CITY OF LONDON
Investment Management Company Limited

Frontier Markets Semi-Annual Outlook

August 2017

Overview

Tighter Times Ahead

Frontier markets (FM) have benefited from the favourable backdrop of ultra-loose monetary policy and easy financial conditions in the past few years. Financing costs for many countries have fallen significantly since the global financial crisis. This has enabled many countries, with sound fundamentals or otherwise, to fund debt at favourable rates and thereby post healthy growth.

However, with a more hawkish stance by the major central banks, there is a significant risk that funding costs move up sharply in the next 6-12 months. This is likely to leave those countries with a substantial debt stock and/or refinancing needs particularly vulnerable. At worst, global tightening could lead to macroeconomic instability, but FM countries that fit into this category are more the exception than the rule. As a result, we expect tightening conditions to impact some FMs, but the vast majority should continue to benefit from favourable domestic and external demand conditions.

Overall, balance sheet dynamics are healthy. The spectrum in FM ranges from those with large current account surpluses and foreign assets, such as Kuwait, to those with widening twin deficits (Kenya, Romania) and high financing needs (Nigeria). Many countries, including Kenya, are posting wider current account deficits as infrastructure build out requires increased imports, while others have witnessed a rise in foreign investment in an attempt to ramp up production, as has been the case in Vietnam's electronics sector.

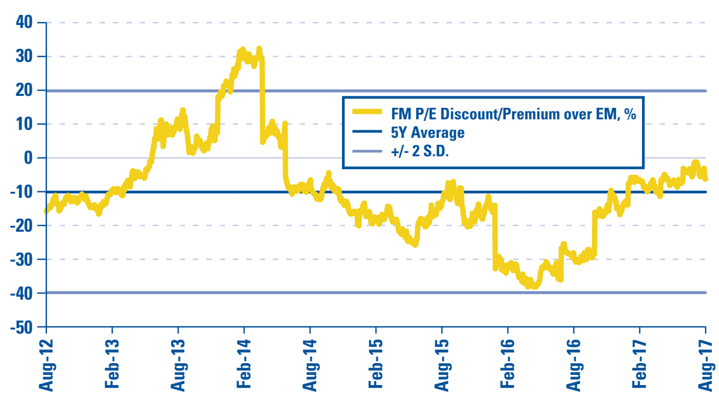
Meanwhile, political risk in FM is higher than it was six months ago. This ranges from the contested election in Kenya in August to upcoming mid-term elections in Argentina, which will be a key test for the Macri administration and its ability to progress with its reform agenda. In Nigeria, the absence of President Buhari for over two months, as he received medical treatment in London for a second time this year, casts doubt over his ability to continue in the role and raises the possibility of a political struggle between northern and southern politicians. A positive here is that the country has implemented policies in his absence and economic conditions have improved. Conversely, the smooth transition of power in Pakistan, where PM Sharif resigned after a Supreme Court ruling against him was upheld, and Romania, where delays in implementing policy led to the dismissal of PM Grindeanu, demonstrate the strength of these democracies and accountability of their leaders. This bodes well for governance over the medium-term.

We continue to favour reform-centric countries and those that are implementing policies in line with economic orthodoxy. These countries are increasing in number in FM, with Argentina the most high-profile. However, other countries are also moving towards a market-based economic model, including Morocco which has made changes to its FX regime as part of a move towards floatation of the dirham. Nigeria also established an 'Investor and Exporter FX window' to improve FX liquidity and the subsequent alignment of the 'Nafex' rate and the interbank rate is a step towards unifying the country's multiple FX rates.

Market Strategy

We expect FM as a whole to prove resilient in the face of tighter global financial conditions. Part of this is due to robust economic fundamentals as the majority of the index does not have a high vulnerability to rising rates. At the same time, valuations are unchallenging, with the FM P/E discount to emerging markets (EM) around its long–term average (see Chart 1).

Chart 1: FM Valuations



Source: Bloomberg

FM has attractive market fundamentals, including a 3.5% dividend yield, which is more than a percentage point above that of EM. This is sustainable given strong profitability, with a profit margin of 13.7% in FM, against 9.2% for EM, and an EBITDA margin of 31%, compared to 19% for EM. The geographical diversification of the FM index also provides some protection against regional risk, with the largest region (Asia) accounting for only 31% of the index. We expect these characteristics to support FM returns.

Our allocation is more cautious than six months ago as political risks are higher in more places, including Pakistan and Argentina. We reduce our *overweights* to both countries, but ultimately retain a positive outlook. Conversely, better policies in Nigeria lead us to reduce the extent of our *underweight*, but we stay below benchmark due to continued economic vulnerabilities. Overall, our allocation is closer to benchmark than earlier in the year as the risk of a short-term correction, perhaps driven by higher yields and a move out of 'risky' assets, leaves FM more vulnerable. However, we would view such a sell off, particularly if indiscriminate, as a buying opportunity given overall favourable economic fundamentals, combined with reform-centric administrations and attractive market metrics.

Latin America

Argentina

Overweight

Economic data has improved as earlier reforms begin to bear fruit, but October's mid-term elections will be key for the durability of the reform agenda.

