

## 2018 OUTLOOK for Frontier Markets

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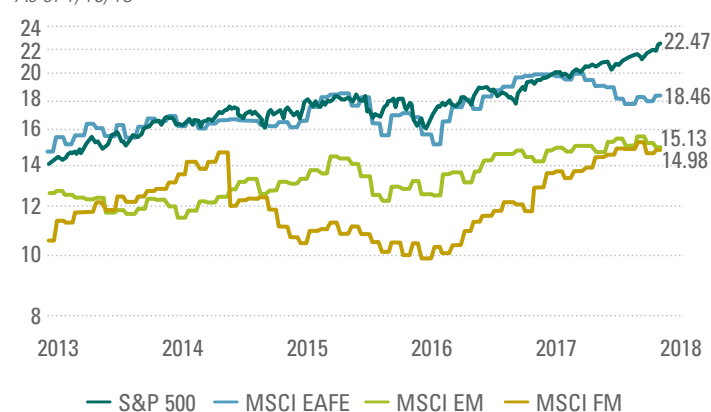
### SUMMARY

Frontier markets surged in 2017, with the MSCI Frontier Markets (FM) index gaining +33%. This is against a backdrop of a +37% return for the MSCI Emerging Markets (EM) index, +25% for the non-US developed markets, and +21% in the U.S. While in EM, this was mostly driven by earnings, FMs were mostly driven by a PE re-rating in the market (see [CHART 1](#)). Part of this closing of the gap with EM is expected to revert, as trailing earnings in Nigeria remain extremely negative and are expected to at least flatten out in 2018, but at least for the coming year, the prospects for FMs are less obvious than they have been over the past two years. The two most promising markets in the index, Argentina and Vietnam, accelerated +77% and +65% in 2017, leading both markets to the top of their 5-year valuation ranges (see [CHART 2](#) on next page), although forward earnings are still very reasonable as both markets portend strong earnings growth next year. ROEs across the frontier markets remain higher than anywhere else outside of the U.S. (see [CHART 3](#) on next page), though there are several markets where we don't feel you're getting paid for those differences. We remain bullish on Argentina, Vietnam, and frontier Europe, with some caveats, and add a new modestly positive view on Kuwait. Where we are less optimistic is in most of sub-Saharan Africa, although our view is colored by lack of relative upside and not so much outright bearishness.

Last year we also flagged the waning structural integrity of the frontier universe, such as it ever was, given the recent and expected upgrade of several of its main constituents. Although Argentina was not elevated to EM status by MSCI in 2017, most observers expect that its promotion in 2018 is all but guaranteed (and largely priced in as well). Nigeria's resolution of its exchange rate mechanism seems to have kept its FM status in

place by both MSCI and FTSE/Russell and Romania remains on watch for a potential upgrade, seeking only a tick up in liquidity to cement its case. Kuwait was upgraded to EM by FTSE/Russell in September 2017 following the establishment of t+3 and DVP settlement. Looking ahead, Kuwait is likely to be added to MSCI's watchlist for upgrade in 2018, which would put the admission of the market into the MSCI EM Index no earlier than 2020. Meanwhile the only near-term entrant to the indexed frontier universe appears to be Iceland, which was recently put on watch by FTSE/Russell for potential admission to the FM Index, though this will yield little excitement to most frontier investors who are more keen to capture the gains of developing economies rather than a fully developed Nordic market.

