	-0.28	626,759	3,506	1.61	1.74	8.0	9.0	8
Pacific Rim	4.07	-5.45	-4.77	-0.21	1,241,504	2,286	2.20	2.43	25.6	31.3	14

Source: FactSet. As of 12/31/15

GLOBAL FM CONCENTRATION

As we have discussed in previous papers on frontier markets,[2] we remain very concerned about the concentration of assets in global frontier markets. Using either EPFR data (see CHART 1) or self-reported AUM data from eVestment, the total AUM of managers with global frontier markets strategies is around $10-$12 billion. Drilling down, however, we see tremendous concentration in just the top four managers in the frontier universe, who together comprise at least 50% of the global frontier market share! (see TABLE 2) This is compared to a mere 15% market share for the top 4 active asset managers

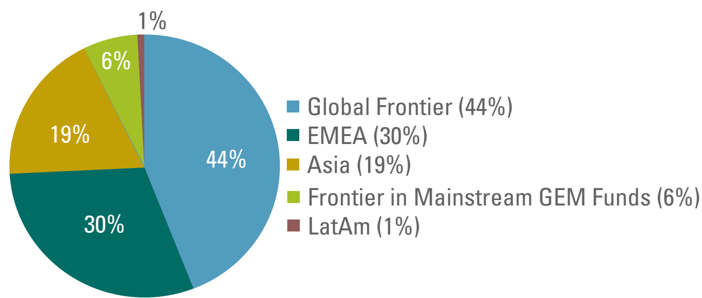
CHART 1 Frontier Assets Under Management *$Millions*



Source: EPFR, Renaissance Capital

1. *All Kazakh and Argentine index securities are actually GDRs and ADRs, respectively. Currency returns are thus for the local market, not for the index securities.*
2. *Market Insights Alert: Big Is Bad (Really Bad) in Frontier Market Equities*

CHART 2 $20 Billion of Frontier Assets Under Management
October 2015



Source: EPFR, Renaissance Capital

TABLE 2 Top 4 Active Asset Managers in Global Emerging Markets

Global Frontier Manager	eVestment reported Product AUM[3]	Est. Market Share of Global Frontier Universe
Franklin Templeton Frontier Markets	$2bn	18%
Schroder Frontier Markets	$1.3bn	12%
Wasatch Frontier Emerging Small Countries	$1.2bn	11.25%
Morgan Stanley Frontier Emerging Markets	$1bn	9%
Top 4 Managers		*50.25% Market Share*

Source: eVestment

in global emerging markets (using the same eVestment data)! Viewed from the top-down, we believe that such concentration places an additional stress on a market already experiencing heightened capital flight. From the bottom-up, it warrants an extra layer of due diligence into individual securities to carefully understand the downside risks imposed by asset erosion from those companies' shareholders.

As such we continue to favor managers and processes that are conscious of the systemic risks posed by the hyper concentration of these frontier strategies in the marketplace which threaten a meaningful disruption in selected names and markets. We also continue to be bearish on managers that are too limited in their investible universes by focusing too heavily on only the most liquid aspects of the frontier universe, which is where redemptions into frontier markets have been concentrated over the past eighteen months of the present bear market in frontier (see Table 3).

TABLE 3 MSCI Frontier Index Returns by ADTV

7/01/2014 to 12/31/2015	Port. Average Weight	Port. Total Return
	100.00	-23.59
Ave. Volume - Last 52 Weeks Quintile 1: 5480.3 - 264807.9	7.59	-42.34
Ave. Volume - Last 52 Weeks Quintile 2: 2412.7 - 5427.3	8.06	-26.86
Ave. Volume - Last 52 Weeks Quintile 3: 1264.5 - 2411.7	19.79	-33.33
Ave. Volume - Last 52 Weeks Quintile 4: 541.5 - 1259.1	20.44	-19.17
Ave. Volume - Last 52 Weeks Quintile 5: 0.0 - 541.0	44.12	-16.26

Source: FactSet

ARGENTINA

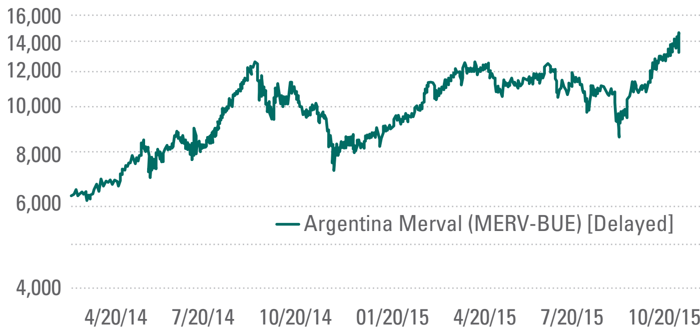
"Argentina has a 10-year cycle, an 8-year memory, and nobody ever knows when its year 9."

