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WHAT'S REALLY HAPPENING IN EMERGING MARKETS?

06

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Welcome to the latest edition of the Quarterly What's Really Happening in Emerging Markets?

Using our unrivalled network of local teams across the globe, we aim to provide you with insights on important themes and debates in the emerging world. This issue focuses specifically in Latin America.

LIFTING FOG ON LATAM ENHANCES CARRY APPEAL

- The shock of 'Brexit' did not derail emerging markets. In our view Brexit reinforces, rather than weakens, the case for EM equities to further outperfrom their developed markets counterparts. We also believe that returns of Emerging Market bonds will not lag those of developed economies for much longer.
- As a whole, Emerging Markets equities and bonds rallied, while currencies stabilised. But performances varied, sometimes substantially, across various regions and countries.
- Eastern European assets performed worst, essentially due to stronger direct links of the region with UK and European Union. Asia and Latin America posted the highest post- Brexit return on equities, but on fixed income LatAM was clearly in the lead.
- In this quarterly we will show you LatAm's fixed income potential, in particular how the region offers some good returns - if you know where to look!

SUNSHINE THROUGH THE CLOUDS: IMPROVING FORECAST FOR EM DEBT

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The widely unexpected has happened: on 23 June, the UK voted to leave the European Union. This historical vote will no doubt weigh on global growth; and indeed the consensus view has already revised world Gross Domestic Product (GDP) growth downward, with economists now expecting the UK to fall into recession and the eurozone to suffer a notable impact on its GDP growth rate. However, global GDP growth is not expected to collapse, thanks to a still resilient US economy and an improvement in activity in many emerging countries, notably Brazil and Russia. And thanks also to the fact that the perceived increased risk to global growth will likely lead to a postponement of policy tightening in the US and to additional monetary easing and fiscal support almost everywhere else in the world, all the more as the Chinese economy is again showing signs of weakness.

The latter is certainly one of the key reasons why financial markets have so far absorbed the 'Brexit' shock very well, with stress being heavily concentrated on the first day of trading after the referendum. Interestingly, and for many somewhat unexpectedly so, emerging markets in this context have fared quite well as the performance of equities, bonds and currencies clearly illustrates. Since global capital will once again be forced to search for better value or higher yields, we believe that – at least over the medium term – 'Brexit' strengthens rather than weakens the case for emerging market equities and even more so in the case of EM fixed income. We stand by the view that EM equities will continue to outperform their developed markets counterparts and believe that the returns from EM bonds will not lag those from developed economies' bonds for much longer.

Between the Brexit decision and 14 July, the returns from global equities as measured by the MSCI World AC in US dollar terms were - overall - widely flat, while bonds rallied. EM equities continued to comfortably outperform Developed Markets equities. In regional terms, Eastern European equity markets were, not surprisingly, the most heavily hit, notably Poland. EM Asia – indisputably the most fundamentally solid emerging region – resisted best. But LatAm equities fared almost as well, despite a far less appealing fundamental background than Asia's. Interestingly, in local terms, LatAm equities even outperformed EM Asia and thus kept their year-to-date leading position.

EM local government bonds markets in US dollar terms have, unsurprisingly, underperformed their DM counterparts since 'Brexit'. High yielders did better in general, among them many LatAm countries. Year-to-date, all LatAm countries except Mexico in the EM MSCI universe have posted US dollar annualised total returns in excess of 10%. Mexico did the least well because of the tightening bias that prevails there. Still, we believe that with volatility receding to more normal levels, as seems increasingly to be the case, carry trades should again become more attractive and thus the appeal for the higher coupon-yielding sovereigns should strengthen.

The 'Brexit' vote weighed on most EM currencies in the MSCI EM universe, although by far less than generally expected. The MSCI emerging market currency index (US dollar), which equates the weight of each currency to the corresponding country weight in the MSCI Emerging Market index, has shed only 0.65 percentage points since 'Brexit'. The currencies most affected by the UK vote were those of Eastern Europe. But most Asian currencies also weakened, accompanying the Chinese yuan on its way down. LatAm currencies behaved relatively well. The Brazilian real appreciated, with the central bank even rumoured to have intervened to avoid it appreciating by too much, and the Chilean peso and Peruvian sol also rose. Columbia, struggling to get its twin-deficits in check, saw its currency depreciate somewhat. The same was true of Mexico and its peso, which is the most liquid of LatAm currencies and thus the natural hedge of other EM currencies.

Against the backdrop of increasing uncertainty over GDP growth, we are currently more biased towards fixed income assets than to equities. To illustrate this, we decided to focus on major LatAm fixed income markets, namely those in Brazil, Mexico, Chile and Argentina. As our four local asset managers explain in this edition, most of these still offer good opportunities even though they have already rallied quite substantially in the aftermath of 'Brexit'.