**CHART 1** Trailing P/E of the major global indices  
As of 1/10/18

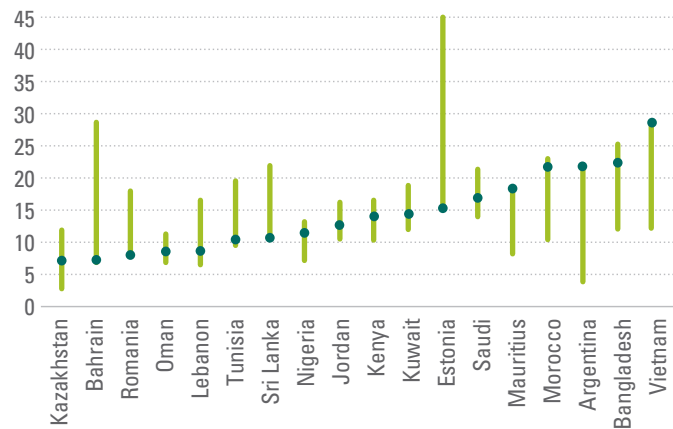


Source: Factset

Summary of our 2018 Themes and Investment Recommendations		Page
1	<b>ARGENTINA</b> – Good governance and a potential explosion of pent up growth at still reasonable (though no longer cheap) valuations. Some new risks here on the horizon, but for at least the next year, the market looks poised to continue apace. Long Argentina and/or overweight vs FM.	3
2	<b>VIETNAM</b> – Solid fundamentals and breakneck growth combined with regulatory and structural catalysts in a market with pent-up demand for access among global investors as growth continues apace amid governance that is good enough. Long Vietnam and/or overweight vs FM.	6
3	<b>FRONTIER EUROPE</b> (x Kazakhstan) – Strong Eurozone growth and a positive economic outlook in Russia will continue to add incremental flows were just a little bit of pump priming can move the needle in an underpriced market. But the largest market, Romania, looks to hit the brakes a bit as rising inflation gives way to higher rates counter-cyclically to the rest of the region. Overweight the Baltics and Balkans, but look to neutral weight Romania before year end, but after a potential EM upgrade announcement by FTSE in September.	7
4	<b>MENA</b> (Kuwait, Saudi, Oman, Morocco) – A rise in oil prices will prove most accretive to the Kuwaiti market, delivering a fiscal surplus which should at a minimum put a floor under the equity market. Meanwhile a turnaround in local real estate offers a modest probability upside scenario while the market delivers a 4% dividend yield in a pegged USD currency. Elsewhere in the region, valuations are not compelling enough to justify the risks, unless oil were to sustain above \$75/barrel. Heavily overweight Kuwait relative to MENA markets, slight overweight vs FM. Add to yield seeking EM portfolios or as a defensive equity hedge to rising oil prices.	8
5	<b>SUB-SAHARAN AFRICA</b> (Nigeria, Kenya, Zimbabwe) – Growth in Nigeria remains elusive outside the oil sector and despite a few years of underperformance, Nigerian consumer stocks remain too pricey. Meanwhile Nigerian banks have closed the gap with their historical valuations and are no longer compelling compared to the rest of FM. In Kenya, the risks are modest, but so is the upside while in Morocco, the risks are low, but the upside is even lower at these stretched valuations. Rising oil prices should also stress both economies at the margin. Add Zimbabwe to your radar, but continue waiting for a better entry point, though this could emerge mid-year. Overall, underweight Africa vs FM.	9

CHART 2 MSCI 5 year P/E range

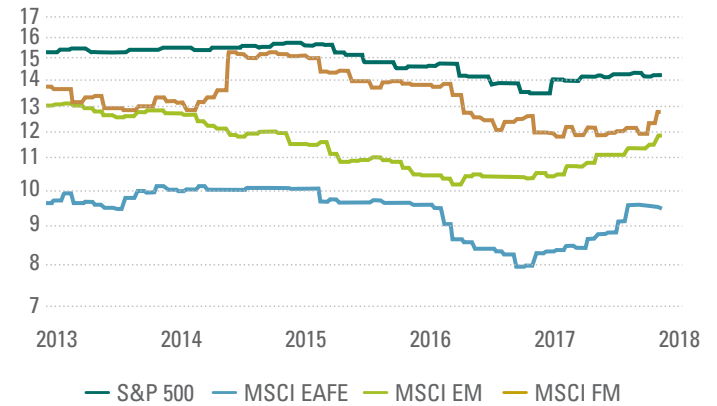
Trailing P/E for MSCI Country Index, as of 12/31/17



Source: Bloomberg

CHART 3 Returns on Equity (ROE) of the major global indices

As of 1/10/18



Source: Factset

CHART 4 MSCI Frontier Markets Index – Country Returns and Valuations (with Nigeria sector breakout)

	Avg. Weight	2017 USD Return	2017 Local Return	ADTV	Mkt Cap	DY	P/B	P/E (LTM)	P/E (NTM)
<b>TOTAL</b>	<b>100.00</b>	<b>33.42</b>	<b>32.43</b>	<b>1,853,882</b>	<b>5,222</b>	<b>3.88</b>	<b>3.42</b>	<b>19.7</b>	<b>17.9</b>
Middle East and North Africa	37.16	10.77	8.24	1,371,324	6,591	4.54	2.17	14.8	14.7
Kuwait	17.82	18.70	17.24	2,369,104	8,959	3.94	1.52	15.4	14.3
Morocco	7.96	11.81	3.26	52,052	7,436	3.60	4.67	20.8	19.8
Bahrain	3.64	11.85	10.89	2,471,703	4,239	6.70	1.28	9.3	8.5
Oman	3.31	-11.02	-11.02	680,143	1,812	6.65	1.13	9.4	9.6
Lebanon	2.70	-3.54	-3.54	43,390	2,222	5.47	0.86	5.4	5.2
Jordan	1.29	9.36	9.44	42,939	3,019	4.93	3.35	13.3	-
Tunisia	0.45	11.70	21.26	8,775	681	3.99	2.06	13.2	16.4
LatAm	20.28	77.25	77.25	423,574	5,298	1.73	3.45	30.3	23.5
Argentina	20.28	77.25	77.25	423,574	5,298	1.73	3.45	30.3	23.5
Africa	15.81	35.78	41.84	5,710,531	3,912	4.09	6.32	19.5	17.5
Nigeria	7.49	37.47	57.12	7,835,245	3,071	3.51	6.12	23.5	20.7
Financials	3.55	75.48	100.56	16,494,142	2,177	5.48	1.41	7.7	6.3
Cons. Staples	2.80	11.77	27.75	2,014,693	2,729	2.05	11.68	34.7	33.0
Materials	0.83	16.81	33.51	1,810,354	8,517	3.35	4.27	13.1	15.9
Energy	0.31	20.86	38.13	138,011	751	-	1.92	197.6	45.3
Kenya	4.43	36.67	37.71	5,525,567	6,032	4.55	8.70	18.2	16.5
Mauritius	2.81	41.90	29.96	83,293	1,926	3.39	1.39	9.6	9.0
Senegal	0.88	14.94	0.96	12,173	4,302	7.09	4.27	12.6	11.8
Ivory Coast	0.19	-6.04	-17.47	3,664	658	5.58	-	11.4	8.3
South East Asia	13.55	50.34	52.02	1,925,403	6,762	1.82	7.37	33.3	30.1
Vietnam	9.82	65.55	65.10	2,590,646	8,902	1.36	8.11	39.2	35.3
Bangladesh	2.34	18.37	25.26	442,433	3,085	2.03	8.05	27.4	23.4
Sri Lanka	1.39	2.87	5.41	720,723	1,192	3.91	2.43	11.1	11.4
EM Europe	9.38	36.04	23.58	1,307,698	2,647	3.83	1.09	13.9	10.2
Romania	3.80	28.58	16.08	3,032,239	2,652	4.81	1.10	15.4	8.9
Kazakhstan	1.93	69.93	69.93	339,080	4,697	0.87	0.92	11.8	6.9
Slovenia	1.54	33.56	17.32	6,567	2,020	5.32	1.22	12.7	12.8
Croatia	1.41	16.78	1.03	3,958	1,860	3.73	1.01	14.6	14.0
Estonia	0.39	49.48	31.30	136,493	816	3.28	1.31	15.2	14.0
Serbia	0.20	29.53	9.03	6,873	987	--	0.92	8.2	4.6
Lithuania	0.12	15.80	1.72	22,229	455	4.50	2.20	11.1	11.2
South Asia	3.83	2.27	2.72	971,609	2,148	6.85	1.67	11.2	12.5
Pakistan	3.83	2.27	2.72	971,609	2,148	6.85	1.67	11.2	12.5

