CITY OF LONDON
Investment Management Company Limited

Emerging Markets Quarterly Outlook

October 2020*

Overview

The Pandemic and the New Inequality

The COVID-19 pandemic risks deepening inequalities between DM and EM economies given the latter's more limited financial resources and poorer health infrastructure. The discovery of a vaccine could exacerbate these differences further. Variations in the ability to cope with the pandemic represent a key element in our country allocation.

The spread of the pandemic and its economic consequences remain the dominant narrative for markets. Sure enough, the US presidential election, the fiscal cliff, the rise of populism in many countries, the ongoing Sino-US tussle and geopolitical flashpoints of various intensity and gravity get plenty of airtime. But it is the "second wave" (although in some countries it is better viewed as an extension of the initial wave) of COVID-19 infections with the attendant economic consequences that represents the biggest challenge of our time. This is nowhere more true than in emerging markets (EM), where new infections surged by 11.5 mn in Q3, more than tripling the number of infections in Q2 and growing more than three times faster than developed markets (DM). The divergence between EM and DM is even starker in terms of fatalities: whereas they doubled to 260,000 in Q3 in EM, they fell to less than half their previous rate in DM.

This exemplifies what could be the beginning of a new rise in inequality between the two regions. With the exception of the well prepared North Asian nations, EM health authorities struggled to cope with the outbreak of the pandemic (e.g. testing), leading to its rapid spread in densely populated cities and slum dwellings. Similarly, the public health structure (hospitals, equipment) in many places is woefully inadequate. And finally, the room for mitigating policy measures is often more tightly circumscribed than in DM: monetary policy faces issues of credibility, while fiscal policy faces market and debt constraints.

And while developed nations weighed the perceived benefits of re-opening economies against the risk of letting the pandemic spread, this was either an impossibility for EM with large informal sectors (e.g. India) or was such a (economically) vital question that a complete lockdown was never even contemplated (e.g. Mexico, Brazil). This experience made it clear that the trade-off between economic growth and national health is at best a short-term one and is in reality non-existent: some of the most "permissive" countries experienced the deepest economic contractions during H1 (see chart 2).

EM Country Allocation

	Chg	-2	-1	0	+1	+2
Asia						
China	↑			■		
South Korea	–				■	
Taiwan	–		■			
Malaysia	–				■	
Indonesia	–			■		
Philippines	↓			■		
Thailand	–			■		
Vietnam	–					■
India	–		■			
Latin America						
Brazil	–		■			
Mexico	↓		■			
Europe, Middle East and Africa						
Russia	↓			■		
Turkey	↑			■		
Saudi Arabia	–		■			
South Africa	↑				■	

Note: Up/down arrows indicate a positive/negative change in our asset allocation compared to the previous quarterly outlook. A dash indicates no change.

Source: CLIM

Unfortunately, these inequalities could be exacerbated by the discovery of a vaccine. Developed nations have already negotiated substantial supply deals, usually with several potential pharmaceutical producers and devoting vast resources to it. In EM, populations are both more exposed to the spread of the virus and less able to afford a vaccine, all the more so if repeat inoculations are required. But this greater need for public procurement support is counteracted by the more limited financial resources EM governments typically have. Yet, financial limitations are only one aspect inhibiting widespread distribution in EM. Production scalability, transport links and the ability to maintain a cold distribution chain in particular represent serious challenges.

**The publication reflects asset performance up to 30 September, 2020, and macro events and data releases up to 8 October, 2020, unless indicated otherwise.*

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Chart 1: New COVID-19 Infections and Fatalities, Q3 2020

	Total infections		Total fatalities	
	Q3	QoQ, %	Q3	QoQ %
World	**23,525,585**	**146**	**505,937**	**9**
DM	6,293,660	76	92,046	-64
EM	11,483,433	230	259,348	102
India	5,727,103	881	81,278	368
Philippines	274,180	674	4,238	260
Indonesia	230,623	320	7,864	187
South Korea	11,039	260	133	11
South Africa	523,130	249	14,077	431
Brazil	3,408,894	144	84,358	42
Mexico	517,127	130	49,877	80
US	4,599,171	88	79,209	-35
China	1,878	-7	-	-100
Russia	523,870	-19	11,324	22
Saudi Arabia	143,782	-24	3,119	90
Turkey	118,757	-36	3,064	-38
Taiwan	67	-46	-	-100
Malaysia	2,585	-56	15	-81
Thailand	398	-74	1	-98

Note: "DM" includes Australia, Austria, Canada, France, Germany, Hong Kong, Israel, Italy, Japan, Singapore, Spain, Sweden, Switzerland, the UK and the US. "EM" includes Brazil, China, India, Indonesia, Malaysia, Mexico, Philippines, Russia, Saudi Arabia, South Africa, South Korea, Taiwan, Thailand and Turkey.

Source: Johns Hopkins University

Market Strategy: During Q3, EM equities outperformed the 7.9% gain achieved by DM equities by 1.7% points. This was mainly due to the incipient signs of recovery as lockdowns were eased (prematurely) and EM benefited from the global manufacturing rebound and persistently benign global liquidity conditions. However, year-to-date, EM equities are still 1.2% below their starting level, whereas DM equities have gained 1.9%.

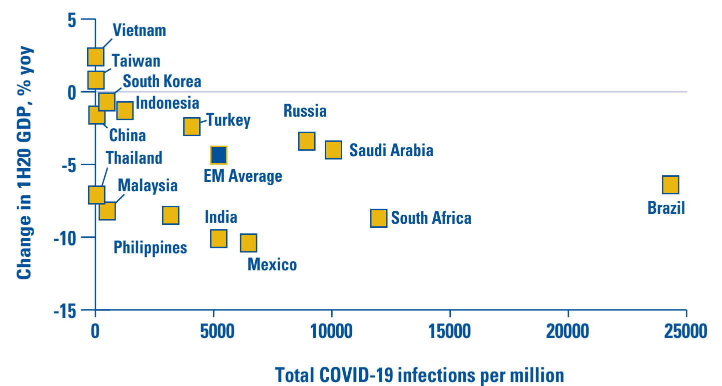
For allocations within the asset class, country variations in the impact of the health crisis matter, but so do other issues. For example, we generally prefer countries that have successfully contained the pandemic (e.g. **Vietnam** and **South Korea**) or have witnessed decelerating growth in new cases (e.g. **South Africa**). But the US election can be equally important for some countries, presenting upside opportunities for China and downside risks for Russia in case of a Biden victory. Russia also suffers from the persistent weakness of oil prices as the energy sector accounts for over 40% of its equity market index. As a result, we upgrade **China** (to *neutral*) and downgrade **Russia** (also to *neutral*).