GILBERTO KFOURI
Head of Fixed Income and Multi assets
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BRAZIL: BRIGHT PROSPECTS FOR FIXED INCOME DESPITE STILL DIFFICULT POLITICAL BACKGROUND

Brazil is facing a very challenging situation on both the political and economic fronts. The economic measures implemented by President Dilma Rousseff during her first mandate significantly undermined both business confidence and private sector consumption. This was due to an acceleration in public spending, particularly in expenditure on social projects, as well as a tax reduction to stimulate certain economic sectors and a fall in government revenues in real terms due to a drop in GDP growth over the last two years. In addition, the government's policy on gas and electricity prices designed to curb inflation and to keep local rates low, reduced Petrobras's ability to invest in the local economy.

Prior to 2014 the fiscal accounts had been improving year on year. However since then, the situation has worsened rapidly and raised once more, after many years, the spectre of deteriorating public debt. This scenario was exacerbated by the financial markets realisation that – on the economic front – the government was not paying enough attention to public spending and high inflation. Meanwhile, the domestic political climate deteriorated as corruption scandals involving the government party started to pop up in the media following the so-called "Car-Wash" investigation by the Federal Police. President Rousseff's approval rate plummeted from a peak of 65% in mid-2013 to 8% in 2016. Brazilian assets sharply depreciated - the Brazilian real lost 50% of its value versus the US dollar, long-term interest rates jumped by 500bp and spreads on sovereign 5-year CDS widened from a stable level of 150 points to 500 points. The three leading credit rating agencies all downgraded Brazil from investment grade.

The gravity of Brazil's situation has taken on new proportions for Dilma during 2016, as a complete lack of support among both the electorate and the Upper and Lower Houses triggered the process of her impeachment. Dilma has been suspended from the presidency for up to 180 days between May and November. During this period, the Senate will vote for the acceptance or not of the impeachment. Acceptance will require two-thirds of all the votes and it is currently expected that this will be achieved.

During this intervening period, the constitution states that Vice-president Michel Temer should assume the presidency and should the impeachment go ahead, he should continue as president until the end of the current mandate in December 2018. He took over in May and, upon changing his cabinet members, is bringing a more liberal economic agenda to bear. For his economic team he chose highly respected names, which went down well with the financial markets. The aim now is for the government to regain credibility and stabilise the debt/GDP ratio. As a result of this new agenda, the real has appreciated almost 20% so far this year, local bonds have moved back to 2014 levels and the spread on Credit Default Swap (CDS) has narrowed significantly, although it still remains much wider than in the past.