Argentina's government has continued to implement its reform agenda in the face of opposition ranging from street protests to nationwide strikes. Measures introduced this year have included the start of a four-year $33 bn spending plan aimed at closing the infrastructure gap. The progress has engendered confidence among investors, which was illustrated by the 3.5x oversubscribed sale of $2.75 bn of century bonds in June. However, enthusiasm was tempered the following day when MSCI announced that it would not reclassify Argentine equities from frontier to emerging markets status. It will remain on the review list, but MSCI said it requires more time to assess whether the institutional and market accessibility improvements are irreversible.

The rationale for MSCI's decision was a nod to mid-term elections in October, which will be key for assessing the sustainability of President Macri's reform agenda. About a third of upper house seats and half of lower house seats are being contested. Polls suggest that the ruling Cambiemos coalition will gain seats, but still fall short of a majority in the lower house. In our view, this would be a favourable result since the election is being fought on both the economy and the current administration's ability to tackle corruption. Meanwhile, former president Cristina Fernández de Kirchner is seeking a seat in the Senate for the Buenos Aires province. Fernández's potential return, which would secure her immunity from prosecution, has hurt sentiment towards Argentine assets.

However, she is likely to be a divisive figure for the opposition since she and her late husband are blamed by some for ruining the economy and weakening the Peronists as a political force. Moreover, August primaries, in which the electorate get one vote each, in Buenos Aires gave Fernández and Macri's candidate, Esteban Bullrich, similar shares of the vote (34%). Thus, when the candidates face each other in October's election, the race may be closer than the market had anticipated.

Meanwhile, GDP expanded for the first time in a year in Q1, with GDP up by 0.3% year over year (yoy). Growth on a sequential basis also accelerated to 1.1% quarter over quarter (qoq), the fastest pace in nearly two years and accelerating from an upwardly revised 0.7% in Q4. The improvement was driven by private consumption (1.4% qoq) and investment (1.7%). Household consumption was supported by inflation-busting pay rises. The momentum continued in Q2, with the official economic activity indicator rising by 3.3% yoy in May, compared to -3.1% a year earlier. Argentina's economic output for 2017 is expected to rebound to post a 2.8% yoy rise, from a 2.3% contraction in 2016, as the expected slowdown in inflation in H2 supports household expenditure.

Price pressures have also moderated. Core inflation, as measured by the Greater Buenos Aires core CPI, has halved in the past 12 months to 1.5% month on month (mom) in June. Headline inflation has also nearly halved from 41.1% yoy in December to 22.9% in July. However, inflation expectations remain elevated at 21.5% for this year. It is worth noting that the new national CPI index has been published, with the first yoy figure available in December 2017, and the ytd difference with the Greater Buenos Aires index has been minimal (20bps). The region has a 44.7% weight in the index, while the Pampeana region is the other large component (34.2%).

Argentina's central bank (BCRA) remains focused on getting inflation down to within its 2017 target range of 12-17% and further still in 2018 to a range of 8-12%, so continued tight policy is expected. BCRA raised its key policy rate by 150bps in April to 26.25%, where it has remained since. The fall in headline inflation has also pushed the real rate up significantly, so financial conditions are likely to remain somewhat tight over the next 6-12 months.

The primary fiscal deficit was 1.5% of GDP in H1, half a percentage point below the target for the period. Some of this was due to tax amnesty proceeds ($117 bn) and advance payments of subsidies in 2H16. Adjusting for these factors the deficit would be 2.1% of GDP. A larger shortfall is likely in H2 as fully two thirds of last year's primary deficit came during this period and slippage is more likely ahead of October's mid-term elections. These factors make the government's 4.2% of GDP target for 2017 look ambitious, as does its 3.2% target for 2018.

The current account deficit widened to $6.9 bn in Q1, up from $4.9 bn in Q1 2016. This brought the 12-month deficit to 3.0% of GDP, compared to 2.8% for full-year 2016. The increased shortfall is being driven by the recovery in economic output as imports rise faster than exports. In H1, exports rose by a monthly average of 1.0% yoy, while imports rose by 12.4%. This is a turnaround from H1 2016, when exports (-1.3% yoy) contracted by less than imports (-5.8%). Overall the current account deficit is set to move to 3.1% of GDP this year, from 2.8% last year, driven by a deteriorating trade balance.

Market Strategy: Argentina's valuations are rich, with P/E ratios reaching post crisis highs. Given MSCI's decision not to upgrade the market to EM status and the spectre of Cristina Fernández's return, there has been a healthy paring back of elevated expectations. The market has underwhelmed in recent months. However, economic indicators and reform progress mean we keep Argentina as a core *overweight*, albeit slightly reduced due to election risk.

Asia

Pakistan

Overweight

The resignation of PM Nawaz Sharif is likely to usher in increased volatility, but we expect political and economic stability to prevail.

The scandal surrounding the "Panama Papers" engulfed the family of Prime Minister Nawaz Sharif, suggesting that assets amassed abroad, including properties in an expensive area of London, were not in line with the PM's stated income. Imran Khan, the former cricketer and leader of opposition party Tehreek-e-Insaf (PTI), had pushed for the Supreme Court to investigate. The court then formed a Joint Investigation Team (JIT) and its report showed that Sharif had not declared on the election forms his income as chairman of a family company in the UAE.