In **Mexico**, we expect the combination of poor management of the pandemic (little containment or fiscal support) and a structural deterioration under AMLO's policies to lead to continued market underperformance. We downgrade it to *underweight*.

In **Turkey**, the monetary authorities finally embarked on a long-overdue policy U-turn by raising interest rates in a surprise move intended to halt the continuous slide of the Turkish lira. But with still-negative real rates, more policy tightening will be required and the position of the government remains unclear. We shift our allocation to *neutral* (from an intra-quarter shift to *underweight*). The upside now more closely balances the downside given Turkey's cheap valuations.

We also upgrade **South Africa** to *overweight* as the pandemic appears to have been contained, allowing the economy to fully reopen, while the central bank remains accommodative. The improvement in the current account balance has made the country less vulnerable to changes in capital flows and the government appears to have become more committed to its fight against corruption. Finally, given the large weight of Naspers in the index, we see some defensive qualities in the exposure in case of a resurgence of the virus.

Chart 2: EM: Growth vs Infection Rates



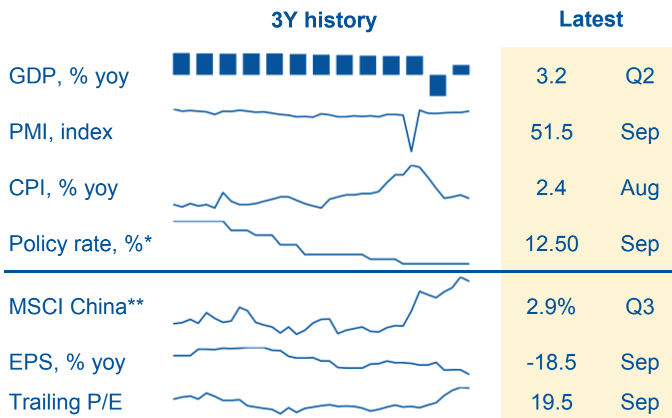
Source: Johns Hopkins University, Bloomberg

Asia

China

Neutral (↑)

The recovery has broadened from manufacturing to services and from investment to consumption, though uncertainties about the US-China conflict linger.



	3Y history	Latest	
GDP, % yoy		3.2	Q2
PMI, index		51.5	Sep
CPI, % yoy		2.4	Aug
Policy rate, %*		12.50	Sep
MSCI China**		2.9%	Q3
EPS, % yoy		-18.5	Sep
Trailing P/E		19.5	Sep

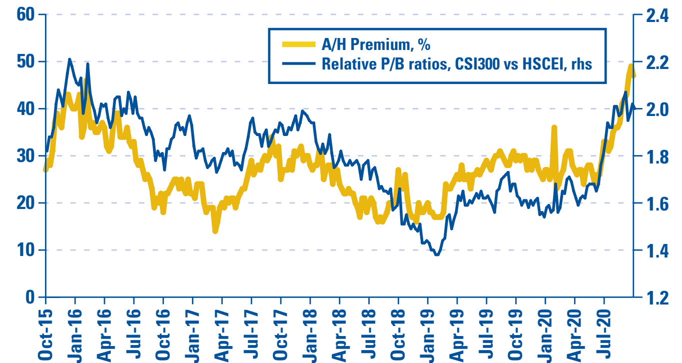
**Required Deposit Reserve Ratio for Major Banks.*
***US$ total return relative to MSCI EM.* *Source: Bloomberg*

The Chinese economy continues to recover, with consumer confidence reviving as the authorities have managed to limit new daily COVID-19 cases to an extremely low level in recent months. The manufacturing sector and investment activity have led services and consumption in the recovery phase, but even the latter has shown notable improvement. For instance, retail sales expanded by 0.5% yoy in August, the first positive year-on-year growth since the pandemic. Services PMIs continue to climb. High-frequency indicators such as road traffic congestion, auto sales and housing transactions also confirm the recovery in economic activity. Consensus expects 5-6% yoy growth in GDP for H2 and the economy is expected to deliver positive growth this year despite the pandemic.

The central bank has begun to normalise its policy support and moderate the pace of easing. A reduction in the reserve requirement ratio of banks later this year is still possible but it will probably be targeted and designed to encourage lending to SME. The authorities have also given more emphasis to macro-prudential policies, notably for real estate. For instance, they have reiterated the principle of "houses for living in, not for speculation", following up with new measures to contain the rise in liabilities of real estate developers.

The US-China conflict remains the most significant uncertainty facing the economy aside from COVID-19. The US-China relationship has deteriorated sharply over the past two years. Some policy analysts even argue that it has reached a new nadir since the re-establishment of diplomatic relations in 1979. This is one reason why investors are paying close attention to the November US presidential elections. A Trump victory could embolden the hawkish faction in the Republican administration and lead to a further escalation in tensions. By contrast, a Biden victory could open up the possibility of tariff cuts even though the conflict is unlikely to be fully resolved and competition would continue to dominate in certain areas, notably technology, for the foreseeable future.

Chart 3: AH Premium and Relative P/B Ratios



Source: Bloomberg, Hang Seng China AH Premium Index

Market Strategy: The US presidential election represents a binary risk for Chinese equities. A Biden victory could induce a relief rally whereas sentiment may deteriorate if President Trump gets re-elected. Delays in holding the election or contested results would add to the uncertainty. While President Trump is lagging in national polls, the odds of his re-election remain too significant to be dismissed. On balance, we move Chinese equities to *neutral*.