Source: Factset

## Summary of our 2017 Country Themes, Recommendations, and Outcomes

	Theme	Outcome	Grade
1	<b>ARGENTINA</b> – Reasonable valuations, continued market reforms, added liquidity, and falling inflation and interest rates all point to good news. There are some risks to this view, but Argentina appears poised for a few years of bull market returns. Long Argentina and/or overweight vs FM.	Argentina roared ahead +77% for the MSCI index and the investible U.S. ETF (ARGT) soared +53.1%.	A+
2	<b>VIETNAM</b> – New regulatory and structural catalysts are adding depth and liquidity to a market where 10 years of growth are not fully reflected in the opportunity set. Long Vietnam and/or overweight vs FM.	The MSCI Vietnam soared +65% while the local Ho Chi Minh index gained 48%.	A+
3	<b>PAKISTAN</b> – Positive structural reforms are bringing local investors back to the market in a meaningful way. Interest rates are way down, which is positive for risk assets, and the market is being upgraded to EM this year. Long Pakistan through May and/or overweight vs FM.	Pakistan gained 10% until just before the MSCI upgrade at the end of May, before selling off sharply over the course of the rest of the year. We followed our own advice and bought on the slump following the upgrade, but did so too soon in hindsight. We remain long Pakistan (see our Global outlook for more coverage, post EM upgrade).	B
4	<b>FRONTIER EUROPE</b> (x Kazakhstan) – Improving Eurozone growth and a turnaround in the Russian market (which helps regional funds with frontier Europe exposure) will add liquidity and access to a reasonably priced, and long neglected region. Overweight Frontier Europe vs FM.	Frontier Europe did well, and as a block gained 36%, just ahead of the FM benchmark, but this was led by Kazakhstan where we did not have an outright call.	B
5	<b>GCC</b> (Saudi, Kuwait, etc.) – Fiscal pressures and policy uncertainty with uncompelling valuations make this region unattractive again. Underweight (even zero weight) vs. FM, unless you're really bullish on oil prices climbing above \$75/barrel.	Saudi Arabia was flat over 2017 while Kuwait gained 18.7%, decisively underperforming the index. Other frontier GCC markets did even worse: Bahrain (+11.8%) and Oman (-11%).	A
6	<b>AFRICA</b> (Nigeria, Kenya, Morocco) – Nigerian consumer stocks remain overbought while financials are very attractive, at least relative to Nigeria, but only modestly compelling compared to the rest of FM. Kenya is poised for some macro-adjustments and policy uncertainty in the financial sector portend little upside to the market this year. Morocco's macro situation is improving and relatively good for the region, but valuations are at their post GFC highs, though some premium to the market is justified. Underweight Nigeria/overweight Nigerian banks within any Nigerian allocation while staying clear of pricey consumer names. Stay clear of Kenya and neutral/slight underweight in Morocco.	We got Nigeria and Morocco largely right as Nigeria outpaced the overall index (+37.5%), led by the banks (+75%), while Nigerian consumer stocks (+11.7%) and Morocco strongly underperformed (+11.8%). Kenya narrowly outpaced the overall index (+36.7%), but stayed well behind our other key long calls in Argentina and Vietnam.	B

## ARGENTINA

In 2017 Argentina looked to continue the reform momentum of 2015/16, liberalizing subsidies and arresting inflation. A critical early yardstick in measuring the public's perception of these reforms happened in October with congressional elections for half of Argentina's lower house and a third of the upper house. President Macri's Cambiemos coalition defied market fears and many forecasters by significantly increasing their hold in the legislature. Markets rallied into the election as local buyers bought the rumor and sold the news (see **CHART 5**). But the electoral victory enabled Macri's government to consolidate their political capital and resume the reform agenda, which had slowed significantly heading into election season. Indeed in December, Macri's government was able to approve pension reform that should slow wage growth in future years and thus help bring down inflation, reduce the corporate tax rate from 35% to 25%, and remove a 15% capital gains tax for foreign investors. The latter reform is also regarded as the final rule change needed to prompt the re-upgrade of Argentina from frontier to emerging status by MSCI, which we expect to be announced at MSCI's

CHART 5 MSCI Argentina

Index price, as of 12/31/17



Source: Factset

mid-year review in May/June. Investors project that this reclassification would see about \$5bn of flows into Argentine equities, with up to 20-30% of that into locally listed, non-ADR shares. While this may be true, we are deeply informed by the recent experiences of UAE, Qatar, Pakistan, China A-shares, and Vina-milk that this information is often overly discounted well ahead of the announcements. In the case of Argentina, we believe that this expectation is certainly reflected in the ADRs, although not yet entirely in the local ordinaries, where until recently market access restrictions limited or slowed foreign access.