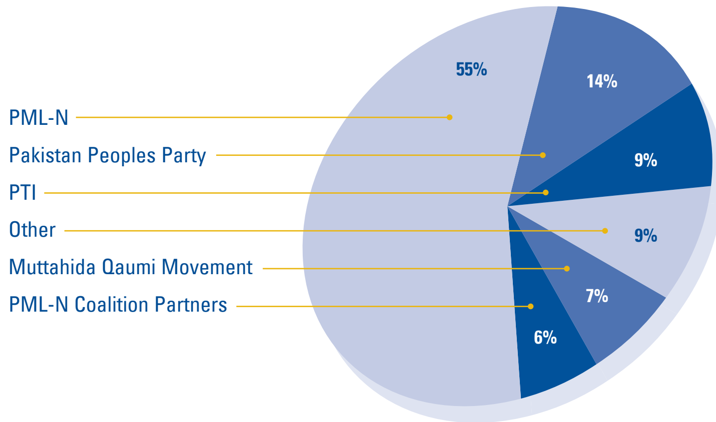
The findings of the JIT led the court to instruct the National Accountability Bureau to bring a case against Sharif and the court ruled in July that he was no longer fit to serve as PM. This was based on Pakistan's constitution, which states that the country's leaders must be "sagacious, righteous and non-profligate, honest and upright". Sharif stepped down on the day the findings were published.

To some extent, we view the resignation of Sharif as positive in that it: 1) demonstrates institutional strength within Pakistan, with the verdict of the Supreme Court respected by the PM and 2) it removes the uncertainty of a prolonged legal battle. Indeed, the transition to date bodes well as it has moved swiftly, with interim PM Shahid Khaqan Abbasi's new cabinet appointed within seven days after Sharif's resignation.

Nawaz's wife Kalsoom or his brother Shahbaz, currently Chief Minister of Punjab, are said to be in line for the role of PM. However, this could risk the credibility of the ruling Pakistan Muslim League (Nawaz) party (PML-N). Sharif's family may be seen as corrupt, while well-respected Finance Minister Ishaq Dar has a criminal investigation against him outstanding. This type of electoral calculus will be important in the next 12 months since legislative elections are scheduled to take place in 2018 between 5th June and 3rd September, inclusive.

In any event, the ruling coalition has a comfortable majority in the National Assembly (lower house), with 208 out of 342 seats (see Chart 2). Should coalition members drop out, the PML-N would still have a majority with 188 seats. Moreover, a recent poll showed that 59% of respondents would accept Shahbaz as Nawaz's replacement. PML-N has substantial support and dominates the Punjab province, which holds a large number of electoral seats and is key to an electoral victory. Despite the party's 10 percentage point drop in support in the region in the Panama Papers' aftermath, PML-N is unlikely to be unseated in the province as it still has a large lead (28-31 percentage points) over fractious opposition parties such as PTI.

Chart 2: Pakistan National Assembly Seats



Source: National Assembly of Pakistan

Meanwhile, economic data has been somewhat mixed. Activity has remained healthy as the agricultural sector rebounded, while manufacturing and services have improved from earlier in the year. GDP growth is expected to remain healthy at around 5.0-5.5% this year and next, similar to last year's 5.3% outturn. This is likely to be aided by a robust expansion in private credit (14% yoy) and falling non-performing loans (NPL). Inflation has declined and recorded 2.9% yoy in July, driven by a fall in food and petrol prices, and comfortably below the central bank's 6% target. Core inflation has been stable, at 5.6% yoy in July, and likely means that the State Bank of Pakistan will keep its policy rate unchanged at 5.75%. Moreover, the real rate is now at 2.8%, its highest level since 2015 and compared to a low of 0.7% in May, so monetary conditions are not excessively loose.

Since the conclusion of the IMF programme in September 2016, there has been some slippage. The current account deficit has widened and is set to double from last year to 2.2% of GDP this year amid rising imports related to the China-Pakistan Economic Corridor and slowing remittances from the Gulf Cooperation Council (GCC). FX reserves have also declined over the past year from 3.7 months of imports to 3.4 as the authorities have sought to support the rupee. Meanwhile, lower than expected tax revenues are set to lead to only a marginal fall in the fiscal deficit to 4.5% of GDP in fiscal year 2016/17 from 4.6% in the previous 12 months.

Market Strategy: Overall, political uncertainty remains, but we expect this to resolve itself in the near-term and the ruling party still maintains a strong political base. Economic deterioration has occurred recently, with the twin deficits expected to widen further and FX reserves falling, but GDP growth is set to remain healthy. Valuations are attractive and compensate for some of the economic and political risk. Pakistan's trailing P/E discount relative to FM is around two standard deviations below its long-term average. We therefore keep our *overweight*, but taper our exposure to reflect the potential for increased political volatility.

Bangladesh

Overweight

Growth is set to remain robust as external demand recovers and domestic activity stays strong.

GDP growth in Bangladesh has remained strong, at 7.2% yoy in fiscal year 2017 (year to end-June, FY17), up marginally from 7.1% in FY16. Growth was boosted by strong domestic demand in turn, aided by strong private credit growth (16% yoy in May). Lacklustre external demand and a 15% fall in remittances in FY17 due to weak economic conditions in the GCC, which accounts for 57% of remittance inflows to Bangladesh, were a drag. The growth recovery in Europe, destination of almost 40% of Bangladesh's exports, is a fillip. Continued private sector credit growth of 16% is set to support domestic demand, with 7.1-7.4 % GDP growth projected for FY18.