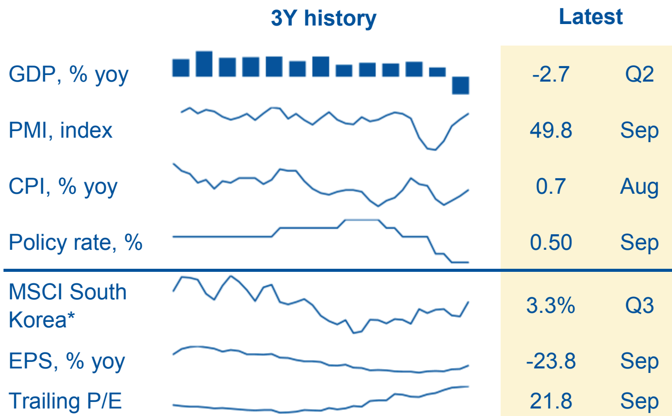
Within Chinese equities, the outlook for H-shares (or more broadly Hong-Kong listed Chinese companies) is improving. Globally, financials have significantly underperformed the broad equity market year-to-date (ytd) on the back of low government bond yields and worries about rising non-performing loans due to the pandemic. The same development also took place in China. Chinese financials dominate H-shares, and the MSCI China H Index and the Hang Seng China Enterprise Index have underperformed both MSCI China and MSCI EM ytd. Nonetheless, Chinese banks are supported by the steady recovery of the Chinese economy – the only G20 country with expected positive growth this year – and a steepened yield curve under normalising monetary policy. Indeed, the Chinese 10-year government bond yields have reached the pre-pandemic level of 3.1% while the US equivalent is still 120bps lower than nine months ago. Also, the P/B ratio of Chinese financials has reached a historical low of 0.7 times.

Therefore, we upgrade Chinese H-shares from *neutral* to *overweight* on the back of an improving economy and cheap valuations. We keep Chinese A-shares at *underweight* due to expensive valuations (Chart 3). A-share prices are nearly at a 50% premium against their H-share counterpart, the highest since 2009.

South Korea

Overweight

The economy withstood the pandemic well, while Korean equities benefit from the global manufacturing recovery.



**US$ total return relative to MSCI EM.* *Source: Bloomberg*

South Korea's economy has been remarkably resilient largely due to the effective containment of COVID-19. The country has shown an extraordinary ability to contain the spread with stringent contact-tracing and isolation, notwithstanding localised outbreaks over the past few months. Domestic demand is recovering and consensus expects GDP to rebound by nearly 2% qoq in both Q3 and Q4, resulting in a mere 1% contraction for the whole year.

Life has mostly gone back to normal in South Korea, in significant contrast to Europe and the US where daily infections are rising and physical distancing measures are increasing. This gives South Korean manufacturers a competitive edge in the global market as their supply chain has largely been restored. Indeed, Korean exports have already surpassed their level prior to the pandemic.

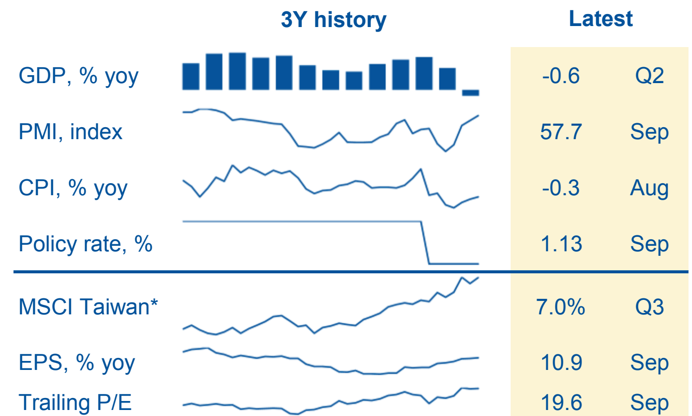
Market Strategy: Global demand represents the major uncertainty for Korean corporates since domestic activity and production have largely normalised. Some green shoots are emerging: 1) DRAM prices have bottomed, NAND prices are largely stable and volumes rebounded by double digits, all of which boost Korea's IT sector; 2) global auto demand has materially recovered as people begin to spend their savings accumulated during lockdown; 3) the resilient domestic economy makes Korean banks less vulnerable than other banks and 4) global manufacturing demand has fared better than services demand, supporting materials and industrials sectors.

There are pockets of exuberance in the market, notably the communication services sector which has rallied by 58% in KRW terms year-to-date, has a trailing P/E ratio of 46 times and accounts for 10% of MSCI Korea. However, the MSCI Korea Index is reasonably priced with the forward P/E premium (vs. EM) close to the five-year average. Tailwinds in global manufacturing demand and competitive valuations support our continued *overweight* to Korean equities.

Taiwan

Underweight

The Taiwanese market faces tailwinds from strong tech demand in the near term and headwinds from de-globalisation in the longer term.



**US$ total return relative to MSCI EM.* *Source: Bloomberg*

Taiwan has successfully contained COVID-19 without resorting to lockdowns. Similar to South Korea, it is well-positioned to take advantage of the strong tech demand and global manufacturing recovery. Exports have turned positive on a year-on-year basis and have supported the economy, which is expected to expand by 1.0% this year.

The US-China conflict has a complicated impact on Taiwanese businesses. Taiwan's manufacturers continue to move their factories from Mainland China back to the island (or open a new factory in the US in the case of TSMC). This increases investment in Taiwan and benefits local suppliers, but has higher cost implications for the factory owners. Another example is the Huawei ban by the US Commerce Department. Huawei's rushed purchase of Taiwanese chips before the ban took effect supported Taiwanese exports. But from now on Taiwanese chip manufacturers are set to lose this important customer.

