For Professional Investors and Advisers Only

RWC

Emerging and
Frontier Market Equities

Composition of GDP & Growth Dynamics in Frontier Markets | February 2016

RWC Emerging & Frontier Markets

February 2016

About Frontier Markets

The frontier markets classification includes some of the fastest growing, most populated and least integrated economies in the world and, importantly, some of the most undervalued equity markets.

Recent economic development and implementation of investor-friendly policies in many countries has helped to begin integrating them into the global economy and has led to increased depth and liquidity in their stock markets.

However, frontier markets continue to be under-researched and are structurally underweighted by institutional investors, making these markets inefficient and undervalued. This offers astute active investors the opportunity to earn attractive and less correlated returns.

In this paper

Cem Akurek, Economist for the RWC Emerging and Frontier Markets strategies, looks at the composition of GDP and growth dynamics in frontier markets, both across commodity and manufacturing exporters.

Contents

A team with two decades' investment experience

The 16-strong investment team, headed-up by John Malloy and James Johnstone, joined RWC in early 2015 from Everest Capital. The portfolio managers have over two decades' experience investing in over 120 emerging and frontier markets; many of the team have worked together for 20 years.

An index-agnostic approach

Investment ideas are generated from a range of emerging, frontier and Asian markets. The team travels extensively and frequently, and most members are native to the markets they research.

Ideas are generated across all strategies from across the whole investment team. Therefore, rather than defining products by strict geographic regions, the team concentrates its research on companies exhibiting strong growth characteristics that are not yet reflected in the share price. A key focus of the team is on opportunities that are not yet broadly followed.

Top-down approach

Cem Akyurek is the team's economist. Cem contributes to the team's top-down research and considers macro factors such as strength of the business cycle, inflation management, foreign exchange reserves, current account balance, fiscal policy, fiscal balance, GDP growth prospects, bank lending prospects and monetary policies. Macro and regional financial data are combined with political and institutional factors to identify themes and secular trends with superior growth prospects.

Investment team

Average industry experience of team: 14 years, shown for each analyst below.

Portfolio Managers	Macro Research	EMEA Research	Asia Research	Latin America Research	Natural Resources Research
John Malloy 23 years	Cem Akyurek 19 years	Marina Bulyguina 5 years	Charles Chen 6 years	Patricio Danzinger 12 years	Duncan Blount 8 years
James Johnstone 19 years		Al Housein Qureiyeh 5 years	Min Chen* 13 years		
Garret Mallal* 11 years		Muchemi Wandimi 9 years	Jessica Lim* 17 years		
Thomas Allraum 34 years			Jaimin Shah* 9 years		
			Anil Tewari 18 years		
			Jamie Xiong* 6 years		

Note: Majority of team based in Miami; *based in Singapore

Contributors

Emerging Market Equities, Portfolio Manager

John Malloy has 23 years of experience in global investment management, commodity, debt and equity research analysis.

Before joining RWC Partners in early 2015 to manage the RWC emerging market equities strategies, John spent 18 years at Everest Capital where he focussed on emerging markets investing. John was formerly a high yield manager at Barings focussing on Latin America and US markets.

John holds a BS in Management, Norwich University and an MBA, Boston University. John speaks Spanish.

Frontier Market Equities, Portfolio Manager

James Johnstone has 19 years of investment management experience.

Prior to joining RWC Partners in early 2015 to manage the RWC frontier market equities strategies, James was responsible for frontier markets analysis and portfolio management at Everest Capital. Before this James as co-founder and CIO of a multi-strategy Asian hedge fund and analyst at Gartmore and Schroders focusing on emerging market equities.

James has an MA (Hons) in Classics and Modern Languages from Christ Church, Oxford University. James speaks Russian.

Macro Analysis, Economist

Cem Akyurek has 19 years of investment and research experience, with a speciality in fixed income strategies and macroeconomic and quantitative research.

Prior to joining RWC Partners in early 2015 Cem held the position of Director, Macro Research at Everest Capital from 2013. Before this Cem worked as a Senior Economist, EMEA, with Deutsche Bank and as Head of Economics and Strategy for Global Securities, both based in Istanbul, Turkey.

Macro Heat Map

The Macro Heat Map, shown below, is one of many tools used by the investment team to understand and evaluate the economies of countries within their universe.