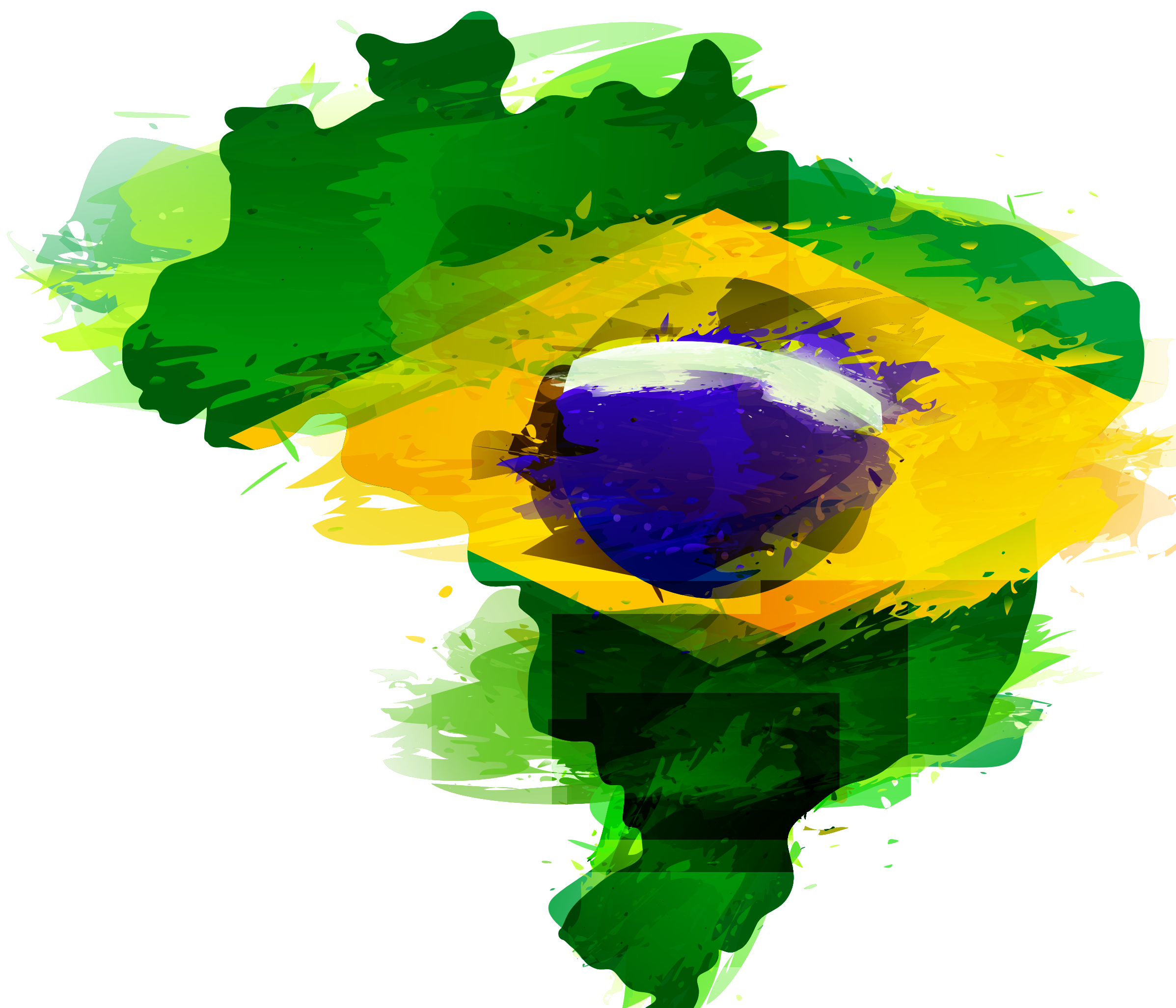
EVERY CLOUD HAS A SILVER LINING

Despite all this turmoil, the crisis is actually having some positive effects. In order to bring growth towards a sustainable path Brazil has in fact to deeply reform. While such structural reforms will be burdensome in the next years to come, they will prove very positive in the longer run. More relevant now is the profound improvement in Brazil's external accounts, which have benefited from the weak local currency as well as the reduction of imports arising from the recessionary conditions. We forecast that Brazil's current account deficit (close to 4.5% in 2014) will be neutral by the end of 2016. This change in the external accounts has helped to stabilise the real, although that is not to say that further depreciation will not occur should the political situation worsen or if the government does not manage to obtain approval for the fiscal measures necessary to achieve sustainable GDP growth.

BRAZILIAN LOCAL CURRENCY DEBT OFFERS A VERY GOOD INVESTMENT OPPORTUNITY

We believe that due to very high interest rates and a well-balanced external account, now is a good time for foreign investors to hold assets in the local currency rather than in hard currency. There are two ways to do this, by either buying local currency bonds offshore or by accessing the local market. Our strong belief is to go via the local market as this should offer higher liquidity and higher returns (up to 150bp better than buying offshore). It is also easy to open an account to invest locally.

The base rate is currently at 14.25% per year and we project 7% inflation in 2016 and 4.7% in 2017. As for GDP growth we forecast -3.8% and -1.5% respectively for this year and the next. Due to weak economic activity, household deleveraging and high unemployment, we project a more positive scenario for inflation moving closer to the central bank's target (4.5% ±1.5pp for 2017) by the end of 2017. We believe the central bank should be able to implement a dovish cycle by the second half of this year. In our view, local rates could reach single digits by the end of 2017. This is not priced in, with futures markets currently pricing only a drop to 12%. We like pre-fixed bonds in the middle section of the yield curve with maturities between 2018 and 2021. One alternative that is quite popular in the local market is inflation-linked bonds. As we have a more positive view for inflation than the market consensus, we avoid such bonds if they mature before 2020. Beyond this tenor, inflation-linked bonds are less volatile than pre-fixed bonds; they are very liquid and offer an attractive return of around 6% per year above inflation. Considering that many countries are currently in an environment of negative rates, we think this could prove to be an excellent alternative even taking into account the risks involved.



CARLOS RIVERA DE LA MORA
Chief Investment Officer Mexico
BNP Paribas Investment Partners

MEXICO: LESS LEEWAY ON MONETARY POLICY, BUT GOOD OPPORTUNITIES IN "UDIBONOS"

RESILIENT GROWTH

Mexico continues to be the country with the highest level of GDP growth within the region. However, analysts have been revising down forecasts on the back of lower growth expectations for the US and continued headwinds in the oil sector; oil production is expected to fall by an additional 5% this year. Risks to growth are not only external as government expenditure will have to be reduced significantly in the coming years to control a widening fiscal deficit.