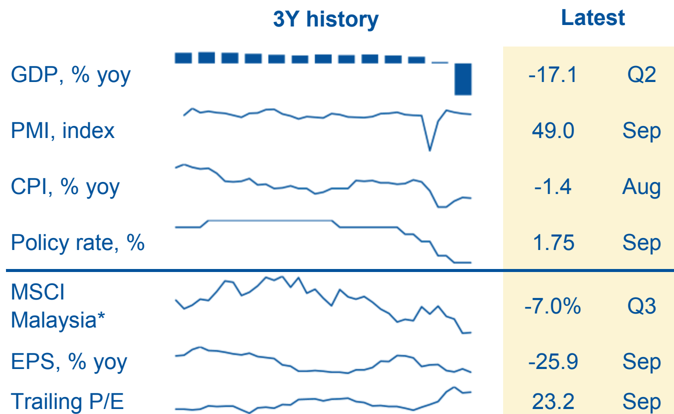
Market Strategy: MSCI Taiwan is dominated by defensive and growth stocks amidst lower government bond yields and strong tech demand. This has pushed valuations (e.g. CAPE, trailing and forward P/E ratios and P/B ratios) to the highest levels since 2005. In the near term, rising infections and increased physical distancing in the US and Europe may continue to support growth stocks over value stocks. In the longer term, though, any rise in global bond yields or progress in treating and preventing COVID-19 may cause Taiwanese equities to start underperforming EM.

Similarly, the US-China conflict may have a short-term positive (e.g. reshoring, pre-emptive purchases by China) and a long-term negative impact on Taiwan's tech companies. In the longer term, de-globalisation, supply-chain fragmentation and China's drive to reduce its reliance on key tech equipment from external suppliers are challenges facing Taiwanese manufacturers. Therefore, we remain *underweight* Taiwan.

Malaysia

Overweight

Malaysia's economic rebound has been uneven, but policy support could help the recovery.



**US$ total return relative to MSCI EM.* *Source: Bloomberg*

Malaysia's recovery from its economic nadir in Q2 has been uneven. Industrial production has risen to just 1% below the pre-pandemic level and manufacturing sales are above the end-2019 level. However, employment is recovering only slowly, a headwind for household consumption (60% of GDP). The unemployment rate recorded 4.7% in July, down from a peak of 5.3% in May, but far higher than the pre-pandemic level of 3.2%. The tourism sector (6% of GDP, 25% of employment) will also likely be slow to recover given that borders remain closed.

The Recovery Movement Control Order implemented in June, which removed most restrictions, should aid growth in H2. Overall, consensus expects GDP to contract by 4.9% this year and to rebound by 6.0% in 2021.

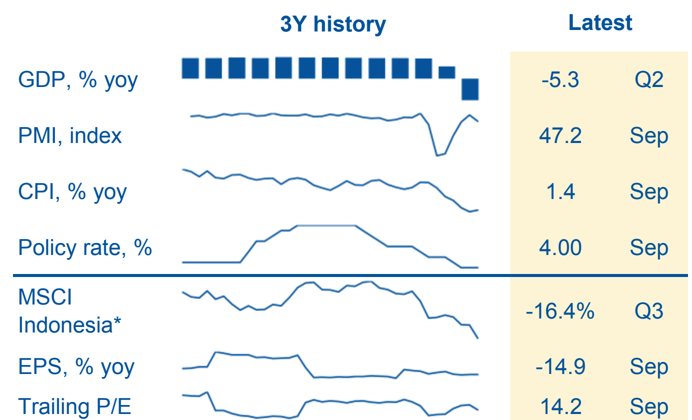
In August, the government approved a 5% point rise in the debt-to-GDP limit to 60% through end-2022, allowing for continued fiscal expansion. Meanwhile, business-friendly opposition leader Anwar Ibrahim announced that he has a parliamentary majority that could unseat embattled PM Muhyiddin Yassin. The king can thus appoint Anwar as PM which would bolster business and investor sentiment. Monetary policy is set to remain supportive, including the extension of loan repayment moratoria to Q1 2021 for businesses and individuals impacted by COVID-19. But additional easing is less likely in Q4 given the ongoing economic rebound.

Market Strategy: The low beta nature of MSCI Malaysia provides a potential hedge for the portfolio against a rise in global risk aversion. Given a decent economic backdrop and unchallenging valuations, with the P/E premium over EM comfortably below the five-year average, we stay *overweight*.

Indonesia

Neutral

Cheap equity valuations reflect elevated COVID-19 infections and the lack of tech stocks in the index.



**US$ total return relative to MSCI EM.* *Source: Bloomberg*

Indonesia is still struggling with the COVID-19 pandemic. Rising infections, a high positive test ratio and a high case fatality rate imply a heavy burden on society. Indicators such as consumer confidence and auto sales moderately increased from the trough in April on the back of lockdown easing. But economic activity is likely to stall again in the near term as the government recently had to re-impose a lockdown on Jakarta, whose activity accounts for 25% of GDP.

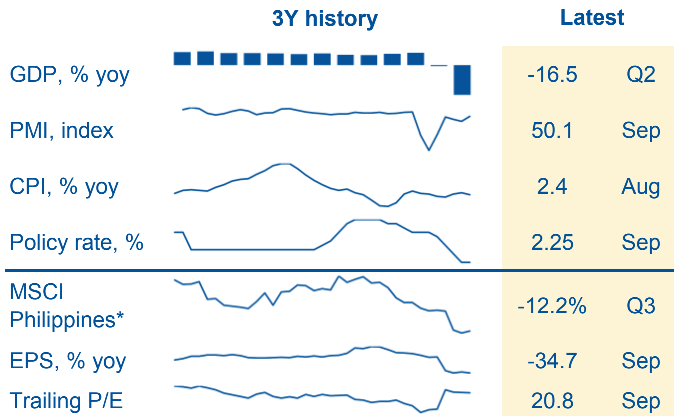
Benign external liquidity conditions mitigate the domestic downturn. Aggressive liquidity provision by DM central banks and a weak USD have tempered rupiah volatility since March. Indonesian government bond yields – in both rupiah and US dollar terms – are lower than at the beginning of the year. This gives Bank Indonesia room to cut interest rates further – after cumulative cuts of 100bps this year - and allows the government to increase its fiscal stimulus. Consensus expects Indonesian GDP to contract by 1.0% this year after expanding by 5% annually over the past six years. Indonesia recently passed the Omnibus Law for Job Creation, a long-term positive as it helps attract investment and improve labour market efficiency.