Region & Country	Growth	Change	External	Fiscal	Inflation	Monetary	Overall Score	Direction	Politics	Comments
EMEA										
Turkey		↑					1.08	↓		Policy uncertainty, high inflation & large external financing needs continue to be main macro risks.
Russia		↑					1.23	↑		Monetary/FX policy has improved, external debt rollover concerns diminished & GDP bottomed out barring further weakness in oil prices.
Poland		↓					1.97	→		Growth should continue to improve & overall fundamentals are strong excepting fiscal dynamics.
Hungary		↓					1.70	→		GDP lost momentum & external/government debt is high. But the latter, as well as overall fundamentals, has improved significantly in the past 3 years.
South Africa		↓					1.03	→		The CAD remains elevated, the economy is weak & inflation is above target, constraining policy options.
LATIN AMERICA										
Brazil		↓					1.06	↓		Bad politics & the resulting low confidence continues to cloud the outlook. The economy remains stuck in a bad equilibrium of recession & high inflation.
Mexico		↑					1.81	↑		Growth momentum is stable but still below potential. Further improvement in exports is likely given the US recovery & competitive FX.
Peru		↓					1.76	↑		The economy is growing below potential, but monetary policy is tightening given high CAD (more than covered by FDI) & some above target inflation.
Colombia		↑					1.41	↑		GDP is decelerating but CAD remains high & inflation is above target, which is forcing monetary tightening.
Chile		↑					1.68	↑		CAD adjusted on weaker FX and GDP. Rapid accumulation of external debt in the past 3 years is concerning while a gradual recovery in GDP is underway.
ASIA										
India		↑					1.83	→		Lower oil prices support external dynamics & disinflation while growth momentum seems to be moderate. Key reforms have been delayed.
Indonesia		→					1.66	→		Reform efforts have stalled post-subsidy cuts, domestic demand is decelerating. CB cut rates but countercyclical policy room is limited given weak external dynamics.
Philippines		↑					2.52	→		Fundamentals remain strong & GDP growth is one of the highest in the EM universe.
Malaysia		↓					1.64	→		FX has become very competitive & the real economy is resilient to volatility in capital flows. Growth remains relatively high although some moderation is likely.
South Korea		↑					2.08	↑		Overall fundamentals are strong & fiscal stimulus is likely to help improve domestic demand weakness, which remains the main concern.
Thailand		↑					1.96	↑		GDP growth stabilized at low levels while domestic demand is weak on low confidence. Fiscal spending is increasing gradually.
China		↓					2.21	→		Capital outflow driven mainly by locals is pressurising the CNY, which is constraining monetary easing while the economy is decelerating.

Low Risk | Neutral | High Risk

This should be used for informational purposes only and does not constitute research. It should not be understood as investment advice or used to make investment decisions.

Source: RWC Partners as at 31 December 2015

Composition of GDP and Growth Dynamics in Frontier Markets

Commodity Exporters

GDP growth in Gulf Corporation Council (GCC) oil exporters is largely driven by government spending. Government expenditures typically comprise about 20% of GDP and the share of capital expenditure is at similar levels, while consumption accounts for a little more than one third. Saudi Arabia and Kuwait have very similar compositions of GDP and, while overall trends are similar in the UAE, the shares of consumption and investment are marginally larger and smaller, respectively. In the frontier market (FM) commodity exporters of Latin America (Chile, Peru and Columbia) where growth has been more inclusive, the share of consumption is much larger compared to GCC, while that of government expenditure is much lower. Over the years consumption has taken a progressively larger share of GDP in these countries. Kazakhstan has a consumption share that falls in between the levels seen in the GCC and Latin American commodity exporters. Going forward, with more inclusive growth and a gradual diversification of economic activity, the share of consumption in GCC and Kazakhstan is likely to converge to Latin American levels.

In all of these commodity economies net exports comprise a large portion of GDP (relatively lower in Latin America), the size of which shows a variation in line with changes in commodity prices. As such, the levels have been much lower in the past couple of years compared to during the commodity price super cycle. A sharp decline in commodity prices has led to greater growth dislocation in Latin America versus the GCC, as fiscal policy has provided a greater offset to lower net exports in the latter. Latin American commodity exporters have less flexibility in their fiscal policy owing partly to binding budget rules that have been in place for many years.

In prospective commodity exporters like Ghana and Kenya, net exports are a drag to growth as the external current account is in deficit. This should change gradually as oil and gas production increases over the next three to five years, and as infrastructure is completed to facilitate higher export volumes. Consumption has a very large share of GDP in these countries which is likely to converge to lower levels in the years ahead. This is due to the expected rapid increase in net exports on the back of greater commodity production and a gradual decline in the pace of capital goods imports. The share of government expenditure in GDP in these future commodity exporters is larger than Latin American commodity exporters but much lower than that in GCC as these countries need to control budget deficits to contain their large current account deficits. That said, a good portion of the current account balance is covered by foreign direct investment (FDI).