–Anonymous long-time foreign investor, March 2012

2015 began with the Argentine market looking ahead, optimistically, to the Presidential elections in October 2015. After 12 years of suffering under the mismanagement of populist left-wing Peronist Cristina Fernández and her predecessor husband Néstor Kirchner, local investors were ready for some good news. Meanwhile, foreign investors, especially in the region, saw only quagmire in Brazil and little optimism elsewhere in emerging markets, were quick to recognize the potential for a turn in the Argentine cycle. They found what they were looking for in early poll numbers that indicated that Daniel Scioli, the leftist heir to the Fernández/Kirchner regime, was trailing either the left-center Sergio Massa or the business friendly center-right candidate Mauricio Macri. But as Scioli surged ahead in the polls in the Spring, markets slipped down and sold off in August and September along with other emerging markets (see CHART 3 and CHART 4). But when Macri surprised with a stronger than expected showing in the October 25 elections, portending a likely Macri victory in the November 22 runoff, markets surged ahead on the euphoria. Macri ultimately won the presidency on the back of strong support from the agro-commercial heartland of Argentina (see MAP 1), which had suffered the most under the Peronist's market distorting and economically oppressive policies.

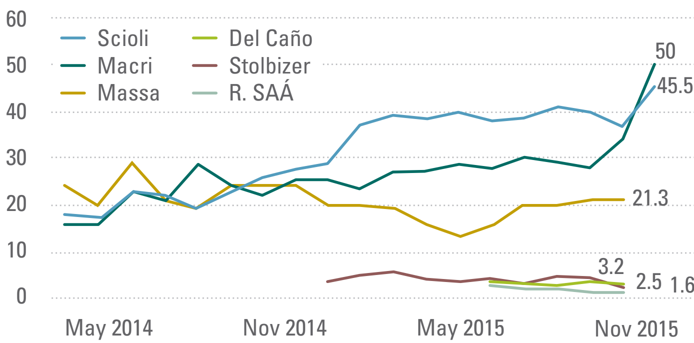
3. This amount may be only 50-60% of their assets in this strategy. As of June 2014, Franklin Templeton managed $4bn in frontier equities according to CIO Mark Mobius as revealed at an industry event. Wasatch and Morgan Stanley were similarly understood to manage closer to $2bn each in their respective frontier strategies including private accounts as of late 2014.

CHART 3 Local Currency Returns *April 2014 to November 2015; ARS; Second Round Elections*



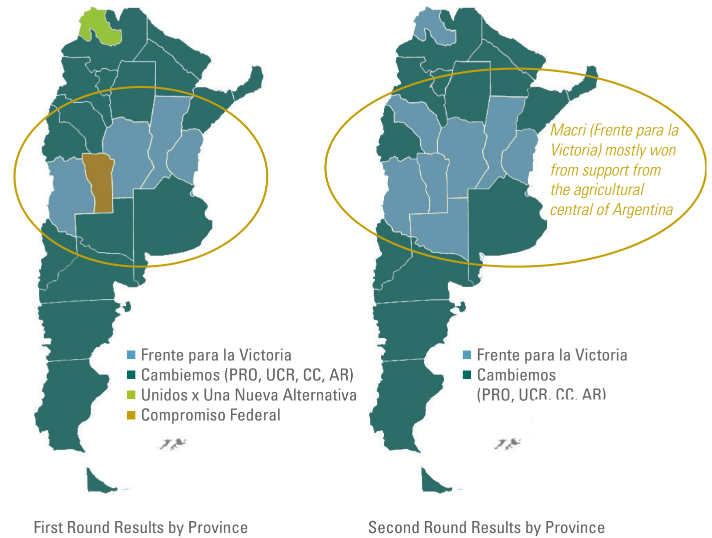
Source: FactSet

CHART 4 Survey of Voting Intentions for Presidency *Average*



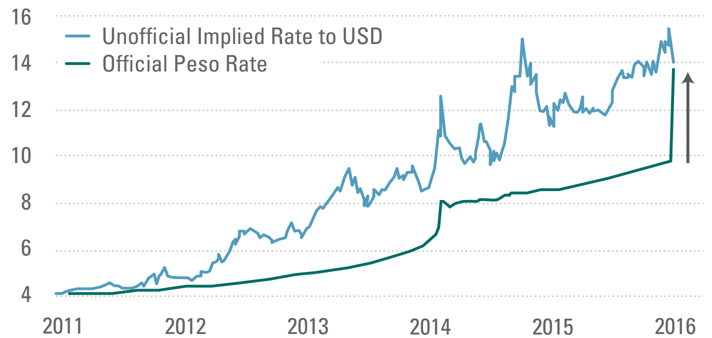
Source: "Encuestas de intencion de voto presidenciales Argentina 2015" by Leoguz - Own work. Licensed under CC BY-SA 4.0 via Commons

MAP 1 Map of Argentina's 2015 General Elections



Source: "Mapa de las elecciones generales argentinas 2015" by Gastón Cuello - Own work, datos: Mapa electoral: resultados de Scioli y Macri en las provincias. Licensed under CC BY-SA 4.0 via Commons

CHART 5 Official Peso Rate & Unofficial Implied Rate to U.S. Dollar



Source: Zerohedge

In less than two weeks, following the elections, Mr. Macri was able to remove export taxes, eliminate most capital controls, unify all exchange markets, and to allow the currency to free float. While all of these moves are both necessary and positive for Argentina's economic growth prospects, they also sent the official exchange rate crashing down from its artificially high price (see CHART 5). Looking forward, such swift moves have established strong confidence in the new policymaking regime which may be likely to yield a medium-term influx of hundreds of millions of the billions of dollars believed to have been stashed offshore by upper and middle class Argentine savers over the past decade.