**CHART 6** Monthly GDP growth estimate

%y/y, as of 12/31/17



Source: CEIC

**CHART 7** Credit to private non-financial sector

Argentina as a % of GDP, as of 10/31/17



Source: Bank of International Settlements

But while there is an overwhelming amount of good news in Argentina these days, we are also starting to see rising risks to the durability of the boom. In last year's outlook we highlighted the pivotal role that normalized inflation has in Macri's politico-economic agenda and even drew a line in the sand at 2% monthly inflation for the latter half of the year. Macri's government succeeded in bringing inflation down below that 2% level from May to November, but then December's inflation number surged up well over 3% (see **CHART 9**). We would normally dismiss such a short-term number and wait for a few more months of confirmation, but the release of this data coincided with a revision of the government's target inflation rate for 2018 up to 15% from its previous level of 8-12 percent, and for 2019 up to 10% from its previous target of 5%. This has given cover for the Argentine Central Bank to signal a pending rate cut, and consensus es-

Meanwhile, the economy has resumed growth (see **CHART 6**). The Argentine Government's budget for 2018 forecasts a further 3.5% growth (real). We find this reasonable and as with other post-recessionary recoveries, Argentine companies have substantial operating leverage and so growth will disproportionately accrue to earnings. Moreover, as we discussed in last year's outlook, the Argentine economy and the banks in particular still remain relatively underleveraged (see **CHART 7**) while non-performing loans (NPLs) remain low (see **CHART 8A**) and banks remain extraordinarily well provisioned (see **CHART 8B**).

**CHART 8A** Private banks' NPLs: non-financial private sector

Argentina, %, as of 10/31/17



**CHART 8B** Private banks' provisions to non-performing loans

Argentina, %, as of 10/31/17



Source: BCA Research

**CHART 9** Argentine consumer price index change

%, monthly, annualized, as of 12/31/17



Source: INDEC (Argentine statistics agency)

timates are projecting them to cut rates by at least 5% (down from about 29%) in early 2018.

Argentine bulls explain this change in policy as a prudent response to the facts on the ground and reflective of Macri's moderate *gradualismo* approach to reform. They also cite this policy change as an unprecedented orthodox way of managing macro policy in Argentina. They cite the above litany of positive reforms as well as an agreement with unions (already secured) that will contain minimum wage growth to a mere 13% y/y through mid-2018 which should also coincide with the expected end of most of the subsidy removals which should have worked their way through the inflation numbers by March 2018.

Meanwhile, Argentine bears see this as the fall of the first pillar in the Argentine house of cards. The early capitulation on inflation, as they see it, is a signal to the market that nominal growth is still more politically necessary than breaking the back of inflation. Over two years into Macri's Administration, Argentina's fiscal deficit continues to be materially worse than their other EM peers (see CHART 10) and the spending is increasingly financed by dollar-denominated debt, now approaching 40% of GDP, one of the highest such levels in the emerging world. Together with persistently high inflation buoyed by persistent wage pressures (see CHART 11), and a sinking current account deficit (see CHART 12), this creates expectations for further depreciation in the peso of 20-25%, which in turn will also aggravate the deficit by expanding dollar-denominated interest payments. At the extreme (or in a couple of years), this yields the same FX/fiscal spiral that we have seen in Argentina before.

For our view, we largely agree with both sides, but see the bull case as present in the status quo and the bear case as yet a mere probability, albeit an increasing probability relative to our view last year. As such we are inclined to go with the present certainty of growth, reform, consolidated political capital, and sentiment over the possibility of their future reversal. But we are watchful, especially of inflation figures. Despite Macri's seemingly consolidated political position, he will ultimately prove no different than many of his predecessors in steering Argentina past the rocky shoals of Peronist populism if he cannot deliver sustainable growth without the instability of inflation. Without containing inflation, his pro-market reforms will ultimately be viewed as having benefited only investors and exporters from the provinces at the expense of unions and salaried workers in the capital, and unrest, manifested in a return of market distorting policies, will ensue. But for the meantime, the market seems fully on board with extending his administration a longer benefit of the doubt. One senior portfolio manager of a leading frontier markets manager recently opined that "Macri is the best leader of a country in the world today." While we are not as unabashedly optimistic, we recognize the clearly positive direction, and informed that with such a view prevailing in the market, and at reasonable (albeit no longer outright cheap) valuations close to 15x P/E (NTM), the Argentine bull market looks likely to at least continue to outperform its frontier peer universe.