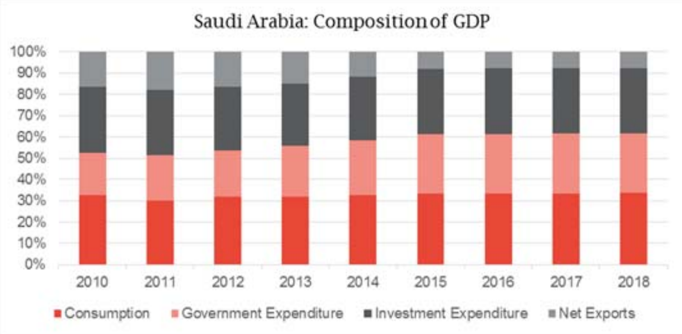
Manufacturing Exporters

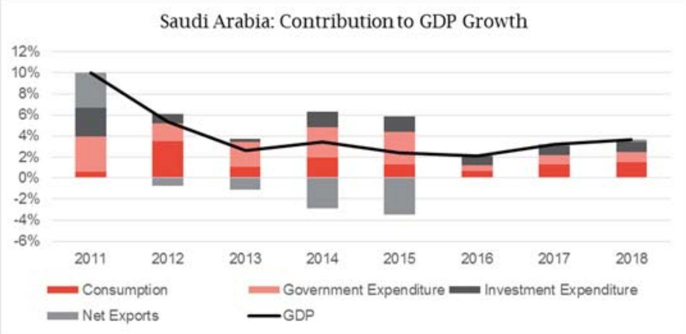
Consumption is a large share of GDP in the FM manufacturing exporters, while net exports are a drag to growth, which is due to the high import content of manufacturing exports. These countries typically have trade deficits. The negative GDP effect is partly offset by the inflow of workers' remittances and/or tourism revenues. Remittances are an important driver of consumption. In Pakistan, Bangladesh and Vietnam, the share of consumption is at similar levels - around 70% of GDP - while the share of net exports has been volatile and mostly negative. Investment expenditure has been on an upward trend in Vietnam and Bangladesh over the past several years, reaching c. 30% of GDP from the low c. 20% levels as both economies have been adding export capacity. Government expenditure has a low share of GDP in both countries. The Philippines has maintained a steady share of capital expenditure in GDP at marginally above 20%, while the government plays a larger role in the economy compared to Bangladesh and Vietnam. These arguments apply to Romania as well, although the share of consumption in the economy is more elevated owing to a sharp increase in recent years.

As FM manufacturing exporters move up the value-added chain, GDP consumption should gradually converge to that of advanced Asian exporters. The share of net exports should increase, while that of consumption should gradually decline. This is mainly due to a rapid expansion in net exports as local intermediate goods replace imports in the production of final goods. As shown by historical trends in South Korea and Taiwan, two economies that have moved up the value-added chain by also successfully developing local technologies, the share of consumption in GDP has declined from c. 70% to c. 50% in the past 15 years, while net exports changed rapidly from negative values to significantly positive territory. Manufacturing exports became progressively less import-dependent in these countries, a shift also expected to happen gradually in FM manufacturing exporters going forward, allowing them to achieve more sustainable and balanced growth dynamics. Thailand is further into its convergence process, while Egypt could accelerate its transition if politics and confidence improve to attract greater amounts of FDI.

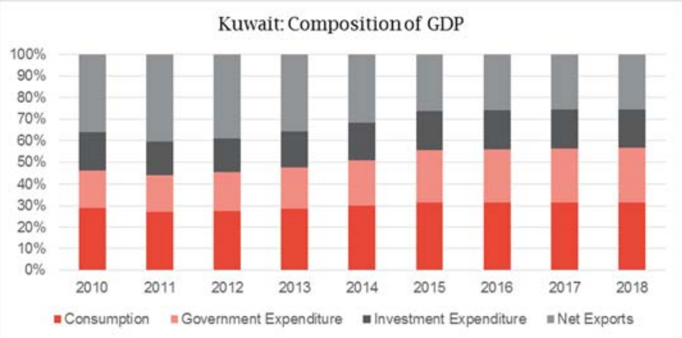
Composition of GDP and Contribution to GDP Growth in Frontier Markets: Commodity Exporters

