Outlook Frontier Markets 2018

Last year the Frontier Markets index recorded a decent gain of 15.68%, measured in euro. For investors who are afraid they missed the rally there might be some good news. This is probably the beginning of a long term development since Frontier Markets (FM) are among the youngest and fastest growing markets in the world. These countries are likely to develop along the same path as we have seen in Emerging Markets (EM) in the past 30 years. The IMF predicts in their World Economic Outlook October 2017 that these new markets will on average grow by more than 4% during 2018-2020. Bangladesh for instance is expected to grow 6.4% in 2018. Within the TCM Global Frontier High Dividend Fund we currently have a weighting of 11% in the country.

For a large part the growth in these countries can be related to demographic trends. These trends are particularly interesting for investors as they can be accurately predicted over a longer time frame. In the developed world the consequences of aging will become more tangible over time as the dependency ratio rises. The reverse is happening in the FM were the “demographic dividend” will contribute to economic growth in the coming decade and thereby offering attractive investment opportunities. As the young generation enters their productive years, demand for commodities and consumer goods will rise. An example is Pakistan. The outlook of rising consumption and the high dividend yields makes this market attractive for investors. In Pakistan approximately 100 million people - on a population of 190 million - are under 19 years old compared to Western Europe were around 85 million people are under 19 on a population of 400 million. Other countries with these favourable demographics are for instance Nigeria, Kenya, Bangladesh and Vietnam.

Apart from demographic trends FM also offer investment opportunities because of the lack of analyst coverage and the low activity of foreign investors. Total institutional investments in FM amounts to only 20 billion USD, compared to 1000 billion USD for EM. A factor 50 difference! FM accounts for 10% of the world GDP and 31% of the world population, while these numbers are respectively 34 and 57% for EM. Looking forward we expect that portfolio allocations will be more aligned with GDP instead of market capitalisation. This will lead to more inflows in FM. The ratio market cap to GDP is only 4% for FM compared to 15.5% and 60.3% for EM and developed markets.

Despite last year’s rally FM stocks are relatively cheap and trade on average at 11.6 times earnings, a discount of 29% compared to developed markets. The TCM Global Frontier High Dividend portfolio has an even lower price-to-earnings ratio of 9.7 and a dividend yield of 5.85%. Dividend stocks are usually not on the radar of investors in these markets as the main focus is on growth and liquidity. This gives ample opportunities for stock picking. We like for example Nigerian Tier I banks as they are trading at an appealing 5x price-to-earnings ratio and have dividend yields around 5%. Domestic credit penetration is still low at 16% of GDP and we think the worst is over for the economy after a reset of the FX rate and the current recovering oil prices.

Reforms provide better prospects, not only in Nigeria, but also in many other FM countries. Like Egypt where after a devaluation exports boosted and the trade balance and reserves strengthened. Moody's sees Egypt’s GDP growth accelerate to 5% in 2019. Other reforms are seen in Saudi Arabia where dependence on oil is scaled back and the stock market is gradually being opened to foreigners. In Vietnam lowering the Foreign Ownership Limits also gave the stock market a boost. Such reforms also increase the chances of Vietnam being promoted to the EM category. History shows that in the run up to such a promotion the share prices often rise sharply, as we saw in Pakistan, the Emirates and Qatar. Currently the same is happening in Argentina.

When these economies mature, inflation and interest rates will gradually trend lower. This is not only positive for business investments, but also a good climate for dividend investors. Sceptics mainly associate FM with risk, but due to the low correlations between the individual FM members, as well as the low correlations as a group with more developed markets, allocating to FM can actually reduce the total portfolio risk. Or, enhance returns with the same level of risk.

Of course there are risks. The best protection against specific risks like political risks is to build a well-diversified portfolio. That's why TCM Global Frontier High Dividend operates worldwide and currently invests in 21 countries allocated over 81 companies. Our track record and our research shows this is an effective way to manage this type of risk in FM. Apart from diversification, part of the risks are also absorbed by the above-average high dividend yield in a large number of these markets. Given the potential and the diversification possibilities ignoring Frontier Markets is perhaps the biggest risk for investors.

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