

Outlook Frontier Markets 2020 – Turning Tide

This year we expect Frontier Markets (FM) to outperform developed countries. This is based on a number of factors such as the rising divergence in economic growth between frontier and developed countries, higher earnings growth compared to last year and the prospect of a weaker dollar, which historically supports the performance of frontier countries. Furthermore, the impact of the global interest rate cut cycle, combined with decreasing tensions over the trade war offers a bullish signal. The change in these underlying economic developments no longer justifies the current large discount in valuation of FM.

FM have been ignored by investors for the past 2 years. The crisis in countries such as Argentina, Pakistan and Nigeria put a lot of pressure on sentiment. Incidents such as the attacks in Sri Lanka also had their impact. In addition, liquidity in the FM universe fell due to the promotion of a number of countries to the Emerging Market (EM) Index. According to Auerbach figures, the 7 largest FM investment funds lost an average of 48% of their assets in the last 2 years, mainly due to withdrawals from investors who preferred stocks in developed markets. As a result, the FM universe with a price-earnings ratio of only 9x, has a record discount of 50% compared to developed markets.

The discount in FM will no longer be sustainable in our opinion due to the change in growth differentials for 2020. The IMF expects economic growth in FM and EM to pick up from 3.9% to 4.6%, while growth in developed markets will be steady at 1.7%. An increasing growth differential has historically always been an important driver of outperformance in FM and EM. In addition to the economic recovery, we also see that the expected profit growth of companies for 2020 in frontier countries (+ 14.9%) is much higher than last year (+ 1.1%). Moreover, it is expected to be higher than in developed markets (+ 9.8%) (Yardeni research, December 2019).

A clear historical link can be observed between a weaker dollar and the outperformance of FM and vice versa. The prospect of a weaker dollar is good for FM, as debts are often quoted in dollars. The strength of the dollar in the last two years has been caused by a number of factors, such as the trade war (flight to safe haven), stimulating fiscal policy (tax cuts by Trump) and an expected tighter monetary policy (raise of interest by the Fed). We see all of these factors weakening in 2020. The IMF expects the growth of the US economy to decline from 2.4% to 2.1% in 2020. Most global central banks are in an interest rate reduction cycle. Combined with the declining trade war tensions this will have a positive effect on growth in frontier countries.

With the promotion from Kuwait to the MSCI EM-index, a major change in the composition of the FM index is on the agenda in 2020. The country has a whopping 36% allocation within the FM index. With the disappearance of Kuwait from the index, the weightings of countries such as Vietnam, Morocco, Nigeria and Kenya will increase considerably. In these countries the TCM Global Frontier fund has a selection of attractive valued high-dividend shares with a portfolio price-earnings ratio of 8.85x and a dividend yield of 7.09%. The historical low drawdown of the fund and the low correlation with developed markets, together with a valuation which is also at record low levels, makes the broad based TCM Global Frontier High Dividend fund an interesting investment in a diversified portfolio.

After the upgrade from Kuwait to EM, Vietnam will become the largest country within the FM Index with a 25% weight. This could potentially trigger an inflow from ETFs and index funds. In addition, Vietnam meets more and more criteria as set by MSCI to promote itself to EM status. We expect this to happen within a year or two. Research shows that on average a market rises 23.2% in the run-up to a promotion to a larger index (Burnham, Gakidis and Wurgler, 2017). The TCM Vietnam High Dividend fund currently holds 31 positions with an average price-earnings ratio of 7.8x and a dividend yield of 6.56%.



The TCM Africa High Dividend fund focuses specifically on frontier countries on the African continent. In Africa almost 1.2 billion people live with an average age of 20. By 2050 the number of residents will double, which will increase the demand for consumer goods and infrastructure. This year 54 of the 55 states, with exception of Eritrea, joined the African Continental Free Trade Area. The deal includes a market with a combined gross domestic product of more than 2.5 trillion US dollars. According to the Economic Commission for Africa, this and other trade-promoting measures should increase intra-continental trade by more than 50% over the next four years.

For 2020 we expect a recovery in the Nigerian market, the country with a 20% weighting in the TCM Africa fund. The price-earnings-ratio and price-to-book ratio of Nigerian shares currently account for an average discount of 25% compared to the ten-year average, while the return on equity is 50% higher than the ten-year average. The TCM Africa fund has positions in 7 different countries and has an average price-earnings ratio of 10.4x with a dividend yield of 7.1%.

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