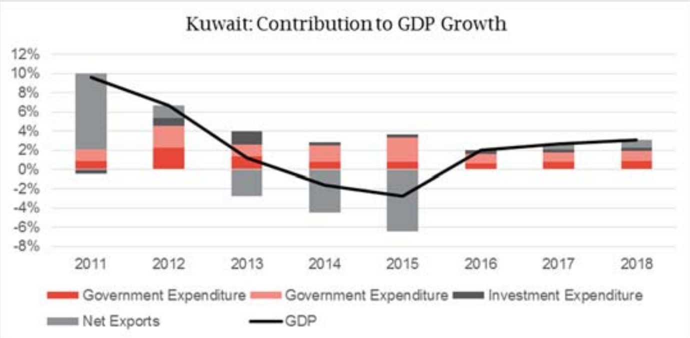
Saudi Arabia: The country built very strong buffers and paid off government debt during the commodity super cycle. These buffers will be used to support growth in this environment of lower oil prices. Lower contribution of net exports to GDP will be offset by greater government expenditure.





Kuwait: Expansionary fiscal policy provided a partial offset to a lower contribution by net exports as capex deteriorated significantly. Kuwati authorities have not been as aggressive in using buffers as the economy fell into a recession.

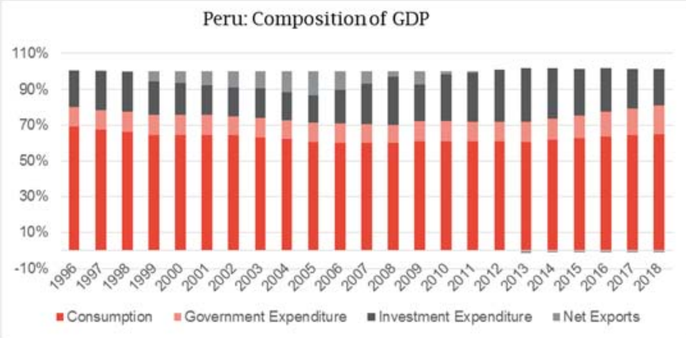


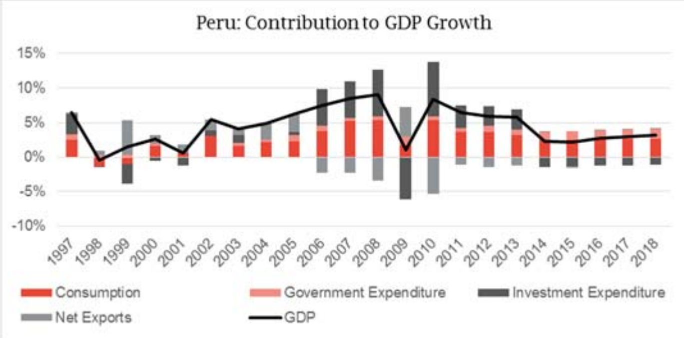


Kazakhstan: The sharp decline in consumer demand resulted in a negative contribution to GDP while strong import compression resulted in a positive contribution by net exports. Capex and fiscal stimulus were strong but the sharp devaluation and recent rate hikes are likely to cause a recession in the near term. Floating of the FX is positive in the medium term as the economy is likely to diversify gradually and become less dependent on oil and gas exports.

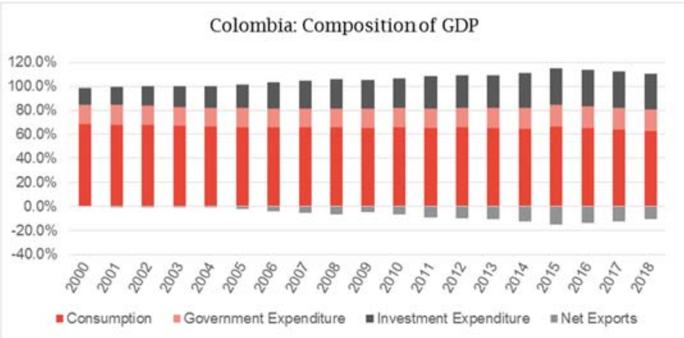
Source for all data: Haver Analytics as at 30 September 2015, based on latest available data.