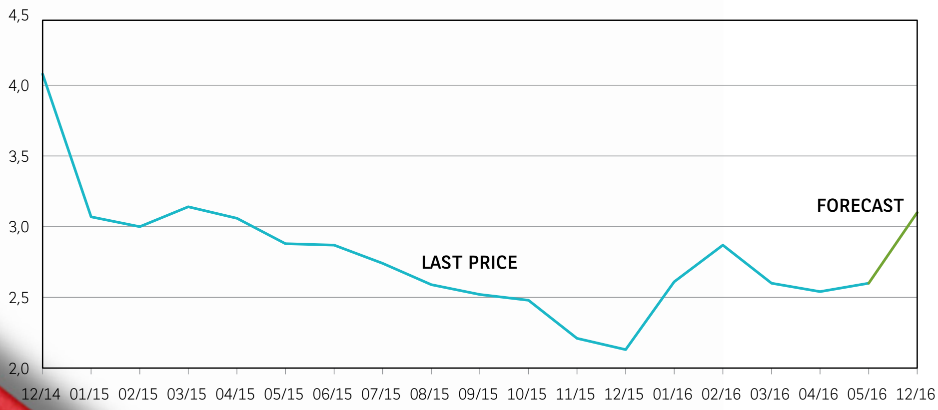
On the bright side, we highlight the growth in private consumption helped by high employment and a steady inflation rate which has led to higher real wages. Real wages have risen at an annual rate of close to 1.5% since 2014, after five years of stagnation. Given the weakness of external markets, the depreciation of the peso has not increased exports; however, remittances have increased significantly, particularly supporting consumption in rural areas. The growth stimulus will thus be coming from internal demand and given that consumption accounts for almost 70% of the economy, this should strengthen the overall GDP growth rate in 2016 to 2.1%.

YEAR-END INFLATION WILL LIKELY SLIGHTLY EXCEED TARGET

Until recently, inflation has remained close to Banxico's 3% target, notwithstanding the 40% depreciation in the Mexican peso (MXN) since the last quarter of 2014. The fall in commodities and telecommunications prices (a benefit of telecommunications industry reform) have more than compensated for the effect of the weakness of the peso on inflation. However, more recently consumer prices – most notably, core product prices – have accelerated modestly, indicating the beginning of some pass-through on inflation.

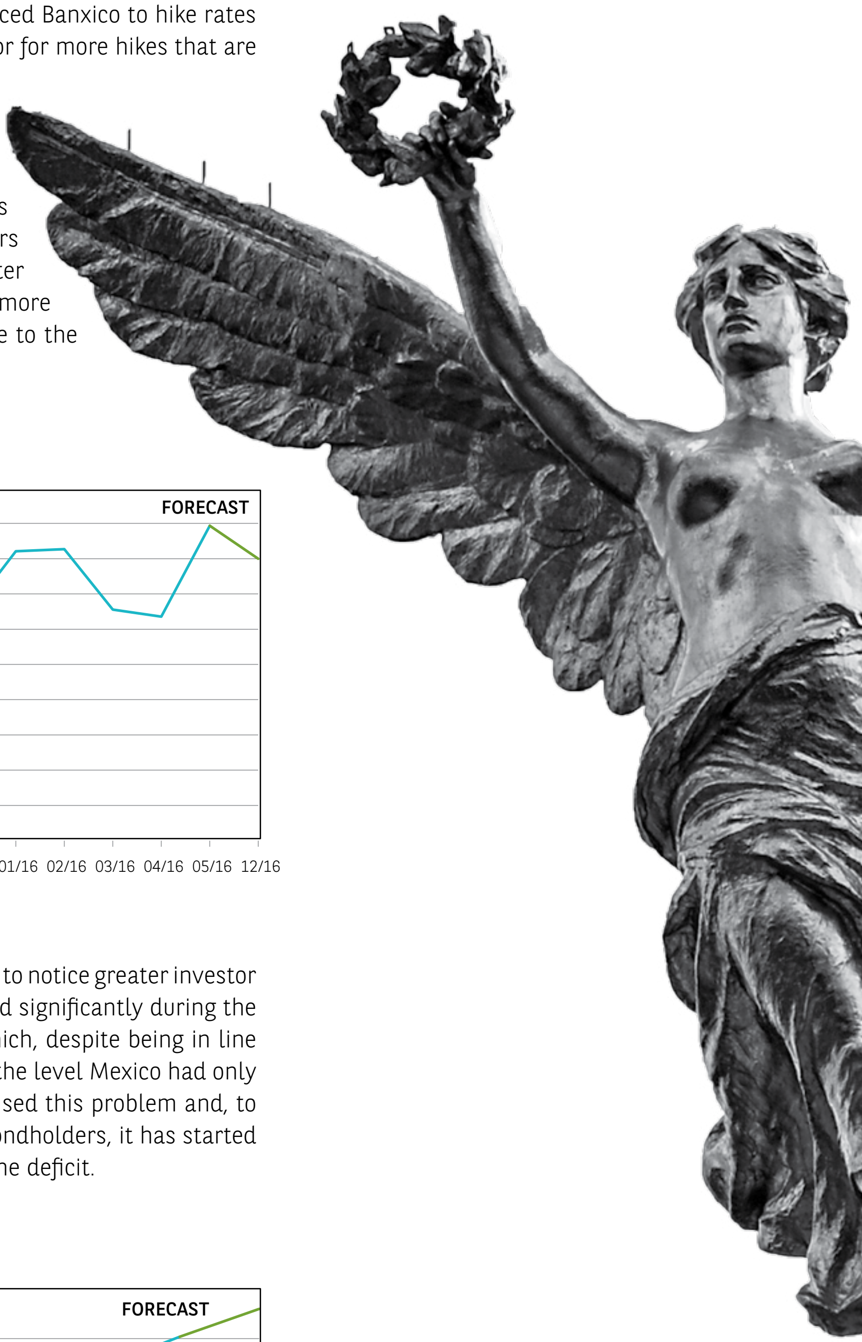
Headline inflation in May dropped to 2.6%, but given the rebound in commodity prices we expect a gradual pickup by the end of 2016 to 3.1%. It is also important to consider that unemployment is already at a very low level (4%), and wages have been rising above inflation. Monetary conditions remain accommodating. Credit, although still representing a small fraction of the economy, is growing at a faster pace and should help sustain the strong consumption data in the coming months.