After reaching a five-year low of 5.0% yoy in December, inflation has accelerated (5.6% rise in July) as higher commodity prices have begun to feed into prices. Moreover, crop losses in the northeast pushed up food price inflation by 2.6 percentage points over the past year to 7.0% in July. However, non-food inflation has been falling (3.5% yoy in July, half the level a year earlier), suggesting that underlying price pressures are muted. This should enable Bangladesh Bank to keep FY18 inflation below the 5.5% target ceiling and keep its policy rate unchanged at 6.75% in the near term.

Meanwhile, the trade balance deteriorated in FY17 as export growth slowed to 1.7% yoy, but robust domestic demand pushed imports up by 9.0%. Improved European demand and taka depreciation against the euro (-16% ytd) should raise exports in FY18, but a trade deficit is still expected as investment-related imports expand. Lacklustre remittances are likely amid low growth in the GCC and the rising costs of sending money home due to more stringent anti-money laundering regulations. A 0.6% of GDP current account deficit is thus forecast for FY18. However, record high FX reserves of $31.6 bn in June (seven months of imports) are a buffer against external shocks.

The delayed implementation of a unified VAT rate, scheduled for July, is disappointing as it had been a pillar of structural reform. This was announced as part of the government's FY18 budget, with the government likely cognizant of elections scheduled to take place between October 2018 and January 2019. A budget deficit of 5% of GDP is likely for FY18. Increased government spending on infrastructure should alleviate bottlenecks and raise potential growth in the medium-term though.

Market Strategy: Bangladesh's P/E is at a 22% premium to FM, less than half its long-term average of 57% and well down from the 70% premium six months ago. Robust growth means we keep our *overweight*, albeit slightly reduced as reforms are less likely given upcoming elections and a deterioration in external accounts.

Vietnam

Overweight

Growth is set to accelerate in H2, with both external and internal dynamics improving.

GDP growth in Vietnam has accelerated to date, posting an expansion of 6.2% yoy in Q2, a full percentage point above the Q1 outturn. Manufacturing was a key support, with output rising by 12.1% yoy. Manufacturing PMI remains in expansionary territory (above 50), at 51.7 in July, so the sector should support growth in H2. Private consumption was also supportive, with retail sales rising by a monthly average of 10% yoy. Economic output is forecast to rise by 6.4% this year, up from 6.2% last year.

Exporters and the economy (exports are 85% of GDP) are likely to benefit from the improved global backdrop, particularly as it relates to the EU (20% of Vietnam's exports) and the US (10%). A ramp up in smartphone production by Samsung should also boost activity. Exports were already strong in Q2, rising by monthly average of 22.6% yoy. Although export growth was outpaced by imports (24.3%), this was due to foreign firms' capex imports and should reverse as new export production comes online in H2. External accounts are supported by strong FDI too, equivalent to 12% of GDP in 2016.

Price pressures have been falling this year, despite rising activity, with CPI rising by 2.5% yoy in July. This is less than half the rate in January (5.2%). Core inflation also fell from 1.9% to 1.3% over the period. The government has increased medical costs, putting upward pressure on prices, but delays in proposed rises should keep headline inflation low by historical standards and close to the government's 4.0% for full-year 2017. Monetary policy is thus expected to remain supportive.

Money supply is growing at an 18% yoy clip and this has pushed the interbank rate down from 5% at end-2016 to 2% at present. This is favourable for consumers, with consumer loans expanding by 30% yoy. Household leverage remains low (below 25% of GDP) and since household consumption is around two-thirds of GDP, credit expansion is set to be growth supportive and is unlikely to lead to any major imbalances in the next 6-12 months.

Private credit is counterbalancing slower fiscal expansion since the government has reached its 65% of GDP public debt limit. The recovery in oil revenues should lead to a 2017 fiscal deficit of 5-6% of GDP, one percentage point down from 2016. Improving fiscal dynamics led Moody's to raise the outlook on its Ba2 foreign currency debt rating from "neutral" to "positive" in April.

Market Strategy: Vietnam's economic conditions are set to improve in H2. Attractive valuations, with the P/E at a 30% premium to FM and comfortably below the five-year average of 49%, suggest the market offers value. We keep our *overweight*.

Middle East and North Africa

Kuwait

Underweight

Growth is set to slow this year as the oil sector continues to stymie activity.

Economic growth in Kuwait accelerated to 3.0% yoy in 2016, up from 1.8% in 2015, supported by a rise in oil production. Non-oil sector activity was lacklustre, rising by 2.0% and though up from 1.3% in 2015, this is still less than half the rate prior to the oil price collapse. The OPEC production cuts should slow GDP growth to 2.5% this year, illustrating a continued reliance on hydrocarbons.

Project awards slowed to KD0.6 bn ($0.2 bn) in Q2, half the quarterly average in 2016 amid postponement of KD2.4 bn of project awards over the period. This included KD 0.9 bn of projects in the transport sector, KD0.8 bn in construction, KD0.5 bn in power and KD 0.2 bn in oil. A pickup in awards and implementation is expected in H2, which should support growth.