Market Strategy: The Indonesian market's CAPE ratio and P/B ratio are still close to their levels of March 2009. The premium of its P/E ratio versus EM (whether on a trailing or a forward basis) is significantly below the historical average. Such a price discount versus EM reflects: 1) the lack of IT, e-commerce, social media and internet entertainment stocks in the Indonesian market and 2) the prolonged domestic pandemic that weighs on sectors such as banks and consumer discretionary. Therefore, we remain *neutral* on Indonesian equities despite depressed valuations and benign external liquidity conditions. We are likely to turn positive if Indonesia gets infections under control.

Philippines

Neutral (↓)

Economic momentum is fading and the fiscal stimulus has been lacklustre.



**US$ total return relative to MSCI EM.* *Source: Bloomberg*

The Philippines' economic recovery is lacking momentum. Consumer confidence reached a historical low in Q3 and this will likely be a major headwind to growth as household consumption accounts for 73% of GDP. It is also reflected in the Google Mobility indices, where retail and recreation activity are 49% below pre-virus levels. It is somewhat countered by a rebound in overseas remittances (7.6% yoy in July), aided by economies reopening globally. Consensus expects GDP to contract by 7.6% yoy this year and to rebound by 7.4% next year.

Control of COVID-19 has been mixed. Although the rate of increase in infections has declined, the proportion of positive tests remains high at 8%. This is one reason why the reopening of the economy has been gradual, with the National Action Plan entering Phase 3 in October. This phase is set to last for at least six months and is based on opening the economy and learning "to live with the virus until the vaccine is available."

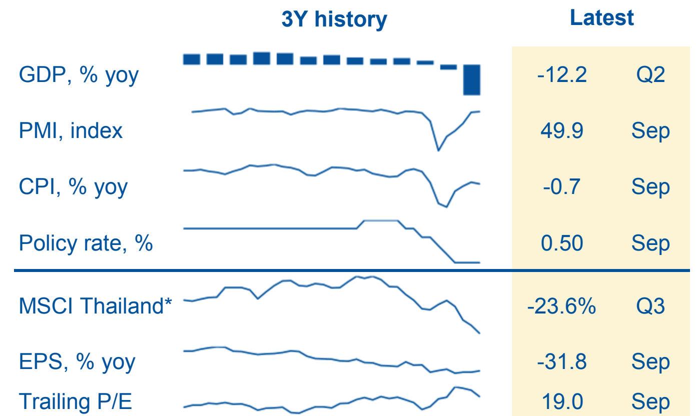
Stimulus is likely needed to boost activity, but the latest fiscal bill (0.8% of GDP) signed into law in September indicates a lack of willingness in this area. Monetary policy has become looser, with a raft of macro-prudential easing measures being adopted. These included extending regulatory relief measures aimed at enabling banks to provide financial relief for borrowers through to end-March 2021.

Market Strategy: Valuations of the MSCI Philippines remain cheap, but this may not be sufficient for outperformance. Industrials, real estate and financials account for 77% of the index and are vulnerable to weak domestic economic momentum. Hence, we downgrade the Philippines to *neutral*.

Thailand

Neutral

Robust policy stimulus is supporting the economic recovery, but social unrest poses a significant downside growth risk.



**US$ total return relative to MSCI EM.* *Source: Bloomberg*

Thailand's economic recovery has been healthy as evidenced by economic data. Google Mobility data suggest that activity in areas like retail and recreation is not far below pre-virus levels. However, there is some way to go to get back to pre-virus levels, with retail sales and industrial production having made up only half their losses.

Sentiment remains weak and the consumer confidence index has only risen by 8% since the April trough. Some of this is likely related to the flagging tourism sector, which accounts for 12% of both employment and GDP. Indeed, the government expects tourist numbers to fall by 83% this year and the ongoing risk of the virus means the sector will likely take some time to recover. Consensus projects GDP to fall by 7.3% yoy in 2020 and to rebound by 4.5% in 2021.

However, additional stimulus measures present some upside risk to these estimates. Recent policies include support for the tourism and retail sectors by way of subsidies for consumers. Meanwhile, given deflation, monetary policy is set to remain ultra-loose, with the key rate held at 0.5% since May. The central bank is also focussing on restructuring debt for corporates and households, both of which remain strained.

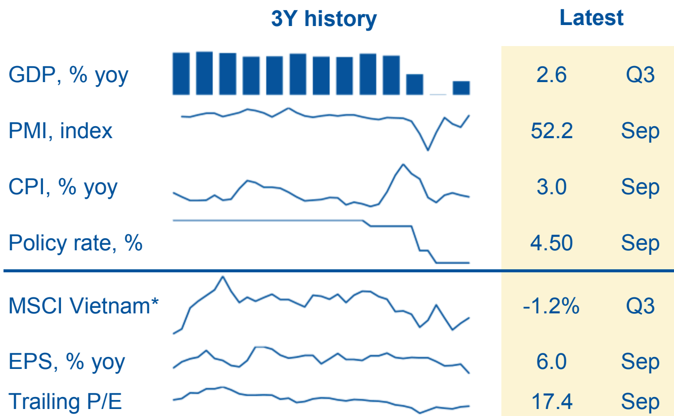
In October, an estimated crowd of 10,000 people protested in Bangkok against the government and the king. An emergency decree was issued, including limiting gatherings to four people. Bangkok Metropolitan Region could become the focus of unrest and the area accounts for some 46% of GDP. This poses significant downside risk to growth.