Mexico Consumer Price Index (CPI) %Year over Year (YoY)



Source: Bloomberg, 31/05/2016

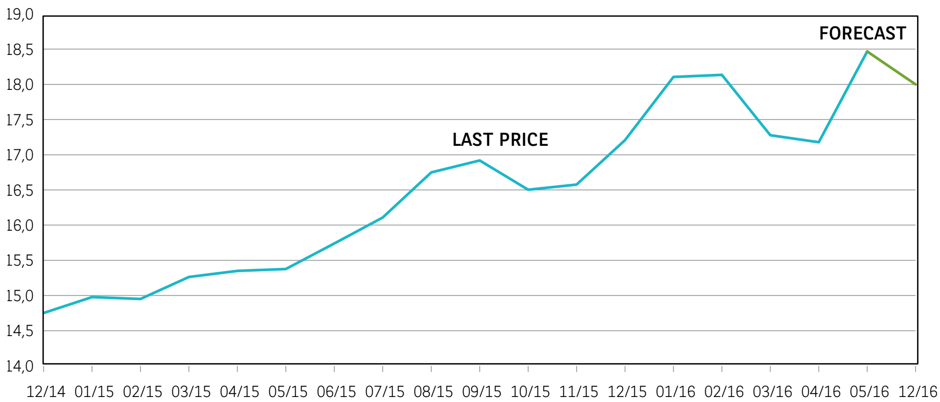
Banxico´s guidance on monetary policy has changed significantly within the last few months. The guidance at the start of the year was that the central bank would move in tandem with the Fed, however the depreciation of the MXN forced Banxico to hike rates by 50bp in February, surprising the market and opening the door for more hikes that are independent of Fed movements.



MEXICAN PESO TO HOVER AROUND CURRENT LEVELS

In general, the market expects the peso to return to levels below MXN 17 per USD. However in our view, various factors will most likely prevent this from happening, including: (i) tighter US monetary policy, (ii) the result of the US elections, and more importantly, (iii) the increase in the current account deficit due to the weakness in external markets, particularly US manufacturing.

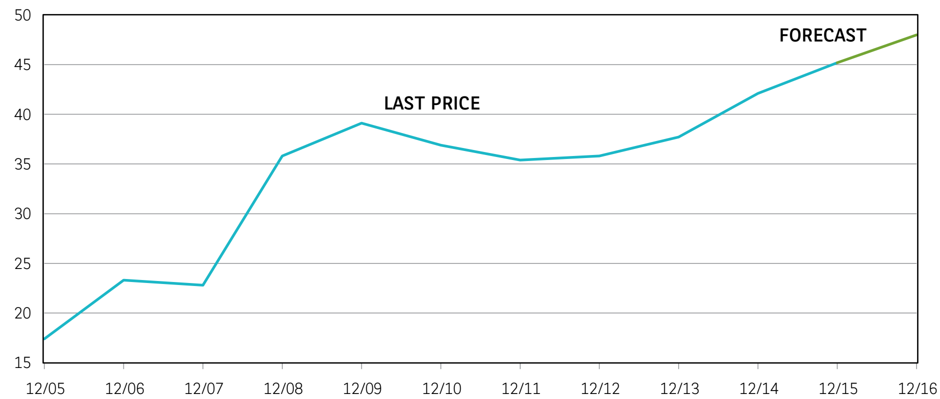
Mexican peso



Source: Bloomberg, 31/05/2016

Additionally, and related to the capital account, we are beginning to notice greater investor concern regarding the fiscal accounts. Public debt has increased significantly during the past three to four years and now represents 48% – a figure which, despite being in line with the average among emerging markets, is twice as high as the level Mexico had only six years ago. The federal government appears to have recognised this problem and, to avoid additional selling from foreign investors, most notably bondholders, it has started to take measures to reduce expenditure and regain control of the deficit.