**Investment Recommendation: Overweight and/or long Argentina in frontier portfolios. Add opportunistically to EM portfolios, especially locally listed stocks, where possible.**

**CHART 10** Argentina fiscal balance  
% GDP 6 month moving average, as of 12/31/17



**CHART 11** Wage growth rate  
% y/y, 3 month moving average, as of 12/31/17



**CHART 12** Current account balance  
% GDP 12-month cumulative, as of 12/31/17





## VIETNAM

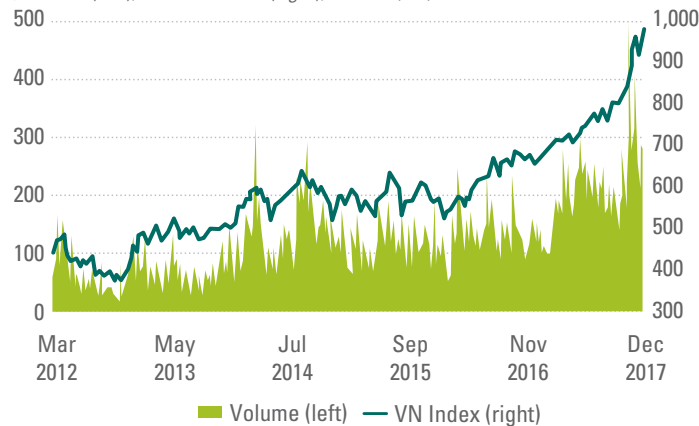
If the pace of reform in Argentina is being described as “gradual,” then in Vietnam the word should be “glacial.” Over two years after the government opened up the market for companies to scrap their foreign ownership limits, and over a year and a half after the company’s pre-eminent blue-chip stock, the Vietnam Dairy Company (aka ‘Vinamilk’), was the first to do so in practice, only a handful of other companies have followed suit. This remains a substantial barrier to foreign investment, as is the Byzantine bureaucratic processes for establishing direct custody in the market, and the non-delivery versus payment structure of the Vietnamese IPO process. Yet despite these persistent barriers, the market continues to boom and foreign investors are going to disproportionate lengths to get into the market. In 2017 the market finished up 65% (see [CHART 13](#)), buoyed in significant part by foreign flows (see [CHART 14](#)). Beyond adding market cap through returns, the stream of IPOs and new listings continued, with the market cap of the Vietnamese market climbing 82% y/y with a further 300 new listings during 2017. There are now over 51 companies with greater than USD \$400m in market capitalization. But roughly 38% of the market

(by market cap) is at their foreign ownership limits, demonstrating the ongoing challenge of investing in the market. When demand is strong and it’s hard to get in, sellers become even more scarce. Absent economic fundamentals or strong earnings, this has the propensity to convert easily into a manic bubble.

Yet bubble fears are misplaced. Vietnam continues to offer both strong economic fundamentals and strong earnings growth. The economy grew at an estimated 6.7% in 2017, the 9th consecutive year of 5%+ real growth. Meanwhile inflation in 2017 was a developed market level 2.6%. Consensus expectations for 2018 are for another year of 6.7% real GDP growth and 3% inflation. A positive trade balance of around 3%, growing FX reserves, and interest rates less than 5%, and the macro-economy clearly offers one of the most favorable environments anywhere in the developing world. Sometimes in such a boom market we see it supported by an unsustainable explosion in credit (such as may be happening in Argentina), but in Vietnam, while credit has surged in recent years (see [CHART 15](#)) it has largely kept pace with deposits (see [CHART 16](#)).

**CHART 13** Market performance

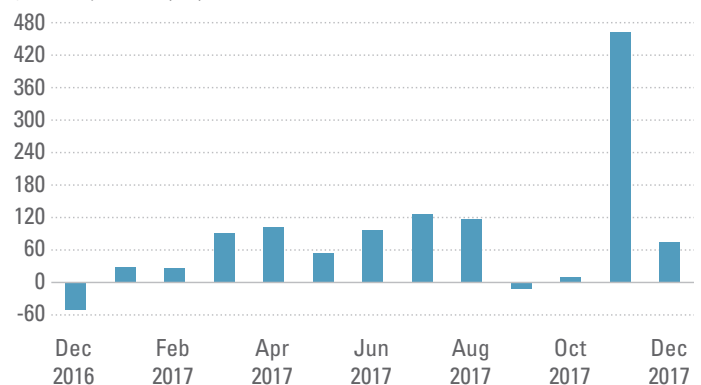
\$millions (left), VN Index level (right), as of 12/31/17



Source: Ho Chi Minh Exchange

**CHART 14** Foreign flows remain strong despite barriers

\$millions, as of 12/31/17



Source: Ho Chi Minh Exchange

**CHART 15** Private credit/GDP ratio

As of 11/30/17



Source: IMF, Haver, CEIC

**CHART 16** Private credit/deposit ratio

As of 11/30/17



Source: IMF, Haver, CEIC

Meanwhile, corporate earnings are surging on both a relative and absolute basis (see [CHART 17](#)). Despite Vietnam finishing at the top of its historical valuation range (see [CHART 2](#) on [PAGE 2](#)), earnings growth for 2018 is estimated at 26% for a still very reasonable 14.7x P/E (NTM) and a 0.8x PEG ratio. Meanwhile, the entire market remains virtually unlevered at 0.2x net debt/equity.

We never like sounding like a broken record, citing for the third year in a row the same combination of strong growth and modest valuations to buttress our market call, but we continue to see the material results that continue to support the same positive view. Moreover, we see few threats to this view. We argued in last year's piece that the pessimism over a pending conflagration with China in the South China Sea or the expectation of a trade war with the Trump Administration were overblown, and thus far we have been right to dismiss such fears. Vietnam's substantial cost advantage over its major manufacturing trading competitors in the U.S. market (Mexico and China, see [CHART 18](#)) obviate fears over marginal tariff increases, which we do not find probable in any event. And China's overwhelming military superiority makes an armed conflict with Vietnam over the South China Sea as likely as an armed conflict between the U.S. and Mexico over trade and immigration frictions, which is to say, nearly unimaginable.

