Market Thoughts:

Emerging Markets leading the way in 2019?

MCB Capital Markets

■ 2018 in a nutshell

While December was a beautiful rally for traditionally deemed safe havens such as gold and government bonds, the contrary can be said for risky assets such as equities and credit. This "correction" reversed the direction of returns for the year.

Q4 price action drove 2018 returns, but still far way from 2009-2018 return profile

	Q4 2018	2018	2009-2018 (cumulative)
Global Aggregate	1.42%	-1.20%	27.83%
US Aggregate	1.73%	0.01%	40.75%
US Treasury	2.70%	0.86%	22.83%
US Investment Grade	-0.09%	-2.51%	77.74%
US High Yield	-4.72%	-2.08%	187.12%
African local currency	3.03%	3.11%	20.86%*
S&P 500	-1.00%	-5.21%	177.54%
DAX	-1.00%	-18.26%	64.57%
CAC40	-1.00%	-9.15%	46.36%
Oil	-30.47%	-24.84%	-46.55%
Gold	7.71%	-1.70%	-21.87%

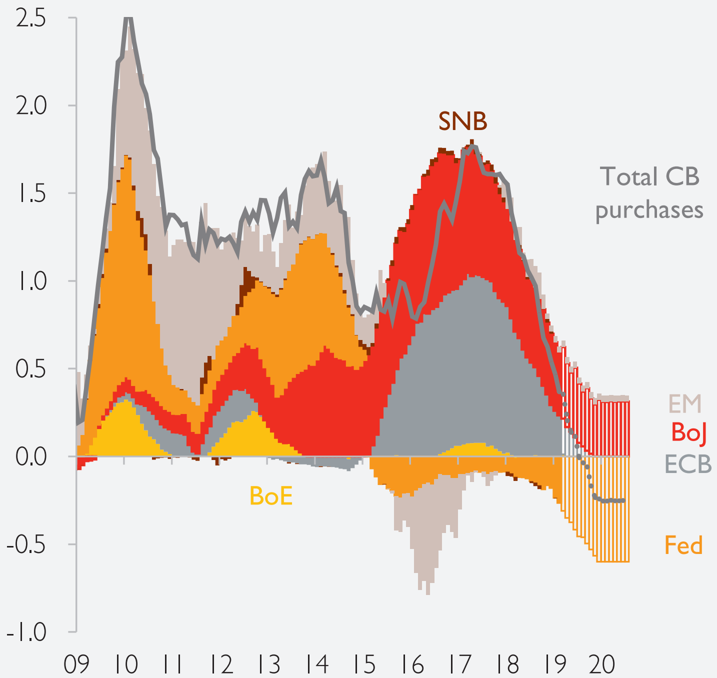
* data from Jun 2012 onwards

Source: Bloomberg

- Interesting to note that the best performer in 2018 was African Local Currency
- In hindsight, a correction in 2018 shouldn't have come as a surprise. Perhaps the surprise was that it took so long
- It seems that the primary driver of the markets since 2009 was liquidity being pumped in and we were bound to see some repercussions of that liquidity being drained out. (See charts below from a Citi chart deck for Central Bank and Private liquidity/credit growth and their actions on equity and credit markets)
- The subdued "volatility" environment of the past has to give way to higher volatility and therein lies opportunities and risks

Central Bank purchases fell by $1tn

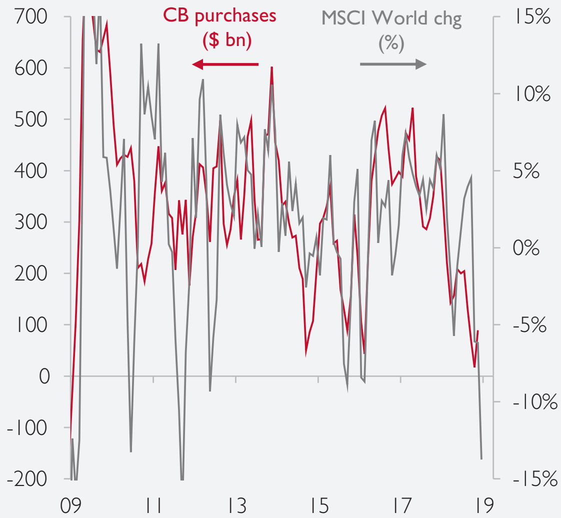
Global central bank securities purchases, rolling 12m, $tn