Mexico debt as a percentage of GDP



Source: Bloomberg, 31/12/2015

INFLATION LINKED BONDS PRESENT THE BEST OPPORTUNITY AT THE CURRENT STAGE

In this context, we expect inflation to gradually pick up in the coming months and knowing that implicit inflation between the nominal rate curve and the inflation linked bonds is still below 3%, we consider Udibonos to be the most attractive securities in the Mexican fixed income market. Additionally, we believe that the Mexican curve is relatively steep. With the central bank hiking rates more aggressively than the US to avoid further MXN deterioration, strategies that benefit from additional curve flattening, particularly within the 3-10 year tenors, remain attractive.

With regard to equities, despite the underperformance of the Mexican market during the last 12 months, we still believe that it remains overvalued; multiples are high compared to global peers and given the reforms implemented in the present administration, competitive forces are likely to continue to reduce margins. We believe that the earnings expectations of analysts remain too optimistic and will need to be adjusted.

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BNP Paribas Investment Partners
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CHILE: STILL GOOD POTENTIAL ON 5-YEARS BONDS

A SUCCESSFUL TRANSITION TO DEMOCRACY

Following the transition to democracy in 1990, Chile has consolidated its economy, placing an emphasis on foreign investment and mining. For two decades now, this has helped to boost economic growth, reduce poverty rates and increase shared prosperity. Due to Chile's small domestic market (17.8 million people in 2014), it has implemented a resolute strategy based on free trade, resulting in the signing of 24 free trade agreements with 63 countries. Despite the country's notable growth over the past 20 years and a decreasing poverty rate (from 40% in 1990 to 18% today, against a 50% median income threshold), Chile still has one of the highest levels of inequality worldwide, as measured by the Gini coefficient. As stressed by the World Bank, "structural changes to drive productivity increases and improve the access to and quality of social services should be implemented for a more inclusive growth. Energy deficits and dependence on copper exports continue to be a source of vulnerability".

AMBITIOUS STRUCTURAL REFORM AGENDA

Since returning to power in March 2014, Michelle Bachelet has pursued a structural reform agenda to achieve her main goal: reducing inequality to improve social cohesion and bolster long-term growth potential. The priorities on the reform agenda are:

1. In education, to deliver higher quality and greater equality in secondary education and extend free tertiary education to all students. These reforms have already begun to be implemented, with 50% of new students in 2016 benefiting from free education, a percentage that is expected to grow to 60% in 2018.

2. A tax reform aimed at increasing fiscal revenue by three percentage points of GDP in order to finance additional expenditure in education and reduce the fiscal gap. This reform, which was implemented in 2015, focused on eliminating the Taxable Profits Fund (FUT) which firms used to postpone payment of taxes on revenue earmarked for investments, and increasing the corporate tax rate to 27% from 20%.

3. A labour reform to strengthen trade unions and increase the bargaining power of workers to improve the distribution of wealth. Congress recently approved the bill, but some parts are still being blocked by the Constitutional Court.

4. A plan to increase infrastructure investment to the equivalent of 3.5% of GDP – one percentage higher than the current level – and increase the share of sustainable energy solutions to 20% of total energy production by 2024.

5. A new banking law to adapt Basel III capital standards to Chilean banks.

MACRO BACKGROUND FAVOURABLE TO LOCAL FIXED INCOME

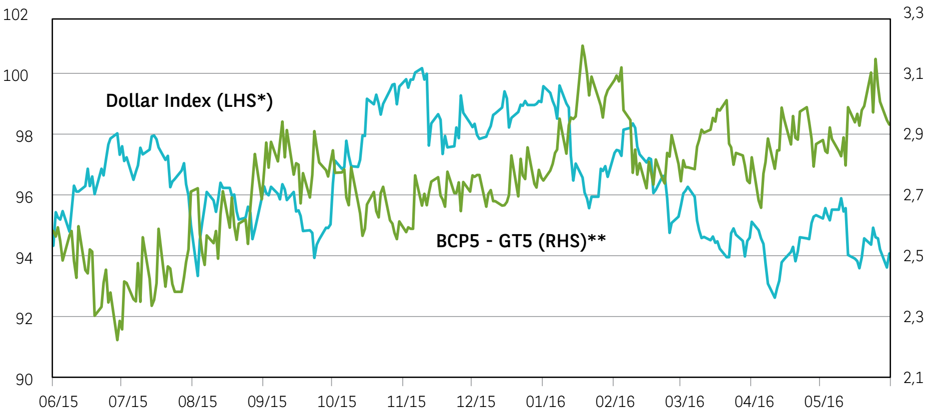
These structural changes are set to increase productivity, capacity and promote innovation over a period of time. Tax and labour reforms have increased uncertainty in the short term and impacted private investment into the world's largest copper producer, as highlighted by the International Monetary Fund in its 2015 report on Chile's economy: "The increase of the cost of capital and the complexity of the new tax regime will likely have a negative effect on economic activity in the short term. The drop in fixed investment partly reflects a decline in business confidence that cannot be fully reconciled with external shocks, and particularly stems from the uncertainty created by the structural reform programme and its short-term costs".