Market Strategy: The MSCI Thailand's P/E premium over EM is now close to the five-year average. Despite robust policy support, we believe these valuations may not fully reflect the risks from social unrest, so we stay *neutral*.

Vietnam

Overweight

Vietnam's economy has rebounded strongly, supported by external demand and monetary and fiscal stimulus.



	3Y history	Latest	
GDP, % yoy		2.6	Q3
PMI, index		52.2	Sep
CPI, % yoy		3.0	Sep
Policy rate, %		4.50	Sep
MSCI Vietnam*		-1.2%	Q3
EPS, % yoy		6.0	Sep
Trailing P/E		17.4	Sep

**US$ total return relative to MSCI EM.* *Source: Bloomberg*

Vietnam's economy has continued to benefit from a rebound in global demand as many economies reopened. At the same time, COVID-19 has been well contained within Vietnam, helping to support domestic demand. Local outbreaks in Da Nang and Hoi An in July led to the re-imposition of restrictions in these areas. But these measures were reversed in September, though restrictions on bars and clubs and the international travel ban have remained.

Monetary and fiscal stimuli have supported activity and will likely remain in place. Interest rates remain low, with the overnight interbank rate at 0.2%, down from 3.3% in 2019. However, credit demand has been weak, perhaps due to income losses and uncertainty over the course of the pandemic and this could remain a growth headwind. Fiscal measures included plans for public investment worth some 9.0% of GDP this year, with some projects carried over from previous years. However, only 47% of this was distributed in the first eight months of 2020. More stimulus is in the offing, but the size is likely to be small as public debt is approaching the legal limit of 65% of GDP. Overall, consensus expects GDP to expand by 3.0% yoy in 2020, down from 7.0% in 2019 and to accelerate to 7.9% in 2021.

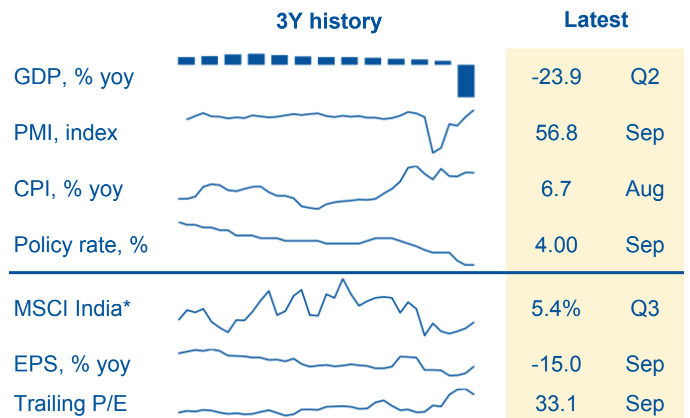
Meanwhile, in October, the US launched an investigation into whether Vietnam should be labelled a "currency manipulator". While dependent on the next US administration, we view this as a headline risk rather than a risk to Vietnam's strong economic fundamentals, including its attractiveness as a place to locate production in Asia.

Market Strategy: The P/E premium of the MSCI Vietnam over the MSCI EM is one standard deviation below the five-year average. In our view, this offers good value given solid fundamentals and a strong policy response to COVID-19. We thus stay *overweight*.

India

Underweight

The economy is recovering swiftly as India eased restrictions early on. But the pandemic rages on and fiscal support remains insufficient.



	3Y history	Latest	
GDP, % yoy		-23.9	Q2
PMI, index		56.8	Sep
CPI, % yoy		6.7	Aug
Policy rate, %		4.00	Sep
MSCI India*		5.4%	Q3
EPS, % yoy		-15.0	Sep
Trailing P/E		33.1	Sep

**US$ total return relative to MSCI EM.* *Source: Bloomberg*

India recorded a league-topping 5.7 mn new COVID-19 cases during Q3, causing over 81,000 additional deaths during the same period. At the same time, it posted a record 24% yoy decline in Q2 GDP. This ranks India as one of the economically worst-hit EM countries in H1, second only to Mexico. The contraction affected all demand components, with private consumption down 27% yoy and only government spending and the external sector contributing positively (thanks to an import collapse) to growth.

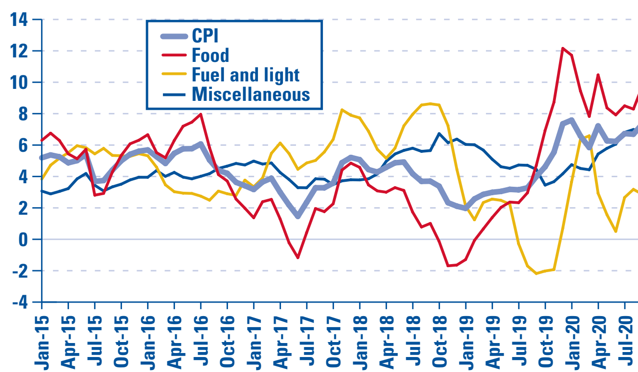
Yet, given the government's decision to ease the lockdown early on, the economy began to recover swiftly. Gyrations in industrial production (IP) have been dramatic: after a 57% yoy contraction in April, IP recovered rapidly in May and was only 10.4% below the year-ago level in July (indicating monthly gains). The manufacturing PMI also staged a comeback, moving from 27.4 in April to 56.8 in September. Similarly, the services PMI recovered from a low of 5.4 to 49.8. Given that services are more dependent on domestic demand, it is unsurprising that this measure remains below the threshold of 50. Altogether, the economy is expected to contract by ca. 10% this year, a sharp change from earlier assessments (e.g. by the IMF), which had expected India to be one of the few countries to record positive growth in 2020.

Despite the collapse of domestic demand, inflation has risen to levels last seen in 2014, with the August CPI easing slightly, but still at a high 6.7% yoy, i.e. within the 6-7% range prevailing for most of this year following a sharp rise in 2019. The inability to keep price increases in check mainly reflects higher food prices (46% of the index), rising gold prices as well as higher transport prices. The latter in turn due to a gasoline tax increase, whereas imported goods prices rose on the back of supply chain disruptions. Indeed,

the H1 outturn could leave the full-year current account balance in slight surplus (even if it will likely slide back into deficit in H2).