The next step to improving investor confidence and normalizing the macroeconomic policy framework is to resolve the ongoing impasse with the holdouts. These are the remaining holders (mostly vulture hedge funds at this point) of Argentine sovereign debt dating back to their 2001 default. New Finance Minister Prat Gay has already suggested that Argentina would benefit from an early solution to the impasse, and is presently offering 120 cents on the dollar to honor the full principal plus some interest, but he has also implied that the stated demands of the creditors (350 cents on the dollar) are excessive and that a negotiated settlement will be necessary.[4] Any such settlement would need to be approved by Congress, setting up the clash between proudly nationalistic politicians and these hedge fund creditors. Clearly the outcome of negotiations with two barely moveable objects remains uncertain, but we believe that there exists enough wiggle room for the two sides to find a face-saving compromise.

4. *"Argentina pledges to honour debts owed to holdout creditors," Financial Times.*

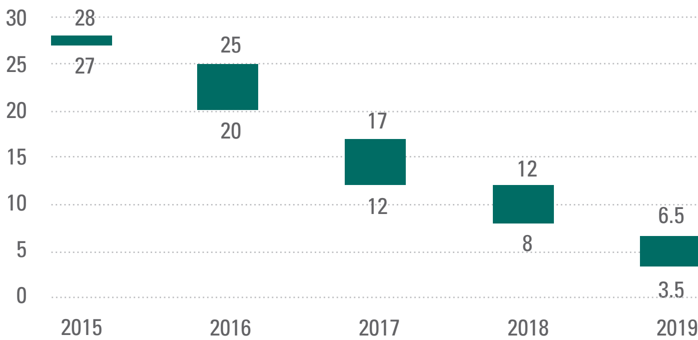
Beyond the bond holdouts, tackling energy subsidies and inflation are the other critical components of Macri's agenda. The former, having been an outright agenda item of both Macri and the left-center Massa, appears politically straight forward, and much less contentious at a time of low energy prices. For inflation, the government has set a four year target of normalizing inflation from its present range of 27-28% down to 3.5-6.5% by 2019 (see CHART 6). Given the official devaluation in December, high inflation will likely persist well into 2016 as previously protected import sectors adjust to higher prices. After that the persistence of inflation in an environment of global disinflation will be set by maintaining a favorable balance between savings and consumption and by local sentiment and expectations. On the former point, we actually believe that the previous distortions from capital controls in Argentina which effectively subsidized consumption versus savings now directionally favor the inverse, at least in the sense of relative change. Thus while some market observers have already opined that the Macri Administration's inflation targets seem optimistic, we see the targets as attainable.

Finally, the Macri Administration needs to address Argentina's worsening fiscal imbalance starting with some disorderly accounting practices leftover by the outgoing government. In this way, the picture looks likely to get worse in 2016 before it gets better (see CHART 7) as the government recognizes some of the previously misstated accounts and reduces revenues from their array of campaign promise tax cuts. In this way a successful settlement with the holdouts will be necessary to enable Argentina to re-enter global debt markets, though they are unlikely to find a warm reception in an global debt market seeking to de-risk away from emerging markets, especially those which are commodity dependent.

Meanwhile Argentine stocks look relatively affordable for a market with improving fundamentals (see TABLE 4) and the early year global market selloff has brought the Argentine market back down to levels prior to the October election euphoria in local currency terms and even further down to levels not seen since early 2014 in USD terms (see CHART 8). As a former emerging market constituent and with all of the leading index constituents easily available to U.S. investors in the form of ADRs, Argentina appears uniquely poised for a re-rating of the market in 2016. While growth portends to be a tepid 0-1% in 2016, projections for 2017 are already emerging at 3.5-4.5%. At these levels, Argentina looks modestly attractive on an absolute basis, fairly attractive relative to most other frontier and even emerging markets, and potentially a screaming buy relative to its otherwise forlorn Latin American neighbors.

INVESTMENT RECOMMENDATION: Heavy overweight and/or Long Argentina in FM and possibly even EM portfolios.