In particular, the labour reform may have long-term negative effects on productivity without fine-tuning the minimum wage, which is used as a basis of negotiation for all wage agreements.
Therefore, the return of business confidence is necessary to minimise the potential for short-term impacts on growth. The reform agenda needs to be carefully implemented and the government is shifting to a more business-friendly policy, reaffirming its focus on promoting growth primarily through its productivity agenda.

The macroeconomic policy mix now combines a tighter fiscal policy with an accommodative monetary policy. As the economy is expected to gradually recover, starting a process of fiscal consolidation is justified in order to maintain Chile's AA- rating (Standard and Poors).

In this environment of modest growth, local fixed income still offers value, with a preference for nominal government bonds in view of inflation being expected to fall from 4% to 3% by the first half of 2017. Our preferred bet would be the pit of the curve, as the spread differential with the 5-year US bond has room to compress, assuming that in the foreseeable future the US dollar continues to hover around its current level. We have a defensive view on corporate bonds given tight spreads that do not offer much value compared to LatAm bonds.

5Y Spread (%) vs US Dollar Index



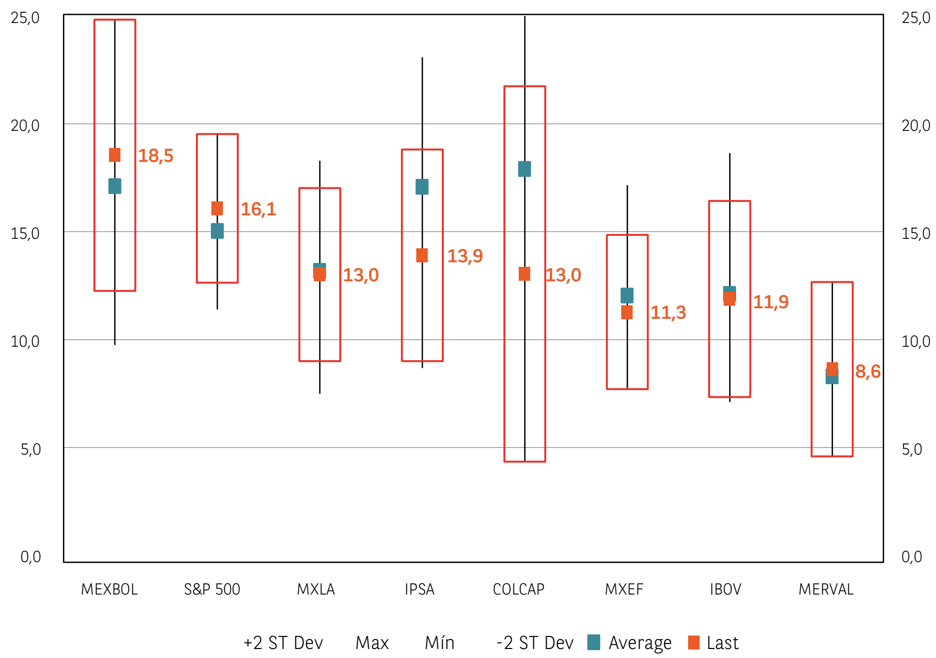
Source: bloomberg, 21/06/2016

*LHS: Left Hand Scale
**BCP5: Chilean 5 years Central Bank Bond, GT5: Generic United States 5 years government note, RHS: Right Hand Scale

Spending on infrastructure should begin contributing to capital growth over the next few years and help to address energy bottlenecks by increasing electricity generation capacity by about 30% by 2020 and reducing electricity costs. As a result, the IMF expects potential GDP growth to be at 3.7% in 2020.

The current limited investment environment means that companies can start to enjoy the benefits of higher margins due to cost cutting. The IPSA Index has performed well so far in 2016 (up by 8.50% year-to-date on 22 June). With valuations historically on the cheap side, a more upbeat global growth scenario would heighten the probability of an increase in commodity prices, boosting earnings growth expectations and further benefiting Chilean equities. However due to the low level of consumer and business confidence, a significant improvement in copper prices is first necessary for this scenario to materialise.

P/E (Price to earnings ratio) 12-Month Forward Multiples



Source: Bloomberg, 23/06/2016

ARGENTINA: CONFIDENCE IS BACK

EMILIO BOTTO
Chief Investment Officer
BNP Paribas Investment Partners

First half of 2016 has brought winds of change to Argentina's political and economic climate. After several years of limited growth and high inflation (which peaked at 40% in 2014 according to private estimates), Mauricio Macri's election as President has built a relatively strong consensus both locally and globally that the country has reached its pit and is on its way to a significant recovery. 2016 is likely to be a transitional year for Argentina, with inflation reaching 40% YoY, but with a remarkable deceleration during 2H (around 1.5-2% Month-over-month); and a probable -0.5% real GDP growth for Fiscal Year 2016. However, estimates for 2017 are optimistic: an inflation targeting regime will be formally launched in 3Q 2016, which is expected to decrease to 19% in the following year (and to 5% in 2019), supported by a persistently positive real interest rate and real GDP growth of around 4%.