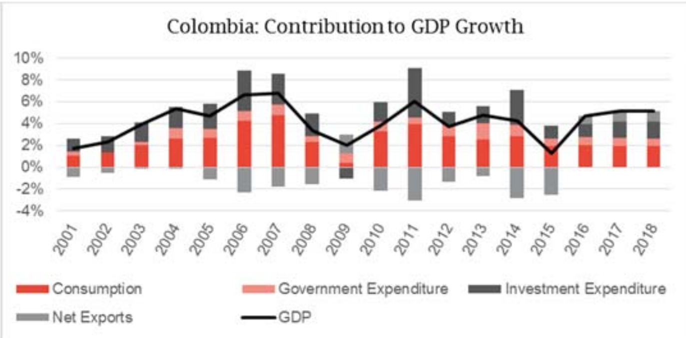
Peru: Monetary and fiscal stimulus kept consumption of GDP strong while investment has declined significantly with lower copper prices and weaker business confidence. Expect more weakening in FX and GDP before the current account deficit declines to sustainable levels over the next several months. This adjustment should be followed by a gradual recovery in GDP towards potential.



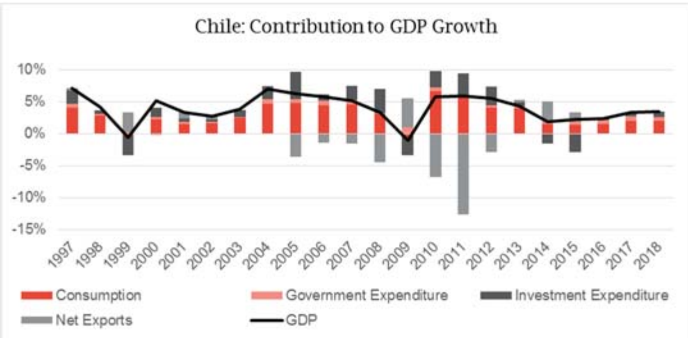


Colombia: The contribution of net exports to GDP decreased significantly with the terms of trade shock while it took several quarters for domestic demand to weaken. The FX has depreciated significantly which is likely to be accompanied by a further weakening in domestic demand and imports before the current account deficit declines to reasonable levels. Expect growth to recover post this external adjustment.





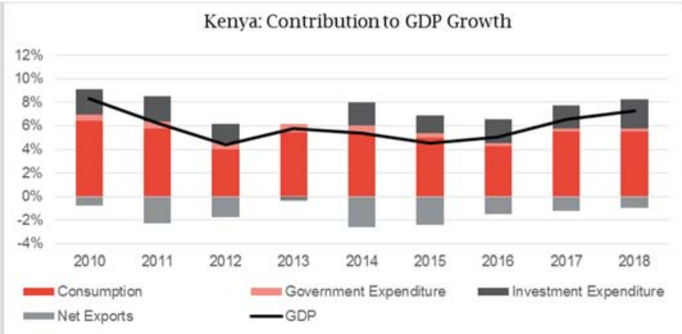
Chile: The sharp import compression led to an increase in contribution of net exports to GDP while capital expenditure collapsed on lower copper prices and consumption weakened with lower consumer confidence. The current account deficit collapsed and the economy began to recover, although higher-than-targeted inflation is preventing further monetary stimulus, which could add further momentum. Composition of GDP data was unavailable for Chile at the time of writing.



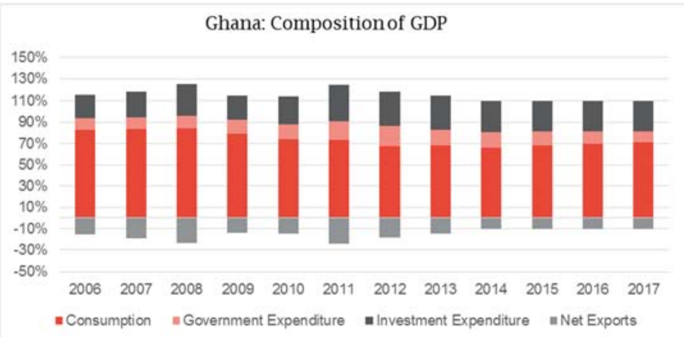
Source for all data: Haver Analytics as at 30 September 2015, based on latest available data.

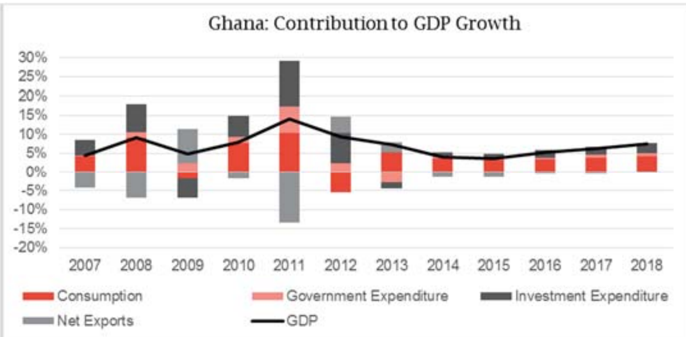
UAE: The current account surplus has evaporated on lower exports due to declining oil prices. Growth decelerated and is likely to decline further as fiscal stimulus weakens and rates increase. Contribution to GDP growth data was unavailable for the UAE at the time of writing.