CHART 6 4 Year Target of Normalizing Inflation *%Yr*



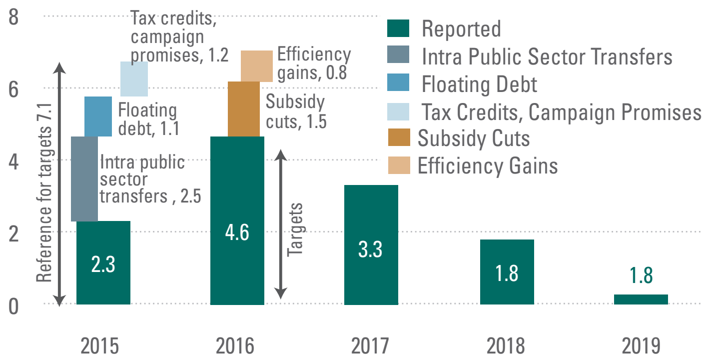
Source: Argentine Ministry of Finance

TABLE 4 MSCI FM Index Constituents for Argentina

	Market Cap	P/B	P/E (LTM)	P/E (NTM)
YPF ADR	5,368	0.58	6.2	6.5
Grupo Financiero Galicia ADR	2,489	2.26	7.1	8.0
Banco Macro ADR	3,196	2.21	8.0	8.8
Telecom Argentina ADR	1,364	1.63	6.6	8.2
BBVA Banco Frances ADR	3,155	2.37	8.2	10.9
Adecoagro S.A.	1,353	1.99	75.0	36.3
Petrobras Argentina ADR	1,111	0.79	14.4	8.3

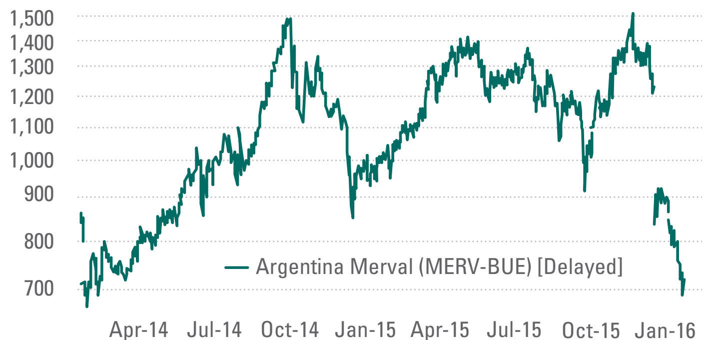
Source: FactSet. As of 1/21/2016

CHART 7 Fiscal Deficit *%GDP*



Source: Argentine Ministry of Finance

CHART 8 Argentine Merval Returns in USD

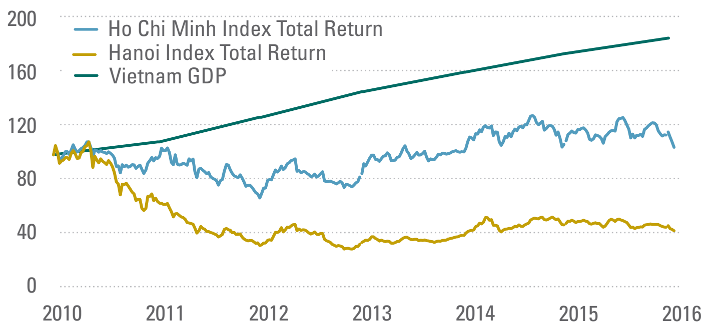


Source: FactSet

VIETNAM

For five years now, Vietnam has seen steady economic growth of 5-6%, while its markets remain flat to negative over the same period of time (see CHART 9). Beyond underscoring that GDP growth is no forward indicator for market returns even amid the inefficient frontier markets, we are reminded that in order to have strong market performance it takes both good fundamentals and a catalyst for demand, especially where market structures limit access. So while we share the general economic optimism for Vietnam in 2016, we have a healthy respect that a positive outlook is merely a necessary, but insufficient condition for concomitant market returns.

CHART 9 Vietnam's Stock Markets Have Not Kept Up With Its Strong Economy



Source: FactSet

To understand what could potentially catalyze the Vietnamese market it helps to have a view on what has held it back over the past several years.

First, Vietnam has been artificially more expensive for foreigners since its opening as a result of strict foreign ownership limits (FOL) of 49% (maximum) across the market. This meant that for firms that were up against their FOLs foreigners had to pay a premium over the local market to access those stocks (which were often the higher quality consumer companies). Beyond that, large foreign investors were almost guaranteed never to be able to accumulate a meaningfully sized position at a reasonable price. This has led some foreign investors to eschew much of the market altogether, not bothering to even devote significant resources to research potential buys. The regulatory restriction on FOLs were removed for most sectors in September 2015. But as the change coincided with the global panic over Chinese PMI numbers and a modest devaluation in the Renminbi, the news did not yield much actual foreign buying in Vietnam. In part this is practical, as the foreign ownership limits were not so much removed as devolved to companies, which now much each individually submit separate proposals to the market regulator requesting a raise in the FOL. Most companies in the market have yet to initiate these requests, but are anticipated to do so over the course of this coming year.

Second, beyond the FOLs, Vietnam has long been one of the most difficult markets in the world (which is also a member of any of the major global indices) in which to establish custody as a foreign investor. Vietnam requests an array of documentation which can take weeks or even months to prepare, Vietnamese regulators are notoriously picky about every detail on an application being perfect and have sent back entire applications for small errors (which can cause months of further delays), and must approve each request from a new foreign investor separately. But effective November 1, 2015 the market regulators changed their foreign investor registration rules, and applications now no longer need to be consularized by a Vietnamese embassy, which was often the longest part of the application process. This shortens what was generally estimated as a 4-6 month process into a 2-3 month process, which could quietly further abet the flow of new investments in Vietnam independent of all the other potential catalysts.

