Emerging Markets, Review

A Year in Review

Emerging Markets in 2016 and What to Expect in 2017

Here we see São Paulo, the most populous city in Brazil. Despite a presidential impeachment, the Bovespa, Brazil's main stock market index, logged over a 60% return in 2016.

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As this year winds to an end, it is fitting to see how different countries from around the world ended up performing in 2016. Although this snapshot report will not contain much statistical analysis, I believe it is important to look back at 2016 and to consider what 2017 will bring to the financial world.

Overall, equities in developed markets moved in parallel. Although Canadian equities performed best this year, with an 18% return for the S&P/TSX Index, the Dow Jones Industrial Average (DJIA) and FTSE 100 were not far behind, with all three of these major indices logging double-digit returns. Thus, overall, developed markets did pretty well in 2016.

For the fourth year in a row, emerging markets failed to outperform the S&P500. Still, however, emerging markets did pretty well in 2016, with the iShares MSCI Emerging Markets ETF finishing the year with a double-digit return. These gains, however, were scattered from country to country, and choosing which emerging markets to invest in remained a challenge for investors.

One reason emerging market returns are so unpredictable is that many emerging market economies are *extremely* dependent on specific commodities; if the price of a main export in a country plummets, the economy of this country may plummet, too. As noted in one Wall Street Journal article titled *Mongolia: Land of Lost Opportunity* written by Rhiannon Hoyle, when prices of copper and other metals began to slump between 2013 and 2015, the World Bank slashed Mongolia's projected growth rate for 2016 to 0.8%, approximately 7% lower than the initial World Bank forecast two years prior.

As stated previously, returns varied from emerging market to emerging market. So what specific countries did best and worst in 2016? Let's identify the three biggest emerging market winners and losers for the past year.

WINNERS

1) Russian ruble, bonds, and equities

Just a couple years ago, Russia was experiencing almost 20% inflation and a crippling economic recession. In 2016, however, the spot rate of the ruble gained 21.31%, the Russian RTSI shot up over 50%, and government bond yields in Russia began to fall. As an added bonus, Russia is nearing economic growth once again, too.

As seen in one of our past analyses, historical prices of the Russian RTSI and historical oil prices are positively associated ($\rho_{\text{Oil, RTSI}} = 0.758$). Thus, the recovery in oil prices in 2016 has been a big help for Russia, as this country is a net-exporter of this commodity. After dipping below $30 early this year, oil prices stabilized around $50 for the remaining portion of 2016, finishing the year with over a 50% increase from the January low. Amazingly, Russia experienced all of these gains in the midst of a variety of political issues and sanctions under Putin's authoritarian rule.

2) Brazilian real, bonds, and equities

Brazilian assets won on all levels in 2016. Government bond yields fell, the Brazilian real gained 20.96%, and the Bovespa, Brazil's main stock index, ended the year up over 60%. Similar to Russia, prices of the Bovespa are historically correlated with higher oil prices ($\rho_{\text{Oil, Bovespa}} = 0.557$), so rising oil prices in 2016 helped Brazilian assets, too. Astonishingly, in 2016, Dilma Rousseff, Brazil's past president was impeached, and the country continued to experience its worst-ever economic recession.

3) Emerging Market Debt Issuers

Due to unprecedented levels of quantitative easing by Central Banks, including the Federal Reserve, the Bank of Japan, and the European Central Bank, global bond yields in the developed world continued to plummet to record lows this past year. At one point in 2016, the Japanese ten-year government bond reached a yield of -0.295%, and over $10 trillion worth of sovereign debt in the global bond market had a negative yield.

For emerging market countries, these low rates were a boon, enabling these countries to tap global debt markets at record levels. For example, this September, Ghana sold $750 million worth of debt at a 9.25% yield. Although Ghana still has high inflation and high debt, investors seemed to shrug these issues off; investors wanted any security with yield, and bonds from Ghana offered these investors a high-yield opportunity in a world of low and negative rates.