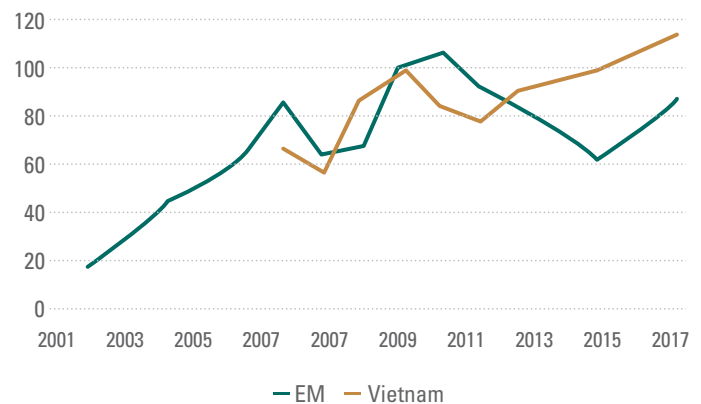
**Investment Recommendation: Overweight and/or Long Vietnam in FM and possibly even EM portfolios.**

## FRONTIER EUROPE

While Vietnam offers breakneck growth at reasonable valuations, frontier Europe offers modest growth at cheap valuations. Frontier Europe should continue to benefit from an improving macro-economic position of the Eurozone and Russia and remains mostly insulated from any potential market instability in Turkey. The region continues to trade at roughly 10x P/E (NTM) and 1.1x P/B, though valuations for the region are a touch higher if you exclude Kazakhstan, which we are not comfortable making a call on given the market structure. In Romania, we note the surging inflation (relative to elsewhere in Europe) from a deflationary trough of -3.5% in mid-2016 to +3.2% y/y in November 2017 (see [CHART 19](#)) and the effect it can have to raise interest rates, already hiked once in early January from 1.75% to 2%, with consensus forecasts for a further 75bps in rate tightening. We expect this to slow earnings and GDP growth modestly, and thus moderates our excitement for the region somewhat, but overall, this remains an underpriced market ripe for stock-picking, and a confident relative call compared to the rest of frontier, at least through mid-year when rate tightening could begin to slow investor expectations. Moreover, Romania is just an uptick in liquidity away from an upgrade to EM by FTSE and being watch-listed by MSCI, either of which would also buoy investor enthusiasm.

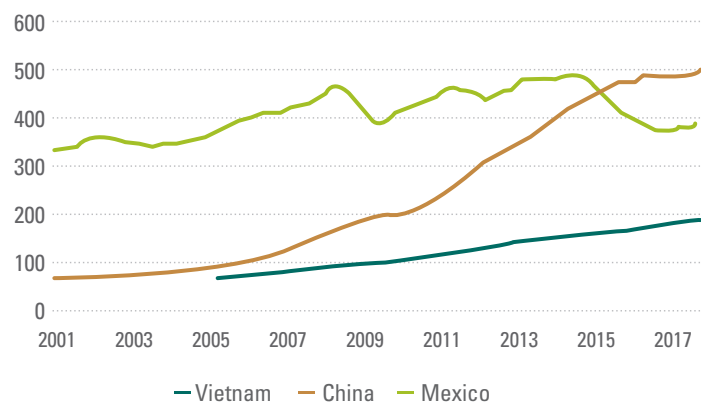
**Investment Recommendation: Overweight frontier Europe in FM portfolios. Watch Romania for EM upgrade.**

**CHART 17** Vietnam vs. EM-listed earnings  
USD, 2010 = 100, as of 12/31/17



Source: Bloomberg

**CHART 18** Vietnam wages in context  
USD, 12 month moving average, as of 12/31/17



Source: CEIC

**CHART 19** Romania consumer prices (incl. Capital Economics' forecast), % y/y, as of 12/31/17



Source: Ara Research & Consultancy

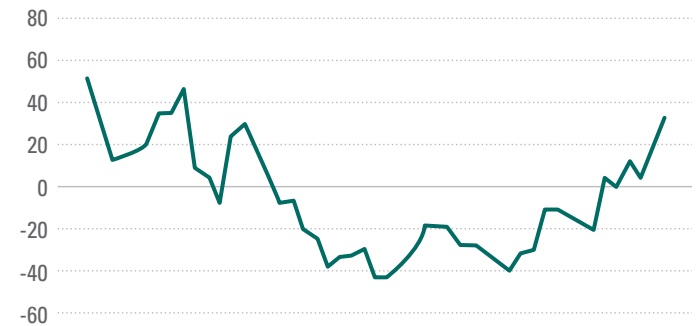
## MENA (KUWAIT, SAUDI ARABIA, AND MOROCCO)

Within the Middle East, or at least the oil exporting economies, oil prices do not have a direct effect on local equity prices. Indeed only a very small fraction of local markets are directly exposed to energy prices (until Aramco lists). Yet oil is clearly relevant, but only first after passing through the translation effects of anticipated government spending and real estate prices. Despite the rebound in oil prices, most oil exporting markets in the Middle East remain below their fiscal break-even, except for Kuwait, which has the lowest fiscal breakeven price in the region at roughly \$47.1/barrel according to IMF estimates. On the technical front, the market already got a boost in September 2017 when FTSE/Russell announced Kuwait's promotion to emerging markets following the establishment of t+3 and DVP settlement. We also expect Kuwait to be added to MSCI's watch list for upgrade in 2018 (though this would put the admission of the market into the MSCI EM Index no earlier than 2020). We view the likely fiscal stimulus to the economy from higher oil prices as putting a firm floor under a market that is trading near its recent (5-year) average valuations, with the anticipation of index-related announcements as confirming that view over the medium-term. Meanwhile, while Kuwait is not cheap on a P/B or P/E basis and does not offer a structural growth story, it does offer a 4% dollar-denominated dividend yield. This makes Kuwait a potential hedge on oil or a potential safe haven within FTSE-following EM portfolios should markets get overheated at some point this year. We also see some incremental buying by FTSE-linked smart beta ETFs, especially from yield chasing European investors.