Third, for the first time in any of these last five years, Vietnam is actually near the top of the best projected growth countries in the world. While Vietnam's growth has been fairly consistent over the past half decade, among investible markets, it has been outshone by even faster growing stars in China, India, Philippines, Tanzania, and even Nigeria. But in 2016, with growth decelerating in so many other places, Vietnam looks, on a relative basis, more attractive (See TABLE 5). Combined with the other catalysts mentioned above, we think this may bring more foreign investor attention to this neglected market.

TABLE 5 Bloomberg Economic Outlook

Country	2016 GDP Forecast (%)
India	7.4
Vietnam	6.6
Bangladesh	6.6
China	6.5
Sri Lanka	6.4
Kenya	6.1
Panama	6.1
Philippines	6.0
Uganda	5.6
Dominican Republic	5.4
Indonesia	5.2
Ghana	4.6
Malaysia	4.5
Qatar	4.5
Nigeria	4.4
Nicaragua	4.2
Ireland	4.1
Bolivia	3.9
Guatemala	3.9

Source: Bloomberg

Fourth, while governance of the country is estimated to have improved meaningfully over the past five and especially ten years (see CHART 10), we hear from managers that corporate governance has not improved at the same pace. But we are encouraged by reports from our managers of some recent improvements in the market, as well as some renewed attention to corporate governance by regulators and even some leading institutional investors. While Vietnam remains a long way off from Berkshire Hathaway standards, in looking for directional change we believe there is reason to be optimistic on this front.

Finally, there are a number of other potential news events which could galvanize foreign investor interest in the market. The recent Communist Party Congress just voted for continuity in installing the protégé of outgoing Vietnamese Prime Minister Nguyen Tan Dung, who guided Vietnam into global economic integration and a myriad of business-friendly market reforms. The government is reportedly considering a further round of privatization IPOs which could significantly increase the overall size of the Vietnamese market, while also pushing for further pension reform that could improve liquidity. Vietnam also recently announced a change in their exchange rate mechanism which some analysts predict will smooth some of the inadvertent volatility in the equity markets that their previous FX regime created. Some reports indicate that Vietnam is pursuing these reforms to secure an upgrade to emerging markets status, following the path laid out by UAE and Qatar in 2014. Finally, implementation of the TPP is believed to disproportionately benefit Vietnam.[5]

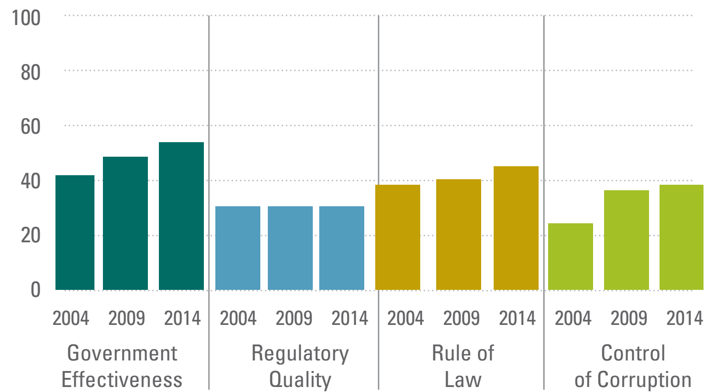
INVESTMENT RECOMMENDATION: Overweight and/or Long Vietnam in FM and possibly even EM portfolios.

FRONTIER EUROPE

Our conviction in frontier Europe is fairly straight forward. The market is cheap (7.8x NTM P/E with a 5.5% dividend yield), neglected (less than 17% of the MSCI Frontier Market Index average daily trading volume) yet easily accessible for custody and trading, and apart from Kazakhstan (which we hold apart from this regional view) all are net energy importers. In our 2016 global outlook we discuss our view on Europe and our view on Emerging Europe (x Russia and Turkey). Our view on the small markets of Frontier Europe is similar, as we see a great propensity to benefit from the emerging growth and liquidity in Europe. We see Romania as the most attractive market here, given their relatively attractive fundamentals of lower household debt and rising domestic demand (see CHART 11 and CHART 12) combined with the potential catalyst from the regulators' strong push for an upgrade to emerging markets status and its concomitant array of quiet and sometimes arcane market reforms they have instituted over the past 2-3 years, but which should now facilitate greater access to match potential demand.

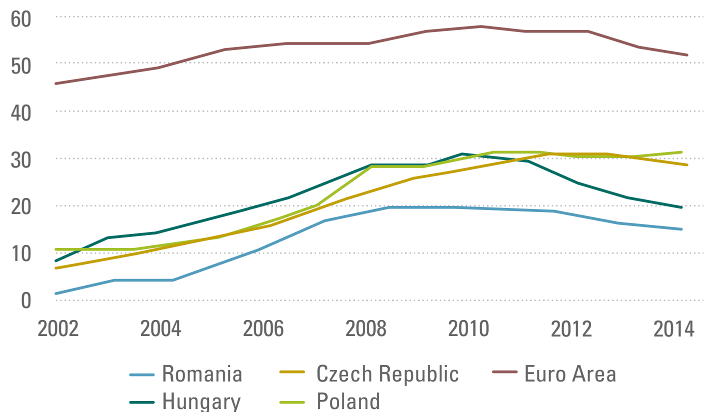
INVESTMENT RECOMMENDATION: Overweight and/or Long Frontier Europe, especially Romania, in FM and possibly even EM portfolios.