The CPI basket was revised in June, with the housing weight increased by four percentage points to 33%, while the education weight was raised and food reduced. This pushed CPI data lower, with the new index up by 2.0% yoy in May, compared to 2.6% under the old basket. Prices rose by just 1.4% yoy in June. Inflation for 2017 is expected to remain below 2% amid softness in housing. This could be counterbalanced somewhat by the expected utility price hikes in H2 as subsidies are removed, but overall low inflation leaves room for policy easing.

The trade surplus has improved over the past 12 months, in line with a recovery in the oil price and was 4.8% of GDP in Q1. Lower oil output is expected to limit the current account surplus to 2% of GDP this year, well down from the 30-40% levels prior to the oil price collapse. Nevertheless, substantial foreign currency assets are supportive for Kuwait's external position, including a $592 bn (500% of GDP) sovereign wealth fund.

Meanwhile, given the breakeven oil price of $60/barrel against a current price of $53, a budget deficit is expected this year. However, the $8 bn government debt sale in March showed confidence in Kuwait's debt position and the ease with which it can raise money to plug fiscal gaps. The sale was 3.6x oversubscribed, 70% of the issue was bought by US and European investors and it was priced at yields close to those of Abu Dhabi, which has the same sovereign debt rating (AA). This is likely to prove useful amid a fractious parliament and opposition parties seeking to delay fiscal austerity.

Market Strategy: Kuwait's P/E is at a 2% discount to FM versus a five-year average of a 23% premium, but the average is distorted by the inclusion of a period of high oil prices. We expect activity to remain subdued as oil production is reduced and keep our *underweight*.

Morocco

Overweight

Formation of a coalition government reduced political uncertainty, while growth is set to recover.

After several months of negotiations, a six-party coalition government was formed in Morocco in April. It is being led by the Islamist Justice and Development Party, which won the most seats in October's election. King Mohammed VI appointed Saad-Eddine El Othmani as PM and a new cabinet has been formed. The reduction in political risk is a positive as it means that policies can be implemented and unrest in the north can be addressed.

GDP has been recovering this year, aided by the rebound in the agricultural sector (+14.2% yoy in Q1). Economic output expanded by 3.8% yoy in Q1, supported by household consumption and investment. Momentum is expected to have continued in Q2, with the Moroccan planning commission projecting Q2 growth of 4.8% amid a broad-based acceleration. A 4.0% expansion is forecast for 2017, suggesting an overall favourable economic backdrop.

Inflation has dropped to close to zero (0.3% yoy in June against 2.3% a year earlier) as a result of the base effect of last year's food price shock. A healthy agricultural sector should keep inflation in check (below 2%) this year. Bank Al-Maghrib is therefore likely to keep its policy rate unchanged at 2.25% this year and could ease should growth disappoint in H2.

The current account deficit more than doubled to 4.4% of GDP in 2016 as the trade deficit widened to 18.2% of GDP from 15.6% in 2015. However, improvements are likely this year, pushing down the shortfall to 3.6% of GDP. This is set to be driven by the trade account since around half Morocco's exports are destined for the Eurozone, where growth is accelerating. Continued FDI of around 2.5% of GDP is also supportive of external accounts. Meanwhile, a mooted floatation of the dirham was delayed in June, but in July, as part of the gradual liberalisation, the PM announced that the currency would be allowed to fluctuate in a 5.0% band, up from 0.6%. This is part of Morocco's gradual move to becoming a market-based economy.

Fiscal accounts deteriorated last year, with the 4.1% of GDP deficit being wider than expected. This was due to a ramp up in investment spending and weak government revenues amid lacklustre growth. The shortfall is forecast to fall by a full percentage point this year as the growth rebound improves tax revenues, which rose by 9% yoy in Q1.

Market Strategy: Morocco's P/E is at a 50% premium, which is 10 percentage points above its long-term average, but we believe ongoing reforms and an improved growth backdrop should support returns, so we stay *overweight*.

Sub-Saharan Africa

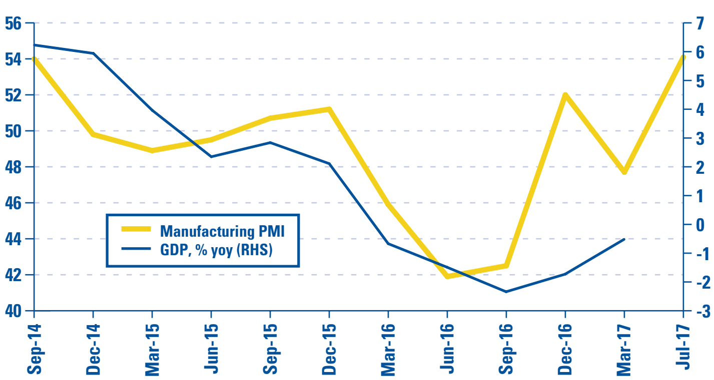
Nigeria

Underweight

A modest economic recovery is taking place, but this is more cyclical than structural.