Meanwhile, the real estate market has rebounded from its two year slump (see CHART 20) and while residential prices have not yet turned up, land and investment buildings have (see CHART 21). Meanwhile consumer sentiment has also ticked up from a multi-year low (see CHART 22). Taken together, we initiate our first positive call on Kuwait in three years and recommend an overweight versus MENA markets and a slight overweight versus FM. But abandon the call if oil prices slump below \$50 and trim tactically on anything outside a +30% move relative to FM or oil prices. Economic forecasts are for +3% GDP growth in 2018.

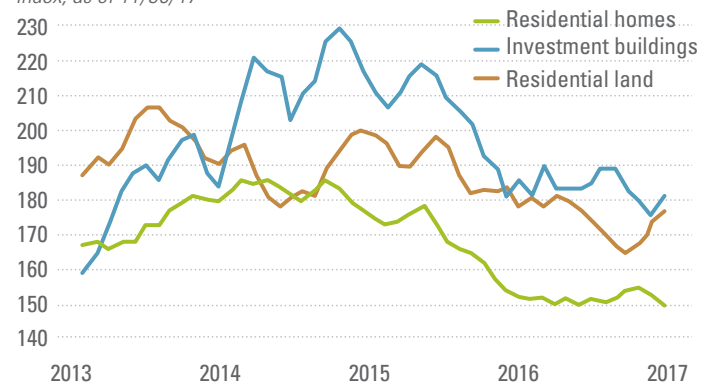
While we see a minor cyclical recovery in Kuwait, across the border in Saudi Arabia we are witnessing an attempt at an historic transformation of one of the world's most conservative societies and languid economies. In the past year, Crown Prince Mohammed Bin Salman (MBS) has opened up the country for women to drive, for live performances, western cinema, and a host of other previously unfathomable luxuries for the conservative Saudi culture. Economically, MBS is keen to restructure the Saudi economy away from its over-dependence on oil and state-led job creation and push the market towards a more dynamic form of Gulf capitalism. In short, they are re-writing the social contract of a nation. MBS has also now launched a charm offensive to lure foreign investment including the flashy new mega-city on the Red Sea called "NEOM," which has already drawn commitments from high profile investors including Richard Branson.

CHART 20 Kuwait real estate sales  
% of y/y, 3-month average, as of 11/30/17



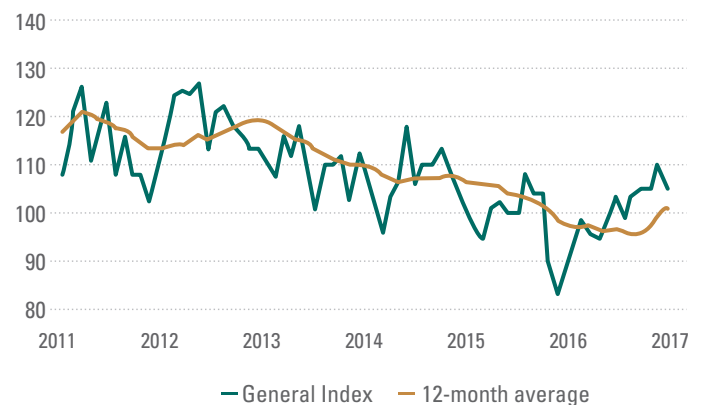
Source: Ministry of Justice

CHART 21 Kuwait real estate prices  
Index, as of 11/30/17



Source: Ministry of Justice, NBK estimates

CHART 22 Kuwaiti consumer confidence rebounds  
Index, as of 12/31/17



Source: Ara Research & Consultancy



But elsewhere in the region, the adventurous young crown prince has launched various military offensives, both hot and cold. Saudi Arabia remains mired in the intractable conflict in Yemen, which is beginning to look more like their own version of America's Vietnam War. And though MBS seems to have surrendered in Syria for now, the proxy conflict with Iran in Lebanon remains in full swing. The failure in Syria has put MBS in a tight spot politically, as he has staked too much political capital on these various regional hotspots, and we don't believe he can afford to be seen as losing another conflict abroad without it curtailing his credibility at home within the religious establishment and the rest of the royal family. Materially, while we don't view any of these regional conflagrations as direct threats to Saudi's reform efforts, per se, they do all require ongoing funding which will pose constraints on the resources MBS has at his disposal to buy-off influential dissenters and appease key interests. At the extreme, the life of MBS himself could be at risk if he pushes too far, too fast.