The rise in inflation has created a dilemma for the central bank (RBI) as it now exceeds the official target of 4% +/-2%. The RBI supported the economy with rate cuts worth 115bps since the start of the year, but halted its easing cycle in June when the repo rate had reached 4.0%. Nevertheless, in early October it determined that the rise in the inflation reading was temporary, doubled its QE purchases and announced that it would also buy state-issued securities.

Chart 4: Indian Consumer Prices, % yoy



Source: Central Statistics Office India, Bloomberg

States face a severe shortfall in VAT revenues (the tax unified in 2017) as the government announced that it would not be distributing the revenue it collected to the states, urging them instead to fund themselves through debt issuance. The sharp deterioration of revenues at all levels (down 30-35% yoy during the first four months of the year) combined with the steady rise of spending is set to boost the fiscal deficit this year substantially; estimates for 2020 exceed 12% of GDP.

Market Strategy: India has one of the largest infected populations in the world, even if the per capita figures appear less dramatic – probably due to a lack of widespread testing. The decision to keep the economy largely open has prompted an early recovery, but this could yet turn out to be a Pyrrhic victory. Despite touting large headline figures, real fiscal assistance is minimal. Yet, the fiscal situation is deteriorating and debt rising. Nevertheless, with a 15% return, the Indian stock market was the second-best performing market during Q3.

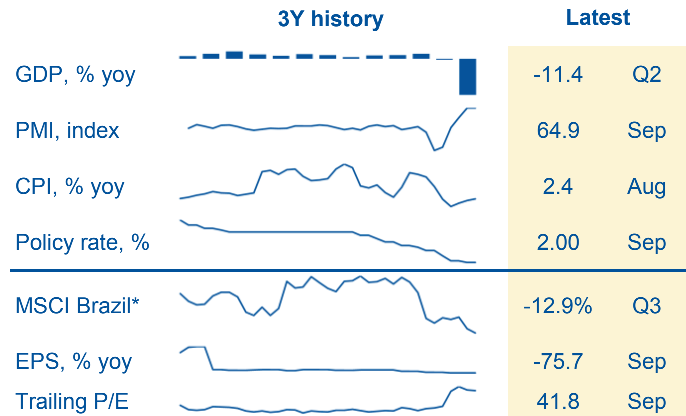
This can partly be explained by the performance of Reliance Industries, owner of Jio Platforms which offer e-commerce, online delivery, a video app, TV streaming, messaging, etc. It constitutes 15% of the MSCI India and doubled in value year-to-date (it is listed as an energy stock). However, the upside for this stock has now become more limited and the market remains expensive with a P/E of 26.5, that is 18% above India's long-run average premium. In light of India's economic challenges, we thus maintain our *underweight*.

Latin America

Brazil

Underweight

The economy and President Bolsonaro's popularity have begun to rebound. But fiscal uncertainties are mounting.



	3Y history	Latest	
GDP, % yoy		-11.4	Q2
PMI, index		64.9	Sep
CPI, % yoy		2.4	Aug
Policy rate, %		2.00	Sep
MSCI Brazil*		-12.9%	Q3
EPS, % yoy		-75.7	Sep
Trailing P/E		41.8	Sep

**US$ total return relative to MSCI EM.* *Source: Bloomberg*

Following a protracted period during which rising asset prices were seemingly disconnected from deteriorating fundamentals in Brazil, the two have recently begun to converge. Following a 23% return in USD terms in Q2, the market retraced and registered a 3.3% loss in Q3. As the market turned negative, the economy began to show signs of recovery. In particular, after a strong August performance, industrial output has recovered most of this year's losses and is now just 2.6% below the pre-pandemic level. In addition, the PMI reached another historical high of 64.9 in September. The recovery that started in May has not percolated to all sectors yet though, as the unemployment rate continues to climb, reaching 13.8% in July. Nevertheless, indicators point to large double-digit gains in Q3 GDP (following an 11.4% yoy contraction in Q2), but this would still leave full-year output ca. 5% lower compared to 2019.

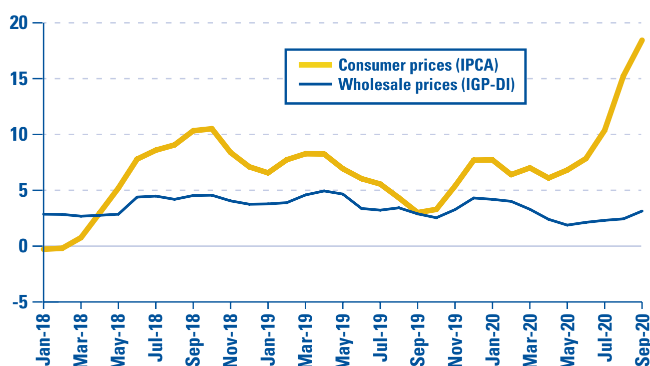
Inflation remains benign, with IPCA inflation readings ranging from 2.3-3.1% yoy in Q3. Potential risks stem from wholesale prices, in particular agricultural prices, which have risen 15.2% yoy as of August. While the food price component in the CPI basket has already risen appreciably, some residual upside risk remains. Yet, this aside, the greatest risk for the outlook for both activity and inflation is the government's fiscal stance.

In early September, the government extended emergency aid at BRL300 per month, which was due to expire in August, until the end of the year for workers affected by the pandemic. However, the government continued to harbour plans for a larger-scale program, leading to contradictory messaging and a rise in political tensions (with President Bolsonaro "forbidding" discussion of the cash transfer program). The extension has underpinned

a resurgence in popularity of President Bolsonaro and may have been agreed with an eye towards the municipal elections due in November. Yet, with the fiscal deficit already at 12% of GDP in July (a primary shortfall of 8% of GDP), the overall balance is heading towards 17-19% of GDP by year-end. Nevertheless, the government eventually announced another cash transfer program (dubbed "renda cidada"), worth 0.5% of GDP. It is to be funded out of the 2021 budget, tapping court-ordered payments. However, details of the plan are not yet fully fleshed out and will require Congressional approval, which is far from assured. Next year will likely deliver both a large deficit (around 10% of GDP) and a sharp contraction from 2020. The key issue in this respect is both the actual level of public debt (approaching 100% of GDP) and whether confidence in the Spending Cap, the key fiscal anchor, can be maintained.