CHART 10 Governance Indicators



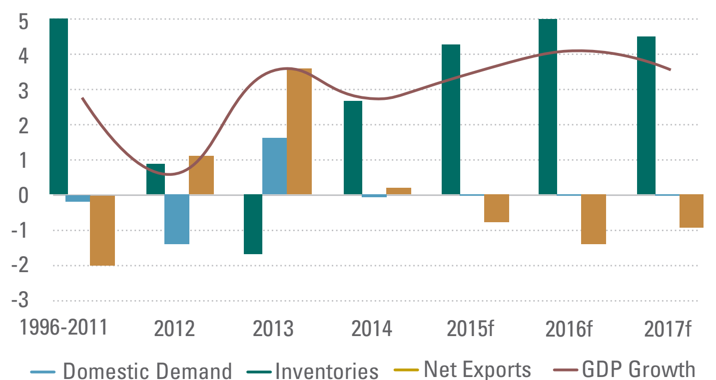
Source: World Bank Governance Indicators

CHART 11 Loans to Households *% of GDP*



Source: Eurostat, IMF, Central Banks

CHART 12 Romania *%*



Source: Eurostat, IMF, Central Banks

5. *"The Biggest Winner From TPP Trade Deal May Be Vietnam," Bloomberg Business.*

SRI LANKA, PAKISTAN, BANGLADESH

The South Asian markets of Pakistan, Sri Lanka, and Bangladesh all seem to have more upside than downside, but none strikes us as so clearly positive to warrant more than a neutral weight. In shedding the country of authoritarian kleptocrat Mahinda Rajapaksa in the January 2015 elections, Sri Lankan companies quietly removed a tax on their earnings, which seems to have gone virtually unnoticed by the broader market. During their ten year reign in power the Rajapaksa family would reportedly shake down each of the listed companies in the market on a quarterly basis for an array of creatively structured bribes. With this particularly auspicious drag on profits now removed, Sri Lankan corporates should see some modest improvements in their margins. But to date we have not seen this bump in earnings and at 14.3x NTM P/E and a 3.5% dividend yield, we don't see any clear case for a heavy overweight from the top down.

Pakistan is a net importer of oil, should benefit from the ending of trade sanctions with Iran by re-starting some long shelved cross-border investments, and appears relatively attractively priced at 9x P/E (NTM) and 6.7% dividend yield. On the other hand, low oil prices could reduce remittances from their large GCC-based population of foreign laborers, and one must never forget that they are still fighting two wars, inside their own country and in Afghanistan. Finally, it feels difficult to get too optimistic about this market given the seemingly endless propensity for political upheaval in Islamabad, of both the democratic and undemocratic varieties.

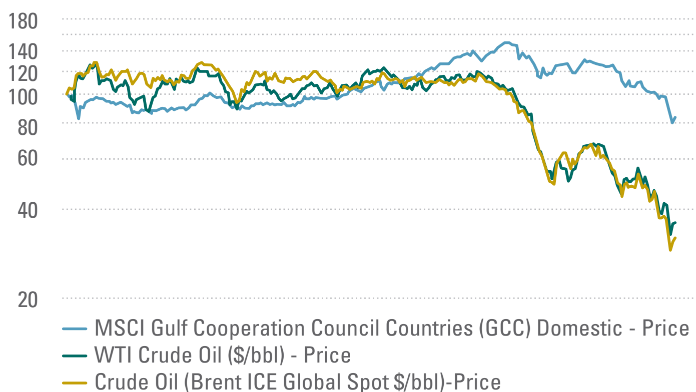
Like Pakistan, Bangladesh is also a net oil importer, but with much higher GDP growth (recent and projected) and without the baggage of fighting two wars. Yet the market is also perhaps already fairly priced at 20x NTM P/E and 2.5% yield, although the nature of the local market has generally meant that Bangladesh consistently trades at a premium to many of its frontier cohort. Here again we see good justification to fish for some bottom-up value, but little to make a top down call on the market.

INVESTMENT RECOMMENDATION: Neutral weight frontier South Asia in FM portfolios.

GCC (SAUDI ARABIA, QATAR, UAE, KUWAIT, OMAN, AND BAHRAIN)

While the GCC economies are clearly oil dependent, the connection between oil and these markets is not as intuitive as most investors might understand. Only 2 companies and less than 2% of the market cap of these markets (as measured by the MSCI GCC) is in the energy sector (see TABLE 6), so the relationship flows through the combination of fiscal spending and market sentiment, more than any direct earnings effects. And of these factors, the most important for much of the GCC is sentiment, given that 80-90% of the average daily volume in the GCC market is driven by retail investors. Yet that sentiment does often follow the price of oil, at least at the extremes of the oil prices and market valuations (see CHART 13), so oil is nonetheless a fair starting point through which to consider such markets.