For the market outlook, we think so much change and uncertainty is positive for active, expert stockpickers, but bad for macro-tactical traders. The market continues to trade at roughly 15x P/E (LTM) and 13.2x P/E (NTM) and a PEG ratio of 1.4x, almost exactly in line with its own recent history, so we don't feel we're getting paid for the risks. Elsewhere in the region, we also do not find valuations compelling enough for the risks. Oman remains in a fiscal free-fall with dwindling FX reserves while Morocco remains strong and stable, but overpriced relative to other frontier opportunities.

**Investment Recommendation: Heavily overweight Kuwait relative to MENA markets, slight overweight vs FM. Add to yield seeking EM portfolios or as a defensive equity hedge to rising oil prices.**

## AFRICA (NIGERIA, KENYA, ZIMBABWE, ETC.)

Nigerian banks rebounded strongly in 2017 to finish the year up 75% while the rest of the market gained only 11%. We followed our own advice and initiated a position in Nigeria in June of last year after the new exchange window removed most of the uncertainty from the FX market, and while custody limited our implementation options to the market ETF, we were happy to deliver 25-30% returns to our clients on this trade. The sector and market are now back to trading in line with its historic levels and thus we have exited our position. But if investors look to frontier markets for growth, they won't find it Nigeria, at least not yet. Non-oil GDP continues to contract based on the latest data. On the policy front, our best case scenario is for an ongoing stalemate as the aging (and ailing) President Buhari seems to lack the political capital for any reforms that could revive sentiment ahead of fundamentals.

Across the continent in Kenya, after another choppy election season, the market seems to have calmed down, while the current account deficit and FX reserves seem to have stabilized (for now). The MSCI Kenya index is comprised 50% of Safaricom and the other 50% in three stocks, so we are wary to make

strong macro calls absent overwhelming conviction, which we do not have either way.

Down the rift valley from Kenya, things have gotten pretty interesting in Zimbabwe. In November, the Zimbabwean military overthrew long-time President Robert Mugabe in a bloodless coup that they are not calling a coup. Mugabe is the 93-year old former freedom fighter turned despot who has led Zimbabwe since its (re)founding from the white minority, illegal post-colonial government of Rhodesia in 1979. Mugabe, was long considered to be untouchable in his life-time given his prominence, but he apparently went one step too far in seemingly attempting to install his 52-year old wife and former typist/mistress, "Gucci" Grace Mugabe as his successor. The final straw was the recent removal of Emmerson "The Crocodile" Mnangagwa from his Cabinet post. Mnangagwa is also a former revolutionary, long-time Mugabe loyalist, and likely a war criminal for his rumored role in a campaign of ethnic cleansing in the early 1980s. Previous Wikileaks reports indicate Mnangagwa is thought by some US diplomats to be potentially more despotic than Mugabe.

Mugabe has stepped down from the leadership of his party, but looks appeared to remain the symbolic President of Zimbabwe until the end of his term this year, albeit essentially under a luxury house arrest, so that Zimbabwe can sheepishly claim that they did not remove him via anti-democratic means. Mnangagwa seems to have already consolidated his hold on power and has promised that the elections will be held this summer and will be "free, credible, fair and indisputable." The only realistic rival to "The Crocodile" is long-time opposition leader Morgan Tsvangirai, who is seriously ill. To that end, we believe that Mnangagwa will deliver on his promise for free and fair elections, if only because he won't need to employ the underhanded tactics of his predecessor to secure victory...this time.

I have long maintained that the best 5-10 year trade in the world was to buy into Zimbabwe's stock market on the day after Mugabe died (his forced removal always seemed unthinkable). Despite the distortions of the past 15-20 years, Zimbabwe still has a strong legal, economic, and social foundation to grow strongly. Indeed, it is for this reason that Zimbabwe is widely regarded as one of the tragedies of governance in the world. A middle-class, educated population known within their region for their strong work ethic and entrepreneurial culture had the country on a path of growth and relative prosperity (GDP per capital in 2000 on par with Nigeria and India and not far behind China) has had its economy decimated by gross mismanagement, kleptocracy, and crony capitalism. I remember hitchhiking through Zimbabwe in 2001 and thinking how different and much more educated, worldly, and just more advanced a society it was than even much of South Africa, but certainly relative to its much poorer neighbors in Mozambique, where I had been living. Despite both of those countries' problems since that time, incomes are up 90% in South Africa and 300% in Mozambique and down 5% in Zimbabwe.

Post-Mugabe, I believe that Zimbabwe has the clearest case for a surging economic rebound of any investible market in the world. "The Crocodile" is assuredly not Macri or Indian Prime

Minister Narendra Modi in terms of having a genuine commitment to reform or the experience to deliver credible economic policies. But the delta of moving from atrocious governance to merely bad governance can be significant by itself. Zimbabwe will also benefit massively from its proximity to South Africa with very deep financial markets looking for places to put their money that is not their home base (and where local rules specifically allow a special carve-out for investments elsewhere in Africa), and its accessibility and familiarity to investors and investment bankers in London, Shanghai, Dubai, and other key markets worldwide.

Unfortunately, this does not appear to be the entry point. Apart

from the uncertain political situation, the market (measured by the MSCI Zimbabwe) surged 600% last year as the currency and debt markets were renationalized, effectively forcing local investors into the stock market as the least bad safe haven of trapped financial assets. Since Mugabe's ouster, the market has collapsed 50% as investors anticipate more normal policy, but we feel there is still room for more normalization. But the market at least now merits attention from stock-pickers, just not yet for macro-tactical equity investors.

**Investment Recommendation: Underweight Nigeria, neutral Kenya. Watch Zimbabwe for a better entry point, possibly by March or April.**

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