Amazingly, before 2006, South Africa was the only sub-Saharan African country to have issued a sovereign bond denominated in a foreign currency. Since 2006, though, at least fourteen additional countries in sub-Saharan Africa have issued sovereign bonds, including countries that rely heavily on external aid (e.g. Rwanda). In 2013, sub-Saharan Africa managed to issue a record $4.6 billion in new sovereign debt.

LOSERS

1) Venezuelan bolivar

Venezuela is in the midst of a brutal economic recession, contracting over 10% this year. Additionally, under president Nicolás Maduro, the country's currency, the bolivar, has also continued to degrade with sky-high inflation levels. Don't be fooled by the massive stock market gains seen in Venezuela this year – the country is in terrible shape, with political upheaval and rampant corruption. The only reason the Caracas Stock Exchange boomed in 2016 is because Venezuelans were forced to pump money into the stock market to avoid losing all the value in their assets. Amazingly, Venezuela has yet to default on its sovereign debt, but *only* because China offered a lifeline of cash in exchange for future oil production.

2) Nigerian equities and Nigerian naira

With crude oil prices accounting for approximately 70% of government revenue, the early-year drop in oil prices sent Nigeria into its most challenging economic recession since the country returned to democracy in 1999. The main Nigerian stock market index is down 40% for the year, and the country continued to battle double-digit inflation. Additionally, the Nigerian naira, which was allowed to float freely in June of 2016, tanked throughout the year, with many economists arguing that the naira should have been allowed to float much sooner.

Boko Haram and rebel attacks created issues for the Nigerian economy in 2016, too. However, unlike Venezuela, I believe there is hope for Nigeria in 2017. Paired with rising oil prices, the relatively low debt levels of Nigeria should enable the country to return to economic growth this upcoming year.

3) Egyptian Pound

In recent years, political turbulence and increased terrorism have slowed foreign direct investment in Egypt, and inflation has soared to nearly 15%. The IMF offered Egypt a vital $12 billion loan, but a more flexible exchange rate was a requirement for Egypt to gain approval for this funding. Thus, similar to the Nigerian naira, the Egyptian pound was allowed to float for the first time in November of 2016. Immediately after the pound was allowed the float, the currency experienced a sharp devaluation. In 2016, EGP/USD fell over 130%. Additionally, in dollar terms, the main stock market index in Egypt, the EGX 30, ended the year down 20%.

BULLISH

1) Russian ruble, equities, and bonds

Continuing the trend seen this past year, with inflation falling to moderate levels, Russian assets should continue to generate positive returns in 2017. UBS Group AG believes the ruble could return 26 percent in 2017, the highest return within currencies of developing EMEA countries.