CHART 13 GCC Domestic and Crude Oil



Source: FactSet

Rarely a day goes by where Saudi Arabia goes without mention in the American business media, generally in the context of its efforts to drive the price of oil down as a squeeze on its oil producing competition, especially in Russia, Iran, the U.S. and Canada. Such geo-economic machinations have been generally well covered in so many other fora (even if still poorly understood), and will not be discussed much here as a result. But for those curious readers seeking better insight into the view from within the house of Saud we recommend this recent report from Stratfor and Real Clear World.[6] For our outlook on frontier markets, we will take as a given an environment of low oil prices (whether at the hands of the Saudis or not) the rationale for which is more fully articulated in our 2016 global outlook.[7] So in short, based only on oil, we see some upside from here given our year-end estimate for roughly $45 oil.

But even in an environment of low oil prices (i.e. if our oil price prediction is wrong to the downside), we are still more sanguine on Saudi than many traders, especially from within the GCC, who seem to believe that there will be an imminent devaluation of the Saudi riyal. The argument appears logical at first, that a cheap and easy way to balance a budget where the revenues are priced in dollars but the expenses are priced overwhelmingly in the local currency would be to devalue. But such pessimism fails to understand the extreme sensitivity to import prices in the Saudi economy and the potential political ramifications from rampant inflation should the royal family devalue the currency. As such, we view unilateral devaluation as an unlikely event. However, should the fiscal pain persist

6. *"Saudi Arabia: Palace Intrigue at a Time of Transition," Real Clear World.*
7. *Market Outlook: Q1 2016*

for Saudi for too long, a multilateral devaluation, in coordination with their GCC neighbors (building on their recent cooperation in proposing a regional VAT tax), based on a trade-weighted basket of imports, is not inconceivable.

Recently, certain senior Saudi officials made headlines with the suggestion that they might IPO Saudi Aramco,[8] which would have an estimated market value of between $5-$10 trillion, larger than the entire MSCI Emerging Markets Index! While this valuation is highly speculative given the opacity of Saudi's reserves, we view the prospect of a public offering for Aramco as completely preposterous, at least in the medium-term. (However, if it can snow in Kuwait for the first time in living memory,[9] anything is possible!) First, the timing of such a move would make little sense today given depressed oil prices. Second, the present opacity around Aramco's reserves is deliberate, and a source of leverage for the Saudis as they seek to maintain their influence over global oil markets (something made even more important given the ongoing petro-political rivalry with Iran). Third, Aramco is reputed, even by the Deputy Crown Prince, to be a large source of politically important contracts, which are considered too important an internal lever of influence to remove from the hands of the Saudi royal family. We believe that such discussions are merely designed to provide political cover for the technocrats to trim some of the bloat and corruption on the books at Aramco and elsewhere to plug some near-term fiscal holes. However, Saudi Arabia may seek to spin-off some of their tangential subsidiaries in the downstream or petrochemical sectors to raise some revenue in the short-term, but we don't see this as any particular catalyst to sentiment, and indeed might be a reason to be bearish given that any such IPOs would undoubtedly crowd out investment from the existing public markets.

Valuations in the region have now reached reasonable levels, at about 1.7x P/B and 12x P/E, but are not yet screaming buys. Though we do think this is an excellent time to be investing in bottom-up, stock specific ideas as Saudi and other GCC markets are even more prone than most to having high quality names more severely mispriced; we see only some marginal upside to the beta. Even if oil rallies back to $40-$50 by the end of 2016, this would not necessarily trigger either a wealth effect (given the previous price of oil) or a restart to the capex cycle in the region (given the three ongoing wars in Yemen, Syria, and with ISIS in addition to the perpetual funding of key allies in Palestine and Egypt). Thus, in spite of our view on oil, we are not moved to buy the GCC just yet, based on top down factors.

INVESTMENT RECOMMENDATION: Underweight GCC to your view on oil.

TABLE 6 MSCI GCC Index

	Port. Average Weight	Dividend Yield	P/B	P/E	# of Sec.
	100.00	**5.20**	**1.59**	**12.2**	**88**
Saudi Arabia	56.06	5.18	1.71	13.3	44
Financials	26.90	3.42	1.41	10.4	16
Materials	16.10	7.60	1.58	12.9	15
Telecommunication Services	5.01	7.62	1.64	12.8	3
Consumer Staples	3.13	3.57	2.87	15.2	2
Consumer Discretionary	2.10	4.80	4.45	10.6	3
Qatar	18.97	5.45	1.67	10.8	14
Financials	12.67	4.89	1.46	10.8	8
Industrials	2.36	7.29	1.75	10.7	1
Energy	1.52	9.41	2.54	8.6	2
Telecommunication Services	1.28	3.89	1.38	13.5	2
Utilities	1.14	4.07	2.91	13.5	1
United Arab Emirates	14.52	4.91	1.24	9.9	12
Financials	12.13	5.34	1.20	8.2	9
Industrials	2.39	2.63	1.50	18.4	3
Kuwait	8.38	4.88	1.29	12.8	8
Financials	6.66	3.40	1.43	13.9	6
Telecommunication Services	1.26	11.94	0.82	8.4	1
Industrials	0.45	8.03	0.54	9.2	1
Oman	1.83	6.60	1.34	8.2	8
Financials	0.90	4.92	0.82	7.1	5
Telecommunication Services	0.85	8.32	1.92	9.3	2
Materials	0.09	7.88	1.33	8.5	1
Bahrain	0.23	7.50	0.84	8.7	2
Telecommunication Services	0.17	8.17	0.97	10.3	1
Materials	0.07	5.82	0.52	4.6	1