Nigeria's economy remained in recession in Q1, with GDP contracting for a fifth consecutive quarter (-0.5% yoy). Militant attacks on oil and gas production (-11.6% yoy) weighed on activity. Conversely, non-oil sector activity expanded for the first time in a year (0.6% yoy) as manufacturing rebounded and agriculture continued its strong performance. An emergence from recession is likely to have taken place in Q2, with forward-looking indicators showing signs of marked improvement over the period. Manufacturing PMI rose from a monthly average of 46.8 in Q1 to expansionary territory (above 50) in Q2, averaging 52.2 over the period. The index rose to a historical high of 54.1 in July, suggesting further momentum in Q3 (see Chart 3).

Chart 3: Nigeria's Economic Activity



Source: Bloomberg

However, the banking sector is likely to be hampered by a rise in NPLs, from 6% of outstanding loans in 2015 to 15% in March, given continued low oil prices and limited output. As a result, the rebound is set to be muted, with the IMF projecting 0.8% GDP growth this year, after a 1.6% contraction in 2016. This is comfortably below the 4-6% rate recorded prior to the oil price collapse (2011-14).

Another growth-limiting factor is high inflation. Despite falling from an 11-year high of 18.7% yoy in January to 16.1% in June, price pressures remain. The Central Bank of Nigeria (CBN) is concerned about continued food price rises. However, monetary policy tightening is unlikely since the economy remains fragile and given that inflation is being driven by factors unaffected by the policy rate such as FX shortages. The Bank has kept its key rate at 14% for over a year. Two of the eight monetary policy committee members voted for a rate cut in July, but the CBN is loathe to ease as it may put downward pressure on the naira.

Some of the improved economic backdrop has been policy driven. The CBN established an 'Investor and Exporter FX window' (I&E) in April. This was aimed at alleviating the shortage of US dollars. The window allows people and firms who require FX for either loan repayments, dividend payments, capital repatriation or trade-related payments to trade at rates determined by willing buyers and sellers, with the CBN only intervening if and when the market needs to be stabilised. This had the desired aim of improving liquidity by attracting dollars, with daily transactions rising from $1.0 bn in May to $2.2 bn in June. The burden on the Bank to provide FX has been reduced, with the CBN only accounting for 30% of the I&E market.

The daily fixing rate ('Nafex') is now close to the interbank rate at around 367/$, illustrating improved liquidity and price discovery. In August, the FMDQ OTC Securities Exchange asked lenders to quote FX rates reflective of the I&E window. This is one step towards unifying the multiple exchange rates quoted. A well-functioning FX market should attract foreign flows and engender confidence to commit to transactions, thereby lifting activity and supporting the economic recovery.

Political uncertainty has risen due to President Muhammadu Buhari's absence. After seven weeks in London for medical treatment in Q1, Buhari underwent further treatment in May and has not been in Nigeria since, leading to questions over his recovery. Vice President Yemi Osinbajo was given power to act as head of state during Buhari's absence and if Buhari resigns or the medical panel and government ministers vote to remove him, Osinbajo, a southern Christian, would replace him automatically. However, there may be a power struggle and even civil unrest as northerners will want their candidate to replace Buhari, especially since the next presidential election is not due until February 2019.

Meanwhile, the current account was in surplus (2.7% of GDP) in Q1. This was largely due to falling imports amid a continued recession and FX shortages. The surplus is expected to come in at 1.0% of GDP for full-year 2017. However, risks are to the downside as oil production disruption due to attacks by Boko Haram and the Niger Delta Revolutionary Crusaders continue and the economic recovery and improved FX liquidity could result in a strong rebound in imports.

Fiscal deficit estimates (3.7% of GDP projected by the IMF) are also skewed to the downside due to both oil production risks and an ambitious budget aimed at boosting growth, in part via infrastructure spending. This may lead to higher bond yields, crimping private sector credit. Fiscal sustainability remains unaddressed, with the government spending 66% of its revenues on interest payments, double the rate a year ago.

Market Strategy: MSCI Nigeria outperformed MSCI FM by 35% in US dollar terms in the past six months, driven by improving economic conditions amid cheap valuations. The trailing P/E was at a 33% discount to FM in February, two standard deviations below its long-term average of 12%. Valuations have since recovered to a 15% discount and given a continued lacklustre economic backdrop, we maintain our *underweight*, but increase our exposure in acknowledgement of improved policies.

Kenya

Underweight

A contested election result could usher in period of instability in the country, slowing growth further.

The build up to Kenya's presidential election in August was marred by the murder of an information technology official in the electoral commission. Official results show that President Uhuru Kenyatta of the Jubilee party won 54.3% of the vote, nearly 10 percentage points ahead of his main rival Raila Odinga, leader of the opposition Orange Democratic Movement (ODM). However, Odinga said the results were "fake" and suggested that the electronic voting system had been hacked. This sparked protests and clashes in the capital, Nairobi, and though not on the scale of the 2007 election, the rejection of the result bodes ill for a smooth transition. The ODM have said they will challenge the result in the Supreme Court.

In an election year, Kenyan GDP growth typically slows, with the Institute of Economic Affairs - Kenya showing that growth in these years has on average been 1.6 percentage points below that of years up mid-way through a government's term. Growth is projected to fall to 5.4% in 2017 from 6.0% for 2016. However, risks are to the downside as consumer and business confidence is likely to be damaged if election uncertainty is prolonged.