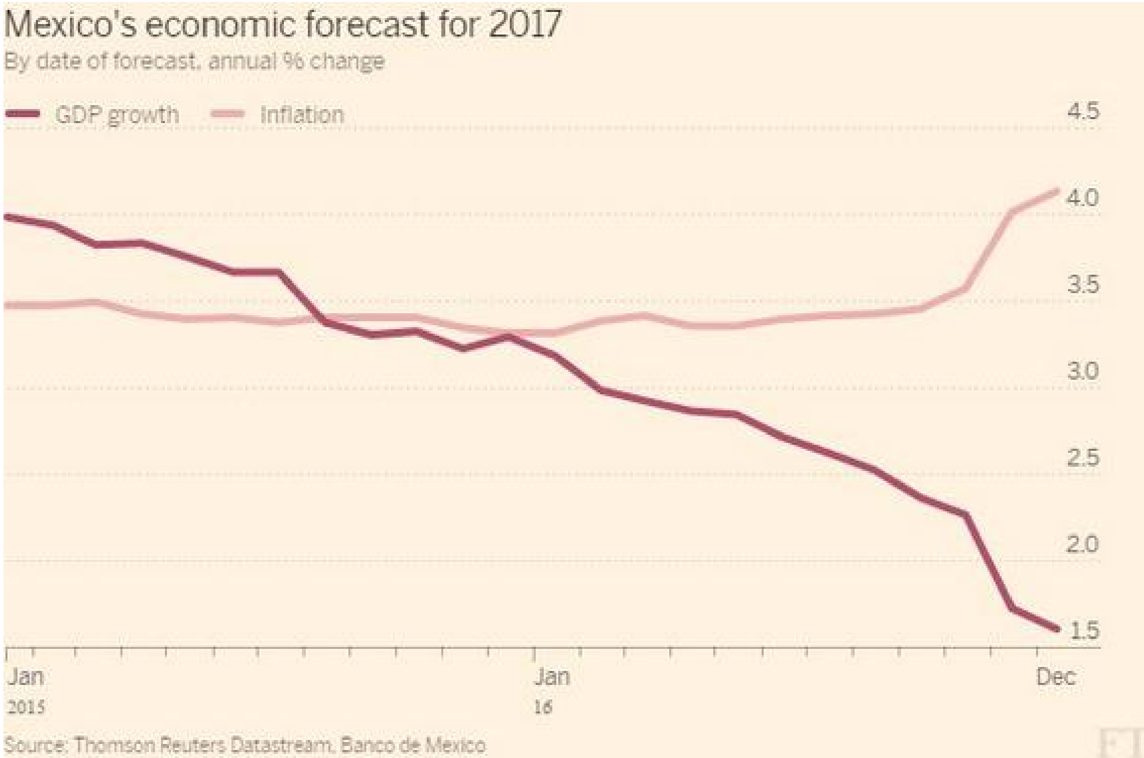
Credit Suisse is also predicting that oil prices will end 2017 near $55, and Goldman is currently predicting oil prices will end this upcoming year around $60. These stabilized oil prices should help the export-driven Russian economy in 2017. Additionally, I believe the Trump administration will be more friendly towards Russia, most likely giving an extra boost to Russian companies.

2) Nigerian equities

As stated previously, over 70% of government export revenue in Nigeria comes from oil production. Since oil prices are set to stabilize in 2017, Nigeria should return to positive economic growth this year. Additionally, since Nigeria has low debt compared to its neighbors, the country has a relatively strong balance sheet heading into 2017. Moody's Investors Service recently affirmed a B1 credit rating for the country with stable outlook, and, if needed, Nigeria could most likely tap global debt markets for external financing in this upcoming year. As an added bonus for Nigeria, fewer threats from Boko Haram and rebel groups are expected in 2017.

3) Mexican peso

After Trump was elected, the peso immediately plummeted over 10%, experiencing the steepest fall since 1994-1995 when Mexico was forced to devalue their currency after a bailout from the U.S. As seen in the figure below, Banco de Mexico continuously raised inflation expectations and lowered growth forecasts for the upcoming year after Trump was elected.



So why am I bullish on the peso? Although a new president always brings uncertainty, until Trump begins to implement his agenda after inauguration in mid-January, it is impossible to understand where Mexico-U.S. relations are headed. Currently, all of Trump's threats to Mexico, from building a wall across the border to tearing up the North American Free Trade Agreement (NAFTA), are simply words. Nothing has actually changed. Of course, the Trump administration *does* have the power to significantly harm Mexico, as 80 percent of Mexican exports are currently sent to the United States. I believe, however, Trump will bail on the majority of his threats towards Mexico, such as his pledge to renegotiate NAFTA, with Congressional Republicans having no desire to enter new trade agreements with Mexico. Thus, I believe the market is overly pessimistic about the peso right now, and, in my opinion, the peso will be one of few emerging market currencies to strengthen against the U.S. dollar in 2017.

BEARISH

1) Emerging Market Debt Issuers

As stated above, with record low borrowing costs, numerous emerging market countries have tapped global debt markets in recent years, initiating a worldwide borrowing binge. At first, emerging market bond issuance seems like a win-win situation for investors and issuers. For example, emerging market countries are able to raise capital in global markets, and investors are able to find a decent return in a world of low and negative yields. However, with changing financial and political conditions, repaying this debt can become *extremely* difficult for some emerging market countries, degrading the value of this debt as the probability of default increases. For instance, in 2008, Seychelles defaulted on its sovereign debt, mainly due to years of excessive government spending.

