FP FINANCIAL PARTNERS

Weekly Digest

Week ending **04 December 2016**

The Waiting Game: How Valuation in Emerging Markets is Worth the Additional Risk

Over the past couple of years news relating to Emerging Markets (EM) investments has been mixed, and a confluence of questions over the region's growth prospects, weaker resource prices and a stronger US dollar weighed on sentiment. Recently, President-elect Donald Trump has made a number of comments that raise the prospects of tariffs and higher interest rates in the US which may pose further challenges for the region. Despite these issues the portfolio managers see good opportunities for long term investors willing to look through any short term noise, both in the equity and fixed income markets.

Valuations in EM remain attractive, with much of the negative news surrounding commodity exporting countries having been priced in and the respective currencies having already adjusted. As a result, there is now a substantial valuation discount for the region compared to developed markets. Furthermore, the managers are starting to see a shift in leading indicators which, if sustained, may see the growth differential between emerging markets and developed markets begin to widen. The risks to this view are that the asset class may face near term headwinds from any US dollar strength and the moderation in Chinese growth (which can heavily influence the EM asset class). Fundamentals in a number of countries including Brazil and Russia remain weak and considerable political risk abounds. Falls in commodities disproportionately hit the emerging markets equity index due to the large weight of the resources sector.

While the managers believe EM equity is attractively valued, it is fair to say that there is a strong valuation bifurcation between the high and low quality stocks in the region. It is also always worth remembering that EM stocks are a volatile section of the equity market and as a result care is required on position sizing to ensure that moves of this section of a portfolio do not dominate the outcome.

Turning to the debt markets, many people considering investing in Emerging Market Debt (EMD) are still circumspect as a result of events such as the Asian debt crisis of 1997 and also occasional, isolated, defaults from EM nations loom large in the mind. Nevertheless, spreads today on hard currency denominated emerging market debt remain reasonably attractive when considering default risks, duration and reinvestment risks. Despite taking some pain recently, in aggregate the sovereign issuers that comprise the EMD universe today have reasonable reserves and free floating currencies that should prevent a meltdown like that seen during previous EM debt crises. The aggregate rating quality is also better. Reasons such as these, combined with a paucity of valuation opportunities in other parts of the fixed income universe, lead us to have a small allocation to EMD in our portfolios.

This trade is not riskless, however. EMD remains sensitive to disappointing growth (both locally and globally), a stronger dollar and 'risk aversion' trades as witnessed in the aftermath of the shock US Presidential election result. The falls in EMD following the Trump victory were not all a result of risk aversion, however. Some of the shifts in hard currency EMD were particularly attributable to the moves out in yield in the US Treasury curve. This is because the hard currency EMD curve is priced off the US reference rates and the move out in US yields following the election would have resonated in hard currency EMD. This move out in both yield and spread is what makes hard currency EMD relatively attractive to us today. EMD is also available in local currency variety but, on balance, we would rather not take on the additional risk (and potential reward) offered by adopting EM foreign exchange risk in addition to the interest rate risk and credit spreads today.

Source: Bloomberg. Returns in US dollars unless otherwise stated.

The **Marketplace**

- Italy rejects Renzi's constitutional reform proposal
- OPEC agrees to cut oil production
- Mixed US employment report ahead of expected rate hike
- Far-right candidate beaten in Austria's Presidential race
- Bond price descent continues into December

Market **Focus**

Europe

- The result of the Italian referendum saw 60% of Italians rejecting Prime Minister Matteo Renzi's constitutional reforms; designed to transfer power away from the senate and towards the Prime Minister. Renzi announced his resignation as the result became clear, placing the country in a state of political disarray with concerns focusing on the long-term impact to the EU constitution and the short-term impact on the Italian banking sector.
- Pro-EU leaders found some solace in Austria, as Alexander Van der Bellen, an independent politician backed by the Green Party, became president by winning 53.3% of the vote to beat far-right populist opponent Norbert Hofer of the Freedom Party. The result represents some respite for Europe's mainstream leaders after the recent flurry of shocks to the political status-quo.
- In markets, Italian equities initially fell 2.1% whilst the euro fell 1.5% against the US dollar. However they have both recovered over the morning; prior to these moves, Continental European equities closed down by 1.0% for the week.

Oil

- After speculation and fractured negotiations spanning the year, the Organization for Petroleum Exporting Countries, which represents roughly one third of the global oil supply, reached a formal agreement on Wednesday to cut oil production by 1.2 million barrels a day by January 2017. Brent crude oil prices rose 8.8% off the back of the announcement and 15.3% over the week to end at USD 54.46 per barrel.
- The agreement is the first of its kind in eight years. The surprise inclusion of non-OPEC member Russia helped it gain further traction with investors.