Private sector credit, a key growth support in recent years, was already weak prior to the election, growing at its slowest pace (3.3% yoy in April) in over a decade. The interest rate cap is also keeping credit expansion muted. Banks now have a preference for lending to the government given that the risk premium that can be applied to private lenders is capped. This, in turn, is crowding out lending to the private sector.

Inflation nearly doubled in H1, from 6.3% yoy in December to a peak of 11.7% in May. This was due to a surge in food prices (21.5%) that was driven by a maize shortage after a poor harvest in April/May. However, price pressures are not especially elevated, with core inflation at 4.5%. Headline inflation has also fallen back recently, to 7.5% yoy in July and is expected to fall within the central bank's 2.5-7.5% target range in H2. The Bank is therefore likely to keep its policy rate unchanged at 10% in H2.

Meanwhile, the twin deficits continue to widen. The maize shortage led to increased imports, which is forecast to widen the current account deficit from 5.2% of GDP in 2016 to 5.8% in 2017. Increased infrastructure and current expenditure pushed up the fiscal deficit to an estimated 8.3% of GDP in FY17, well above the government's 6.9% target.

Market Strategy: Political risk, widening twin deficits and slowing growth leave Kenyan assets vulnerable. Despite this, the P/E is at an 11% discount to FM, less than half that six months ago, so we keep our *underweight*.

Europe

Romania

Neutral

Growth is set to accelerate, but inflation is likely to rise in H2 and prompt tightening from the NBR.

Economic growth in Romania has continued to accelerate. Q1 GDP expanded by 5.7% yoy, up from 4.8% in Q4. Household consumption was key, contributing 4.8 percentage points as real wages rose by 13% yoy in Q1. Economic conditions are set to remain favourable amid ongoing fiscal expansion, with GDP forecast to expand by 4.0-4.5% this year.

However, the inflation backdrop has become less benign. The January 2016 VAT has dropped out of yoy comparisons, marking the return of inflation after 19 consecutive months of deflation. CPI rose by1.4% yoy in July and core inflation, adjusted for the impact of the VAT cuts, was 2.5%. This normalisation of price rises means that the National Bank of Romania's (NBR) has become increasingly hawkish. Governor Mugur Isarescu has said inflation could begin to test the upper bound of the Bank's 2.5% +/- 1% inflation target range in 2018, when CPI is projected to rise by 3.2% yoy. Isarescu also acknowledged the NBR may be "behind the curve," suggesting that the key policy rate could be raised sharply.

Meanwhile, external accounts have deteriorated as robust domestic demand has meant that the rise in imports has outpaced that of exports. Romania's trade deficit widened to 6.6% of GDP in the year to June, from 5.9% in the previous 12 months. The trend is set to continue despite improving conditions in key export markets like the Eurozone, where 40% of Romania's exports are destined for. The current account deficit is thus projected to widen to 3.0% of GDP in 2017 from 2.3% in 2016.

In June, there was a change of leadership in the Social Democratic Party-led coalition government. Delays in implementing policy led to the dismissal of Prime Minister Sorin Grindeanu and he was replaced by Mihai Tudose, who was endorsed in a parliamentary vote. Tudose is expected to maintain the planned fiscal expansion, with an emphasis on raising income redistribution. To this end, the public wage law approved in June includes salary increases of 25% for public sector workers in January 2018. Other measures proposed under the new government include a reduction in income tax from 16% to 10% and a near 40% rise in the minimum wage. This is set to widen budget deficit from 3.0% of GDP 2016 to 5.0% in 2018.

Market Strategy: Romania's market remains cheap, with its P/E trading at a 30% discount to FM, one standard deviation below its long-term average. In our view this is counterbalanced by widening twin deficits and rising inflation, presenting downside risk to the leu. We stay *neutral*.

Michael Hart & Lyndon Barreto, CFA, August 2017

KEY ECONOMIC AND FINANCIAL INDICATORS *(All data shown are as at end-July 2017 unless otherwise stated)*