Kenya: Net exports contributed negatively to GDP last year due to stronger imports while domestic demand and consumption, in particular, contributed significantly to growth. This is likely to be the case for several more years before Kenya becomes a major commodity exporter. Growth will slow down in the near term, as monetary policy has tightened and fiscal policy is also expected to tighten. Slower near-term growth will reduce external risks and pave the way for a reacceleration of GDP in the medium term.



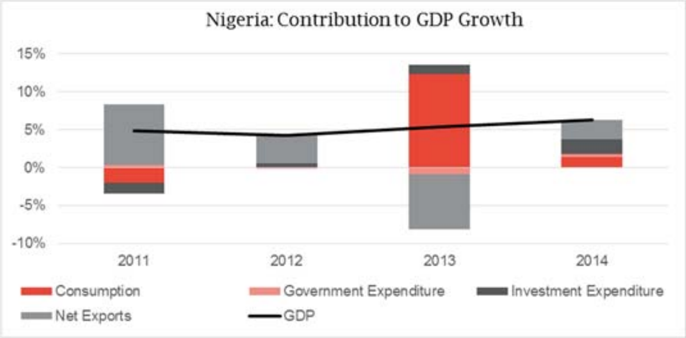
Ghana: Growth has declined significantly with tighter fiscal policy and very high rates. The fiscal position remains unsustainable, the current account deficit is still elevated and inflation has settled at close to 18%. Growth should remain below potential over the next two years with external and fiscal adjustment.





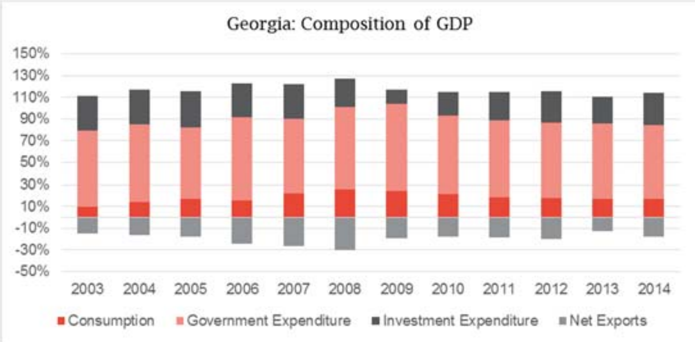
Source for all data: Haver Analytics as at 30 September 2015, based on latest available data.

Nigeria: The country had exhausted its fiscal and FX buffers prior to the decline in oil prices. The buffers were weak to begin with, and therefore growth declined significantly on the back of pro-cycle policies/measures to maintain the FX peg. Further devaluation is inescapable and weak growth is likely to persist for several quarters. Composition of GDP data was unavailable for Nigeria at the time of writing.



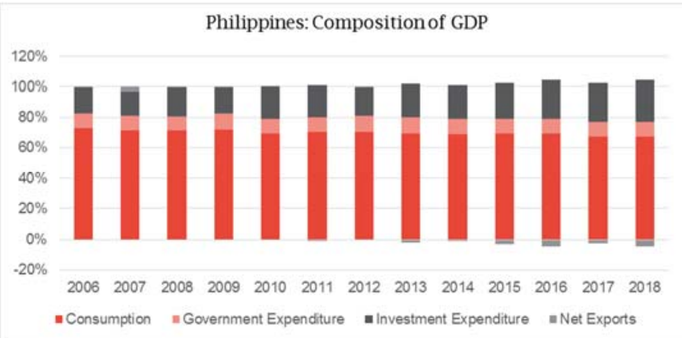
Composition of GDP and Contribution to GDP Growth in Frontier Markets: Manufacturing Exporters

Georgia: The current account deficit has widened significantly on weaker exports due to declining commodity prices. The currency has weakened while domestic demand remained relatively strong. Monetary policy has tightened and fiscal policy remains relatively tight. Growth should slow down with a lower contribution from domestic demand and continued weakness in exports. Contribution to GDP growth data was unavailable for Georgia at the time of writing.