Thus, I believe this increased debt issuance from emerging market countries should worry investors and economists. A high percentage of emerging market debt is set to mature in the early to mid 2020s, and many of these new emerging market bond issuers may have trouble repaying this debt. After Donald Trump was elected in November of 2016, the dollar has strengthened, too, moving towards parity with the Euro. As the dollar strengthens, external debt becomes more expensive for emerging markets to service, since the debt is typically denoted in U.S. dollars. Thus, in upcoming years, with more protectionist policies under the new Trump administration and a strengthening dollar, we may find that emerging market economies have difficulty repaying investors, leading to increased defaults in the next few years.

2) Brazilian equities

As stated previously, Brazilian assets won on all levels in 2016, with the real and Bovespa finishing the year up over 20% and over 60%, respectively. However, I believe many of these gains will be given up in 2017. This past November, Brazil posted its worst-ever budget deficit under the new president Michel Temer. The country is still struggling to rebalance depleted public accounts, and the economy continues to contract, with households and companies struggling to pay off high debt loads.

Additionally, in a Bloomberg survey, 51% of respondents rated Temer's government as "bad" or "terrible." Temer's majority in Congress has begun to crumble, too, and he continues to be investigated over his use of illegal campaign financing techniques. Thus, in my opinion, the market right now is overly optimistic for Brazil's situation.