	Frontier Market	Macroeconomic Data: % change on year ago: Annual GDP Growth YoY	Quarterly GDP Growth QoQ*	Industrial Production Growth YoY	Consumer Price Index YoY	Latest 12 months: Trade Balance	Current Account	Foreign Reserves 2017 Latest	Foreign Reserves 2016 Year Ago	Currency vs $ 2017 Latest	Currency vs $ 2016 Year ago	Sovereign Rating S&P	Budget Balance % of GDP 2017F	Short-Term Interest Rates	Market Performance: % S&P Frontier 150 Index***	Stock Market Index (S&P Frontier 150 Index) US$	Change since 12/31/16 US$	Change since 12/31/16 Local	Trailing P/E	Forecast: 6 month Currency vs $ +/-
		%	%	%	%	$ Bns	$ Bns	$ Bns	$ Bns					%	Jul. 31, 2017	Jul. 31, 2017	%	%		
Over Weight	VIETNAM	5.7	n.a.	8.6	2.5	-4.8	8.5	37.5	31.2	22728.00	22300.00	BB-	-5.4	4.80	12.88	336.21	13.15	12.93	17.6	-
Over Weight	MOROCCO	3.8	n.a.	8.9	0.3	-19.2	-7.5	22.4	23.7	9.43	9.76	BBB-	-3.1	3.02	10.51	1242.22	10.11	2.85	22.2	+
Over Weight	ARGENTINA	0.3	4.4	6.6	22.9**	-1.2	-16.8	48.3	34.0	17.58	14.99	B	-5.9	18.72	14.69	2689.48	49.94	67.61	185.8	+
Over Weight	PAKISTAN	5.7	n.a.	9.7	2.9	-32.8	-3.6	0.0	0.0	105.32	104.80	B	-4.2	4.46	12.95	4521.26	-7.34	-6.45	7.2	-
Over Weight	PANAMA	6.2	n.a.	n.a.	0.7	-4.4	7.3	2.7	2.9	1.00	1.00	BBB	-3.6	2.14	3.66	6519.21	35.79	35.79	21.9	uc
Over Weight	BANGLADESH	7.1	n.a.	7.4	5.9	-12.6	-1.9	31.6	28.2	81.17	78.38	BB-	7.0	5.51	3.60	1787.37	12.40	16.37	18.3	-
Neutral	BAHRAIN	2.9	n.a.	n.a.	1.0	2.9	n.a.	2.7	3.1	0.38	0.38	BB-	-12.5	2.25	1.41	3295.84	15.25	15.23	8.3	uc
Neutral	BOTSWANA	0.8	0.8	n.a.	3.5	1.7	1.9	7.5	7.3	0.10	0.09	A-	n.a.	1.69	0.00	1278.49	5.25	0.52	9.9	-
Neutral	CAMBODIA	7.2	n.a.	n.a.	3.2	n.a.	170.0	8.6	6.9	4098.00	4093.80	n.a.	n.a.	1.55	0.68	888.98	6.60	7.31	n.a.	-
Neutral	COTE D'IVOIRE	8.8	n.a.	n.a.	0.7	n.a.	n.a.	0.0	0.0	557.42	594.27	BB-	-3.2	6.60	0.00	1684.01	0.55	-10.05	n.a.	-
Neutral	GEORGIA	4.8	n.a.	4.2	7.1	-6.3	-1.9	2.8	2.7	2.39	2.35	BB-	n.a.	n.a.	2.04	1461.28	29.03	15.99	20.6	-
Neutral	JORDAN	2.2	n.a.	-4.5	3.7	-13.6	-3.6	12.6	14.3	0.71	0.71	BB-	-3.0	2.75	0.00	530.08	1.85	1.90	12.3	-
Neutral	KAZAKHSTAN	3.6	n.a.	7.5	7.1	15.2	-8.7	18.4	19.5	331.22	352.35	BBB-	-3.2	15.00	3.69	143.19	57.84	55.56	7.6	-
Neutral	MAURITIUS	3.4	n.a.	n.a.	6.4	-1.2	-44.9	4.6	4.1	33.08	35.45	n.a.	n.a.	3.00	0.00	478.83	25.76	16.64	6.4	-
Neutral	OMAN	3.1	n.a.	-2.9	0.9	3.5	-10.8	18.8	17.0	0.39	0.39	BB+	-11.4	0.95	1.82	2174.06	-16.48	-16.49	8.1	uc
Neutral	ROMANIA	5.7	6.8	15.3	0.9	-7.6	-26.3	38.3	35.9	3.85	3.99	BBB-	-3.5	0.64	3.57	1174.61	30.35	16.94	10.2	-
Neutral	SLOVENIA	5.3	6.0	9.1	1.0	0.9	2.3	0.4	0.3	1.18	1.12	A+	-1.4	+0.2	0.00	420.10	18.13	5.67	11.3	uc
Neutral	SRI LANKA	3.8	n.a.	2.3	4.8	-9.4	n.a.	4.1	5.1	153.39	145.90	B+	-5.0	11.78	0.96	3560.98	16.41	12.93	12.0	-
Under Weight	NIGERIA	-0.5	-51.7	n.a.	16.1	1.6	4.5	30.8	26.2	365.50	316.50	B	-2.5	10.57	9.18	1199.76	53.07	53.20	12.3	-
Under Weight	KUWAIT	1.8	n.a.	n.a.	1.4	19.4	5.9	30.3	31.1	0.30	0.30	AA	-8.6	1.7	14.57	1531.77	14.96	13.61	14.9	-
Under Weight	KENYA	4.7	7.3	n.a.	7.5	-9.4	-45.9	8.6	8.0	103.92	101.40	B+	-7.3	7.12	2.74	3497.97	25.34	27.22	13.4	-
Under Weight	UKRAINE	2.5	-1.2	3.8	15.6	-0.5	-1.4	13.8	11.1	25.85	24.81	B-	-2.9	9.21	1.05	614.10	33.98	27.56	3.8	-

*Note: S&P credit rating shown is long-term foreign currency rating. *% change in GDP on previous quarter, annual rate. **Greater Buenos Aires Consumer Price Index. ***S&P/IFCG Extended Frontier 150 Net Total Return Index Data are the latest available, but in certain cases relate to periods more than one year ago. Any forward looking statements or forecasts are based on assumptions and actual results may vary from any such statements or forecasts. Past performance is no guarantee of future results.*

Source: Bloomberg, City of London Investment Management

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