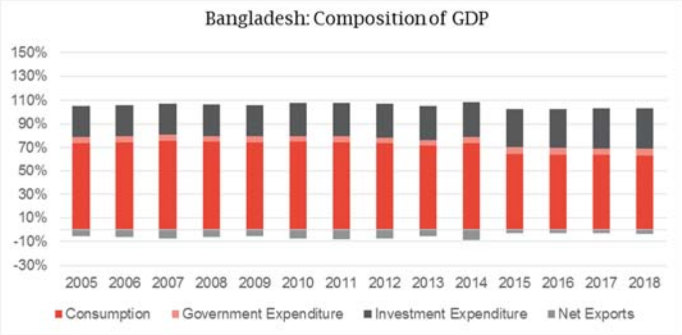
Pakistan: Growth has accelerated with a growing contribution from domestic demand while the current account balance looks sustainable and inflation is low. Pakistan continues to make good progress in structural reforms under the IMF programme. Expect growth to accelerate with a further expansion in domestic demand.

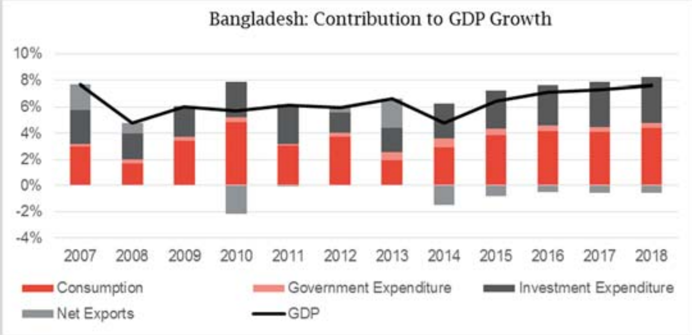
Philippines: Growth remained strong with a balanced contribution from domestic demand and net exports. Exports have been decelerating very recently but the authorities have room for policy stimulus.



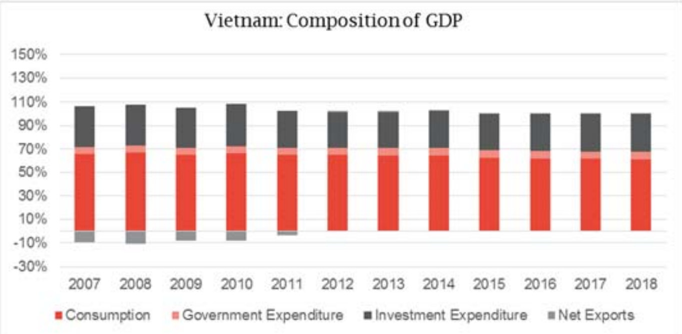
Source for all data: Haver Analytics as at 30 September 2015, based on latest available data.

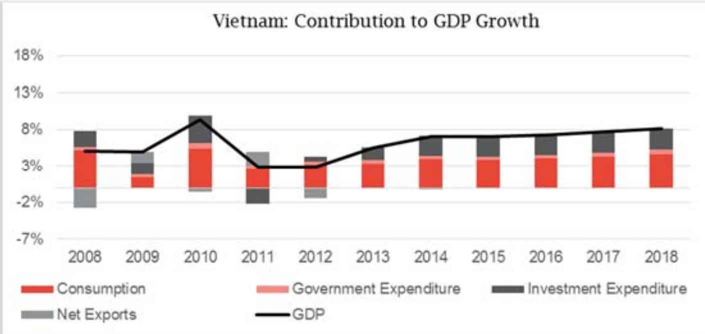
Bangladesh: Domestic demand strength continues to provide strong contribution to GDP. Investments are expanding which is adding export capacity. But this is leading to stronger imports and a negative contribution of net exports to GDP. Growth dynamics are unlikely to change in the near future as GDP expands at a rapid pace. Strong remittances will continue to play a key role in containing the current account deficit at sustainable levels.



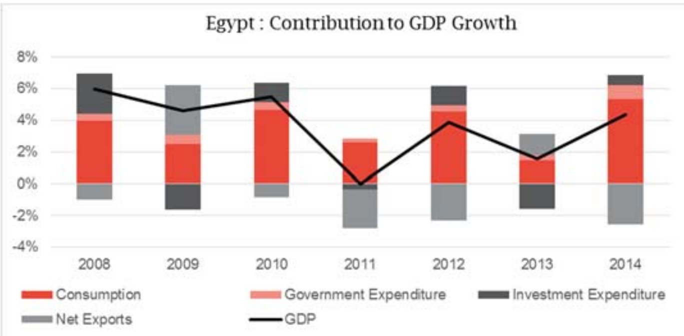


Vietnam: Domestic demand strength continues to provide strong contribution to GDP while strong imports have shifted the current account into deficit. Vietnam is adding export capacity and is gradually diversifying its manufacturing base towards higher value added goods. External dynamics should improve but growth will continue to be domestic demand-orientated in the foreseeable future.