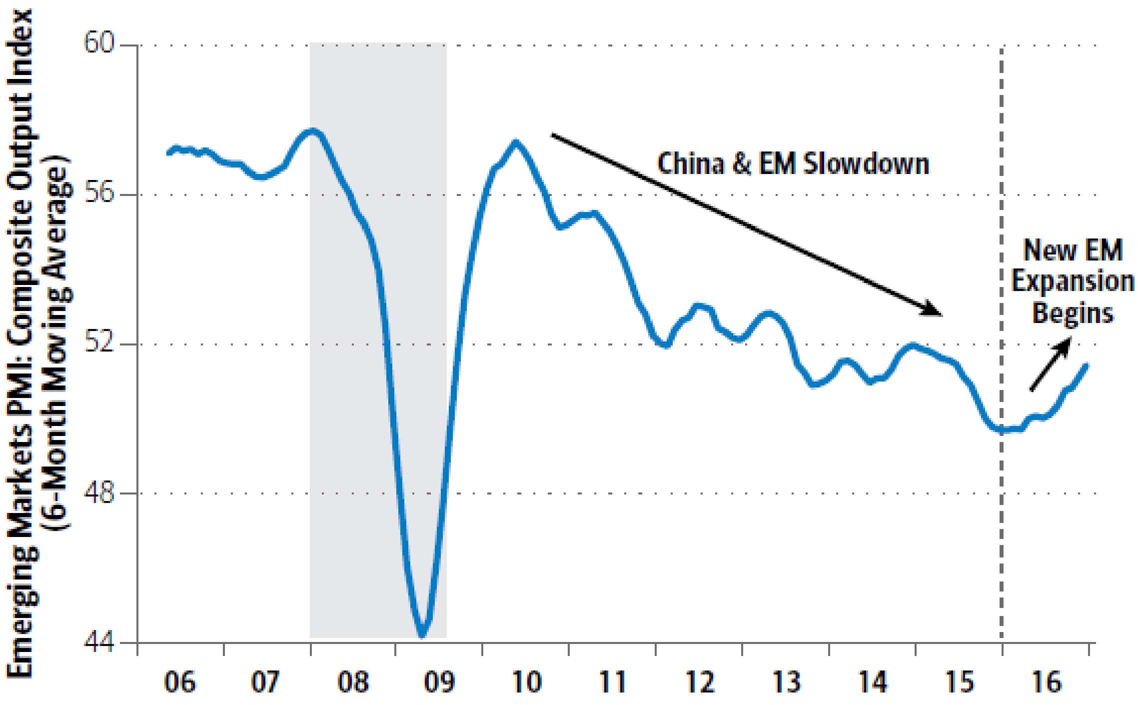
3) Chilean equities

Since Chile is a large exporter of copper, Chilean stocks benefited from higher copper prices in 2016. However, according to predictions from Goldman, copper prices should fall in 2017, harming Chilean exporters. Additionally, under socialist president Michelle Bachelet, slow wage and job growth continue to hold back Chile, with the country having a relatively high level of hostility towards business. For all these reasons, I am bearish on Chilean equities in 2017.

Of course, emerging markets are unpredictable, and, undoubtedly, not all of my 2017 projections will pan out as planned. For example, copper prices could continue to boom, causing Chilean equities to blast to new highs. Or, an unpredictable Trump could decide to tear up NAFTA and attempt to rewrite trade agreements, causing the Mexican peso to sink even further.

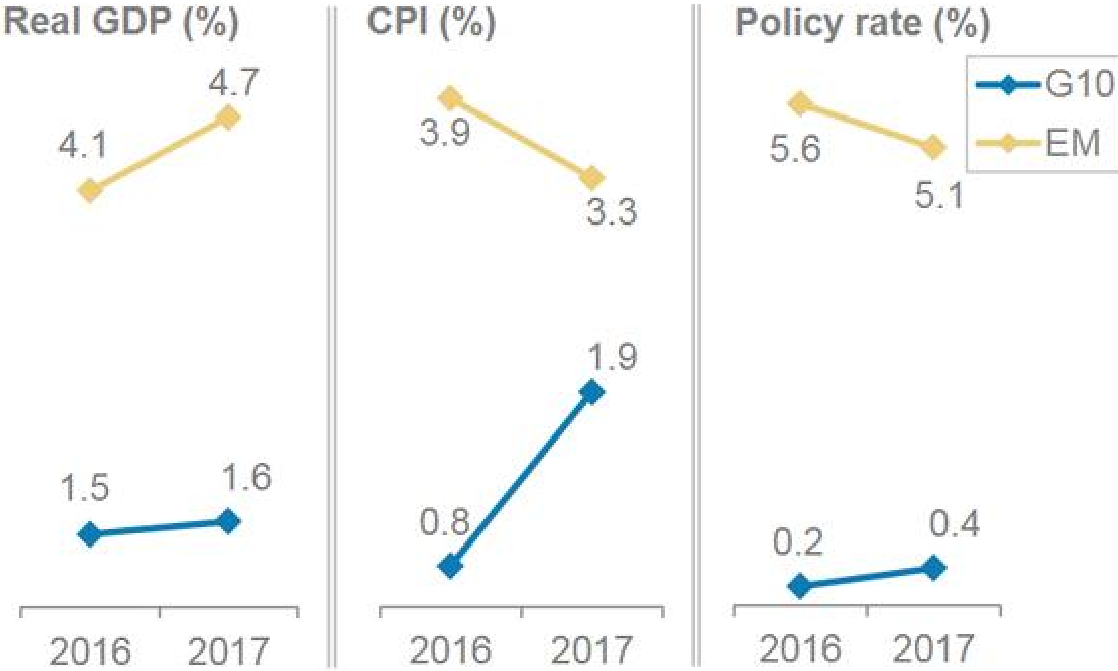
Overall, however, the outlook for emerging markets in 2017 is bright. Credit Suisse is predicting 6.4% growth in the MSCI emerging markets index, and the following two graphs from the Bank of America and Morgan Stanley (respectively) support stronger growth for emerging markets in 2017, too. Let's hope this new year brings gains for both developed and emerging market economies in 2017.

EM Recovery Just Starting After Five-Year Slowdown



Source: IHS Markit/Haver Analytics. Data as of December 5, 2016.

Improving EM macro story: Higher growth, lower inflation, and easier policies



Source: Morgan Stanley Research forecasts.