Source: National Central Banks, Citi Research

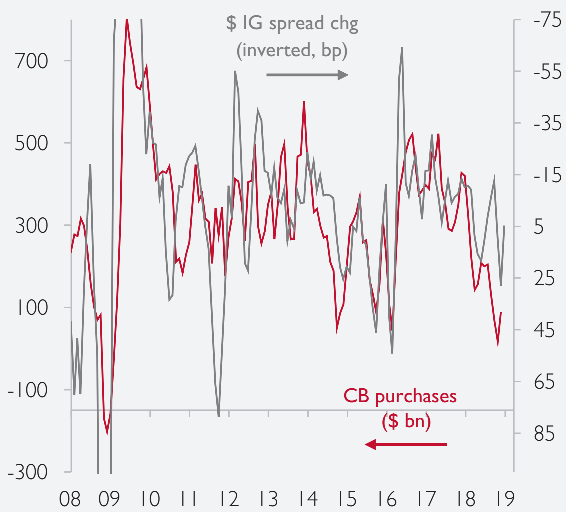
CB purchases have driven equities…

3m global CB purchases vs 3m chg MSCI World



…and credit

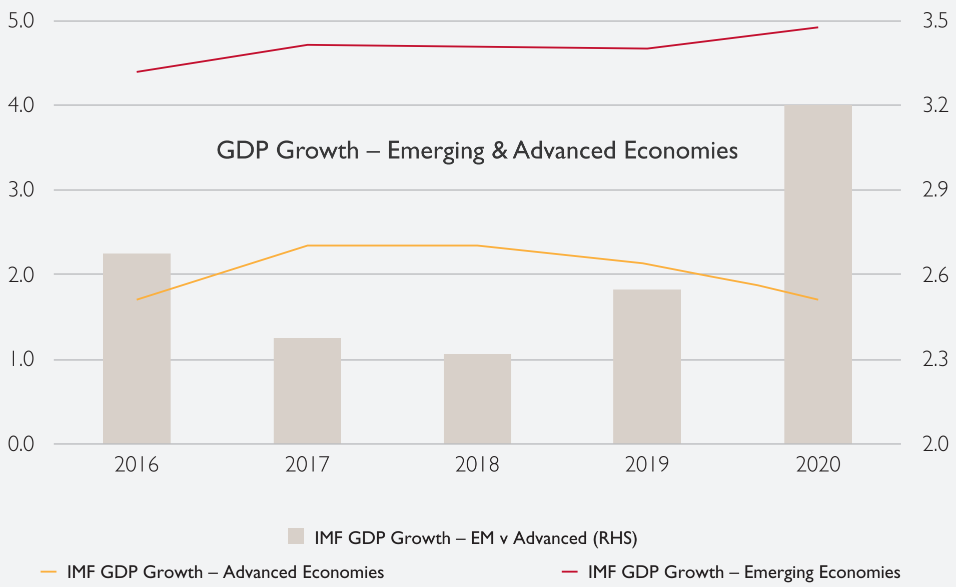
3m global CB purchases vs 3m chg $ IG



Source: National Central Banks, Citi Research

■ 2019, the year for Emerging Markets dominance?

- The short-term correlations with central bank purchases are both astonishing and disturbing (see charts above)
- Aside from liquidity, **growth and inflation**, while stable, are **trending lower**
- A synchronized advance of the global economy faces significant headwinds in 2019, primary being the various liquidity reducing actions in aggregate and relative terms being undertaken by different Central Banks
- While the year is still young, the news flow is already highlighting that the US consumer is weak and getting weaker – see Macy's, Apple, Ford, Jaguar, American Airlines, Blackrock. The US consumer is basically the US economy, driving around 70% of GDP
- The surprisingly robust 312,000 rise in US non-farm payrolls in December soothed market jitters about an imminent recession, but it's important to note that payrolls, being a lagging indicator, offer no help in predicting recessions
- Emerging Markets, on the other hand, is a whole different story. Could 2019 be the year we see the Emerging Markets asset classes outperform Developed Markets?
- A few important points regarding EM include:
  - Going forward, **the US dollar** – which is already overvalued – won't necessarily strengthen. This is an important development for emerging markets, as a stronger US dollar often coincides with lackluster emerging market performance and vice versa.
  - There is also the **gap between GDP growth in emerging and developed countries**, which is seen widening this year for the first time since 2016 (see chart below).



- Yet, Emerging Markets will probably be a better play in 2H19 than 1H19 as the market comes around to lower fed hikes.
- Below is a snippet of a recent return forecasting exercise that we did for different fixed income asset classes. The **biggest assumption** (and hence risk) hinging these forecast is that the **USD weakens** against EM FX in 2019 (not so much versus EUR or GBP).

Assumptions	Current	Bull	Base	Bear
US 10 year	2.70	2.25	2.75	3.65

					Nominal Returns			
	FX	**Carry**	**Duration**	*Dur notes*	**Bull**	**Base**	**Bear**	**Inflation**
US 10 year		2.70%	8.78		6.65%	2.26%	**-5.64%**	2.00%
US IG		4.21%	7.32		7.50%	3.84%	**-2.74%**	2.0%
US HY		7.46%	4.33		9.41%	7.24%	3.35%	2.0%
EM Hard Currency		5.94%	5.80		8.55%	10.00%	0.43%	2.0%
EM Local Currency	8.00%	6.80%	6.20	*Small rally*	1.80%	16.04%	18.04%	
Africa Local Currency	7.00%	14.59%	4.38	*Unch*	9.59%	21.59%	23.59%	
Mauritius 5 year		4.85%	4.30	*+/-35bps*	6.36%	4.85%	3.56%	3.2%

Conclusion

There is growing consensus on the value of the Emerging Frontier markets asset class, be it equities or fixed income, especially versus developed markets. We believe with growth continuing to outpace developed economies and more importantly FX devaluations/pain mostly out of the way, a falling dollar will lend a strong tailwind to the asset class in 2019. Much like with global liquidity being drained and affecting most asset classes in 2018, it is a matter of when not if.

About the author

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Abhimanyu Yadav is based in Mauritius and heads the fixed income team for the asset management arm of MCB Capital Markets. He joined the firm in May 2015 and has since helped grow its product offerings and investor reach, positioning it as a leading Africa focused asset manager. Prior to that, Abhi was a portfolio manager at MEAG New York, managing and trading $32 billion in various credit strategies. Abhi has extensive experience across multiple fixed income asset classes (credit – cash and derivatives, rates, commercial mortgages, CLOs) and geographies having worked in Asia, Europe, North America and Africa.

Abhi is a graduate in Economics, certified as a Professional Risk Manager (PRM) and CFA Charterholder.

About MCB Capital Markets

MCB Capital Markets is the investment banking arm of MCB Group, the largest banking group in Mauritius. The company provides a broad range of services under one roof, including corporate finance advice, asset management, stockbroking, private equity, structured products and registry services. Based in Mauritius, the team works with clients wishing to start or grow their operations in Africa and helps them develop solutions that meet their financing, strategic and investment objectives.