US

- The November employment report showed nonfarm payrolls increasing by 178,000 over the month, closely matching expectations for a number of 180,000. Meanwhile the unemployment rate unexpectedly dropped from 4.9% to 4.6%, its lowest level since August 2007, although average hourly earnings dropped 0.1% month-on-month for the first time since December 2014.
- US equities retreated from their all-time highs by dropping 0.9% last week. Whilst US Treasury prices dropped a further 0.1% and the yield on the 10-year reached 2.4%. A December interest rate hike is now fully priced in.
- Looking back on a broader scale, the Barclays Global Aggregate Bond Index lost 4.0% in November, its largest decline since inception in 1996; illustrating the profound effect that Trump's win has had on global bond markets.

James Klempster (CFA) & Oliver Bickley

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Asset Class/Region	Currency	Currency returns			
		Week ending 02 December 2016	Month to date	YTD 2016	12 months
Developed Market Equities					
United States	USD	-0.9%	-0.3%	8.8%	7.0%
United Kingdom	GBP	-1.5%	-0.7%	12.4%	9.2%
Continental Europe	EUR	-1.0%	-1.1%	-4.7%	-8.6%
Japan	JPY	0.9%	0.6%	-2.5%	-5.7%
Asia Pacific (ex Japan)	USD	-0.2%	-0.5%	7.4%	5.8%
Australia	AUD	-1.2%	0.1%	7.2%	8.2%
Global	USD	-0.7%	-0.2%	4.8%	2.8%
Emerging Market Equities					
Emerging Europe	USD	1.1%	0.6%	15.5%	8.8%
Emerging Asia	USD	0.0%	-0.8%	6.8%	4.5%
Emerging Latin America	USD	-2.0%	-3.5%	25.4%	19.6%
BRICs	USD	-0.7%	-1.6%	11.7%	8.2%
MENA countries	USD	2.5%	1.1%	5.4%	2.9%
South Africa	USD	-1.8%	-1.8%	9.9%	-0.3%
India	USD	0.5%	-0.9%	0.4%	1.1%
Global emerging markets	USD	-0.3%	-1.1%	9.7%	6.3%
Bonds					
US Treasuries	USD	-0.1%	-0.1%	1.1%	0.6%
US Treasuries (inflation protected)	USD	0.1%	-0.3%	4.7%	3.7%
US Corporate (investment grade)	USD	0.1%	-0.1%	5.3%	4.1%
US High Yield	USD	0.4%	0.1%	15.1%	11.8%
UK Gilts	GBP	0.5%	0.3%	8.8%	6.7%
UK Corporate (investment grade)	GBP	0.3%	0.1%	8.6%	7.2%
Euro Government Bonds	EUR	0.3%	0.0%	2.6%	1.4%
Euro Corporate (investment grade)	EUR	-0.3%	-0.1%	3.9%	3.0%
Euro High Yield	EUR	0.1%	0.0%	7.1%	4.9%
Japanese Government	JPY	0.1%	-0.2%	4.1%	4.9%
Australian Government	AUD	-0.6%	-0.8%	2.0%	2.2%
Global Government Bonds	USD	0.2%	0.2%	2.4%	3.1%
Global Bonds	USD	0.3%	0.2%	2.5%	2.9%
Global Convertible Bonds	USD	-0.5%	-0.3%	-0.8%	-1.3%
Emerging Market Bonds	USD	-0.6%	-0.7%	7.4%	6.1%

Source: Bloomberg

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Asset Class/Region	Currency	Currency returns			
		Week ending 02 December 2016	Month to date	YTD 2016	12 months
Property					
US Property Securities	USD	-0.2%	-0.5%	2.0%	4.4%
Australian Property Securities	AUD	-1.7%	-2.8%	-0.2%	0.7%
Asia Property Securities	USD	1.3%	-0.3%	5.7%	4.7%
Global Property Securities	USD	0.2%	-0.5%	2.0%	2.8%
Currencies					
Euro	USD	0.6%	0.7%	-1.8%	0.5%
UK Pound Sterling	USD	2.0%	1.7%	-13.7%	-14.9%
Japanese Yen	USD	-0.2%	0.8%	6.0%	8.6%
Australian Dollar	USD	0.0%	0.9%	2.3%	2.0%
South African Rand	USD	2.2%	2.0%	12.1%	4.0%
Swiss Franc	USD	0.4%	0.7%	-0.8%	0.8%
Chinese Yuan	USD	0.6%	0.4%	-5.5%	-6.9%
Commodities & Alternatives					
Commodities	USD	3.6%	1.8%	12.5%	8.7%
Agricultural Commodities	USD	-1.7%	-0.3%	1.6%	0.8%
Oil	USD	15.3%	7.9%	46.1%	28.2%
Gold	USD	-0.6%	0.3%	10.9%	11.7%
Hedge funds	USD	0.0%	0.0%	1.4%	0.1%

Source: Bloomberg

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Important notes