FIRST REFORM STEPS OF MACRI'S ADMINISTRATION FAULTLESS

Economically, expectations are mainly driven by the fact that Argentina has been able to successfully eliminate FX restrictions and relax capital controls, which had been in place for several years, as well as adopt a floating currency regime. A relaunched national bureau of statistics (INDEC) and an optimistic fiscal program for the next four years, which seems achievable, will help build confidence. The country's Securities and Exchange Commission has fully cooperated with the Ministry of Finance to fully recover integration of Argentina in international credit markets. Negotiating and closing the hold-out debt default has been a key challenge for this, with April's issuance proving them successful. The final order book closed at USD 67.8bn (+4.1x), the largest recorded cash order book of all-time for a high yield or EM senior unsecured issuance.

Politically, Macri's administration has demonstrated strong commitment towards institutional confidence a nd transparency, paving the w ay for justice to investigate former politicians' suspicion of corruption, a long-standing demand from the Argentine people. The ruling party only holds 34% of seats in the Lower Chamber, but this has not prevented the government from passing several key bills since it has shown an ability to form occasional, but reliable alliances. Even the Peronist party (a historical, main opposition force) has been working conjunctly with Macri's Progressive Party of Argentina (PRO) in numerous political projects and a sensation of recovered dialogue (so claimed during the Kirchnerist years) rules the politics. The opposition and primarily Peronism remain fragmented, helping ahead of the 2017 mid-term election, which will be crucial for Macri to gain power.

Nonetheless, results are not showing as fast as the government would like. Following this delay, Macri's cabinet has decided to shift from the original economic plan which aimed at correcting macro imbalances to lower inflation and attract foreign investments. Instead, the government will prioritize growth by reactivating consumption and boosting public expenditure, leaving the balanced fiscal result target temporarily aside. Although the 2016 objective is still achievable, a pension reform has been approved by the Congress leading to a permanent 1% of GDP increase in public expenditure, partly financed by a recently passed tax amnesty bill. . Together, this heightens the chances for a rapid growth reactivation in 2017, but also makes the inflation target rate of 19% more challenging to reach.

BOTH EQUITIES AND BONDS ARE GOOD INVESTMENT OPPORTUNITIES

The equity market brings positive news: MSCI has announced in June that it will consider the MSCI Argentina Index for a potential reclassification of the emerging market status as part of the 2017 Annual Market Classification Review. The Argentinian equity market meets most of the accessibility criteria for emerging markets, since in December 2015 the Central Bank made several regulatory changes resulting in: (1) a floating currency, (2) the elimination of cash reserves and monthly repatriation limits on the equity market and (3) a significant reduction in the capital lock-up period for investments.

There is consensus that the local government will do all that it takes to fulfil the MSCI's requirements. Based on trading volumes, the market estimates that Argentina could initially have a 1.8% weight in the MSCI LatAm index. The eligible stocks for the EM status are YPF, Grupo Financiero Galicia, Banco Macro, BBVA Banco Francés, Adecoagro and Pampa Energía. These stocks have already experienced buying pressure in the past days, meaning that buying activity will likely start now rather than waiting for MSCI's confirmation of Argentina's EM status next year.

In relation to the fixed income market, the average yield of Argentine sovereign debt has compressed about 270bps between 27 June 2015 and 10 December 2015 (the latter being the date during which Macri's government took office) and has acquired a B- rating (Standard and Poor's) after successfully ending the holdout debt issue. Such reduction was greater than that of other LatAm countries: Brazil (BB, Standard and Poor's) -140bps; Colombia (BBB, Standard and Poor's) -117bps; and Peru (BBB+, Standard and Poor's) just -27bps. We believe that as Argentina begins to show signals of economic reactivation and fiscal deficit reduction, the yield of its US-Dollar sovereign debt (BONAR and Argentina) will continue to compress, especially in the mid and long tranches of the curve. For those willing to sacrifice liquidity in favour of yield, we see provincial global issuances as attractive, with focus on the province of Buenos Aires, which is likely to benefit from a higher share of national tax collection.

The value of investments and the income they generate may go down as well as up and it is possible that investors will not recover their initial outlay.

Investing in emerging markets, or specialized or restricted sectors is likely to be subject to a higher than average volatility due to a high degree of concentration, greater uncertainty because less information is available, there is less liquidity, or due to greater sensitivity to changes in market conditions (social, political and economic conditions).

Some emerging markets offer less security than the majority of international developed markets. For this reason, services for portfolio transactions, liquidation and conservation on behalf of funds invested in emerging markets may carry greater risk.

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