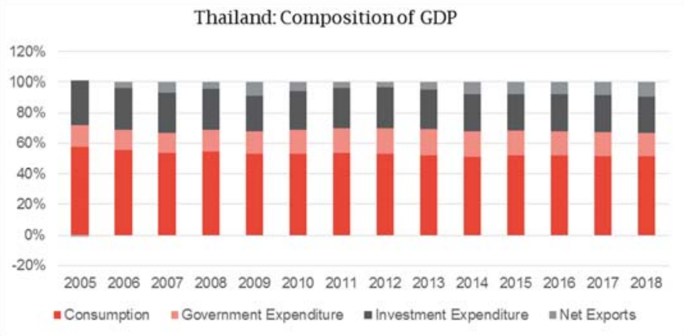


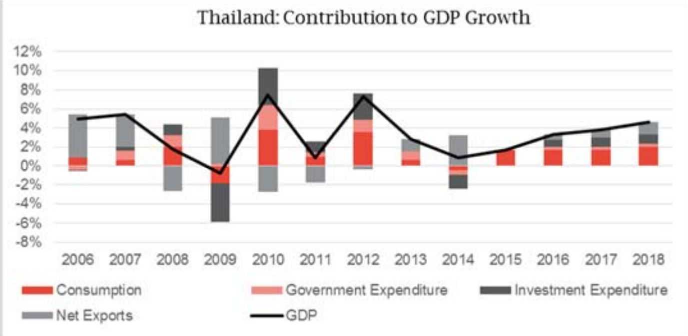
Egypt: Domestic demand recovered from low levels and the contribution of net exports to GDP turned negative due to a strengthening in import demand. Egypt is facing a severe foreign exchange bottleneck which is likely to persist in the foreseeable future, limiting its growth potential. Composition of GDP data was unavailable for Eqypt at the time of writing.



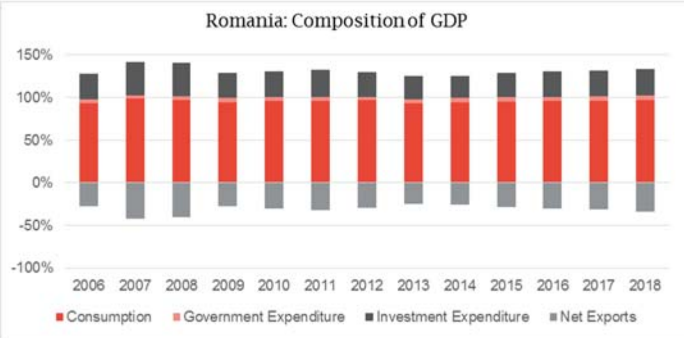
Source for all data: Haver Analytics as at 30 September 2015, based on latest available data.

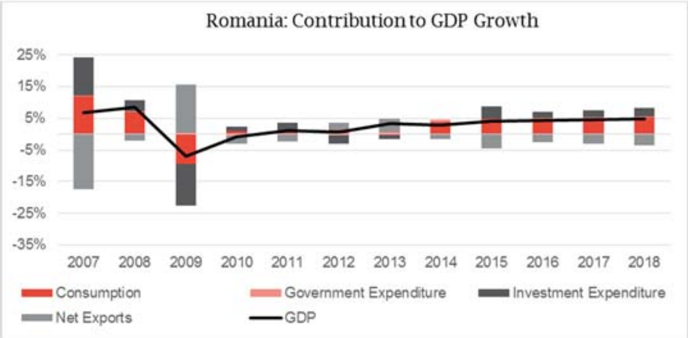
Thailand: The contribution to growth from domestic demand collapsed while import compression improved net exports. The authorities have more room to increase monetary and fiscal stimulus. Domestic demand is recovering gradually. Expect growth to accelerate with balance contribution from domestic and external demand over the medium term.





Romania: The export-based GDP recovery began in 2010 following the sharp adjustment in credit growth, domestic demand and the current account deficit. Exports have recently slowed but stronger domestic demand is providing progressively stronger support to GDP growth while inflation remains at very low levels. A gradual increase in growth and balanced growth dynamics is likely over the medium term.





Source for all data: Haver Analytics as at 30 September 2015, based on latest available data.

Contact Us

Please call us with any questions on this research note or to discuss the various ways in which we partner with our investors to provide access to the existing opportunities we see in emerging and frontier market equities.

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