Source: FactSet

8. *"Saudis Unbowed by Oil Crash With No Spending Cut Before IPO," Bloomberg and "Transcript: Interview with Muhammad bin Salman," The Economist.*
9. *"Snow falls in Kuwait for 'first time ever'," Middle East Eye*

SUB-SAHARAN AFRICA (KENYA, MOROCCO, AND NIGERIA)

Kenya and Morocco remain expensive (See TABLE 1), with little justification for such premiums other than a larger captive audience from their own domestic pension schemes. As the experiences of South Africa, Chile, Colombia and others have shown over the past decade, such structural distortions are only beneficial on the front-end of asset flows, but can be devastating on the back-end as local policymakers liberalize the investment policies under pressure for diversification and greater returns. Several of the leading names in these markets (East African Breweries, Safaricom, Maroc Telecom, and others) are also too thickly held by some of the over-extended global frontier investors that portend more outflows in their strategies than inflows.

Nigeria, however, is a more complicated story. Nigeria is an economy with highly favorable demographics, but an equally unfavorable political economy. The naira may well be the most overvalued currency in the index (the Central Bank rate is 200/USD, but the black market rate is now 300/USD) and a devaluation seems inevitable, despite the government's bewildering attempt to avoid it. Meanwhile the consumer companies which have been the darlings of the bloated consumer-facing frontier funds as well as the myriad of sub-Saharan Africa funds catering to the South African pension market could be poised for stagnation or selloff fuelled more by asset erosion of their investors than their own fundamentals. Moreover, they are fairly richly priced at present with a P/E (LTM) of 33.7x and 8x P/B. Meanwhile, the Nigerian banks are trading at 0.7x P/B, 3.6x P/E (LTM), with a 10.5% dividend yield. The consensus opinion on why these banks are so cheap even relative to their EM/FM peers, is that the seemingly inevitable currency devaluation would further exacerbate NPLs, which are already rising on the back of low oil prices. However, we think that sufficient pessimism is likely priced in already and that the risk of rising NPLs may be overstated, at least at these valuations. Fitch Ratings recently estimated that NPLs would be unlikely to rise above 10% of their book at the top end, and that stress scenario was an estimate based on $20 oil.[10] As such, it's possible that Nigerian banks might be attractive on an absolute basis globally, especially as a more attractive levered play on oil (as opposed to GCC equities, which appears to be an unattractive de-levered play on oil prices). We are more confident, however, of their relative attractiveness within a frontier universe with only a few pockets of clearly attractive valuations, and believe that when compared to a paucity of reasonable valuations across the relatively thickly held universe of African equities, that they appear quite interesting. We are most confident of their relative and probably absolute outperformance immediately following the widely expected devaluation of the naira.

TABLE 7 MSCI Nigeria Index

	Port. Average Weight	Dividend Yield	P/B	P/E	# of Sec.
	100.00	**6.41**	**5.83**	**23.1**	**16**
Consumer Staples	40.50	4.02	8.15	33.7	5
Financials	37.61	10.57	0.73	3.6	7
Materials	13.98	4.65	2.82	11.5	2
Energy	7.91	0.66	31.17	105.3	2

Source: FactSet

INVESTMENT RECOMMENDATION: Underweight Kenya and Morocco. Underweight Nigerian consumer stocks, overweight Nigerian financials, esp. immediately following a devaluation of the naira.

10. *"Mass Retrenchment Looms In Nigeria's Bank Sector Over Tough Business Environment," Naija247 News.*

Important Disclosures:

This report is neither an offer to sell nor a solicitation to invest in any product offered by FIS Group, Inc. and should not be considered as investment advice. This report was prepared for clients and prospective clients of FIS Group and is intended to be used solely by such clients and prospects for educational and illustrative purposes. The information contained herein is proprietary to FIS Group and may not be duplicated or used for any purpose other than the educational purpose for which it has been provided. Any unauthorized use, duplication or disclosure of this report is strictly prohibited.

This report is based on information believed to be correct, but is subject to revision. Although the information provided herein has been obtained from sources which FIS Group believes to be reliable, FIS Group does not guarantee its accuracy, and such information may be incomplete or condensed. Additional information is available from FIS Group upon request.

All performance and other projections are historical and do not guarantee future performance. No assurance can be given that any particular investment objective or strategy will be achieved at a given time and actual investment results may vary over any given time.