Respecting the cap would allow the central bank to keep rates low after having lowered the Selic rate to 2.0% in nine consecutive cuts. The recent introduction of forward guidance suggests that the central bank expects rates to remain subdued, but it also warned that it could not tolerate inflation pressures that stem from fiscal slippage.

Chart 5: Brazilian Consumer and Wholsesale Prices, % yoy



Source: IGBE, Fundacao Getulio Vargas, Bloomberg

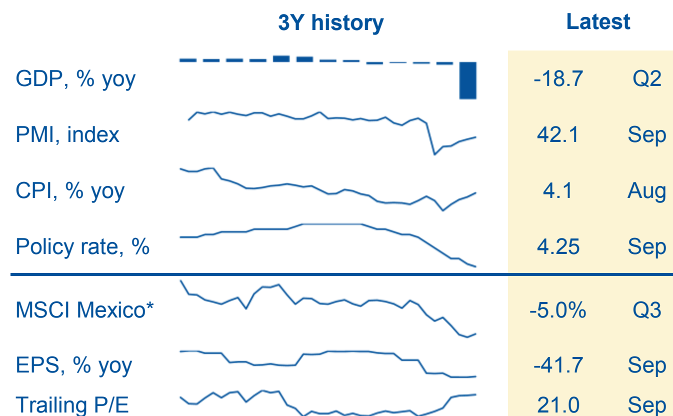
Market Strategy: While President Bolsonaro's recovery in popularity rebuilds some of his political capital, there are few reforms left that are easily achievable and could ignite a market rally. The administrative reform the government sent to Congress in September, which aims to reduce payroll spending on public servants, is one such project. But it is doubtful that much political will exists to pass it ahead of the municipal elections or that it would be viewed as game-changing by investors. Meanwhile, the fiscal deterioration is building into a significant risk that has unseated previous governments.

The Brazilian market lost 38% ytd in USD terms, yet it remains expensive. Given the government's poor handling of health- and economic policy in response to the pandemic, we maintain our *underweight*.

Mexico

Underweight (↓)

With high infection rates and no fiscal support on offer, Mexico risks falling behind its peers.



**US$ total return relative to MSCI EM.* *Source: Bloomberg*

Mexico witnessed a 130% increase in COVID-19 infections during Q3, putting it in fourth place in absolute numbers in EM. A large part of this outturn can be explained by the nonchalance of the government and its leader, President Lopez Obrador, in addressing the crisis. However, as the same approach extends to economic policymaking, the absence of any sizeable fiscal support also meant that the economy fared worse than its peers in 2020.

While Q2 witnessed one of the sharpest GDP downturns amongst EMs, Mexico's recovery is now primarily taking place on the back of rising foreign demand, in particular for manufactured goods and cars. The bilateral trade surplus with the US has hit a record high as a result and trade will likely contribute positively to GDP this year. By contrast, domestic consumption has been slow to resume. While industrial output surged at double-digit monthly rates and PMI recovered swiftly (while still remaining in the sub-50 territory), the services sector continued to lag, with retail sales recovering at a much slower pace.

Headline inflation has risen sharply throughout the summer, peaking at 4.1% yoy in August. However, it began to moderate in September and will likely decelerate further. The Banco de Mexico continued to ease through the summer at a 50bps clip, given that it was the only institution supporting the economy. Only in September did its easing cycle slow to 25bps when rates reached 4.25%, the lowest level in four years.

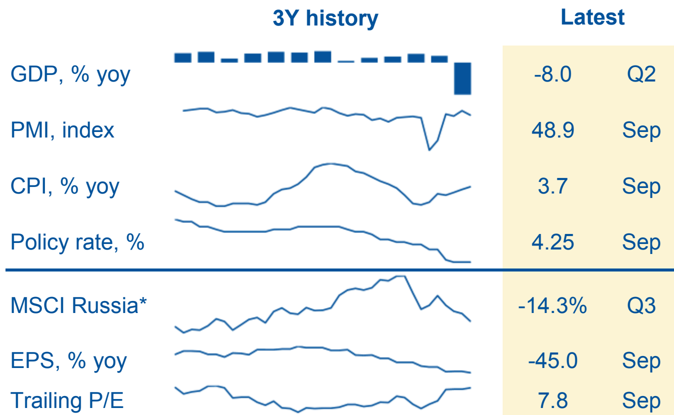
Market Strategy: Mexico underperformed MSCI EM by 5.3% points in Q3 and by 24% points ytd. The poor response to the pandemic and a lack of progress on AMLO's public-private infrastructure projects – notably in the critical energy sector – point to both cyclical and structural headwinds. Even though the market is one standard deviation below its usual P/E premium, we now shift our allocation to *underweight*.

Europe, Middle East and Africa

Russia

Neutral (↓)

Despite an economic recovery, low oil prices and the threat of US sanctions present downside risks.



	3Y history	Latest	
GDP, % yoy		-8.0	Q2
PMI, index		48.9	Sep
CPI, % yoy		3.7	Sep
Policy rate, %		4.25	Sep
MSCI Russia*		-14.3%	Q3
EPS, % yoy		-45.0	Sep
Trailing P/E		7.8	Sep

**US$ total return relative to MSCI EM.* *Source: Bloomberg*

Russia remains amongst the three countries hit hardest by the COVID-19 pandemic, but has witnessed the pace of new infections decline by 19% qoq in Q3. The release of an unproven vaccine (in the sense of not having undergone large-scale trials) is giving hope to the government that it can now exit the current crisis swiftly.

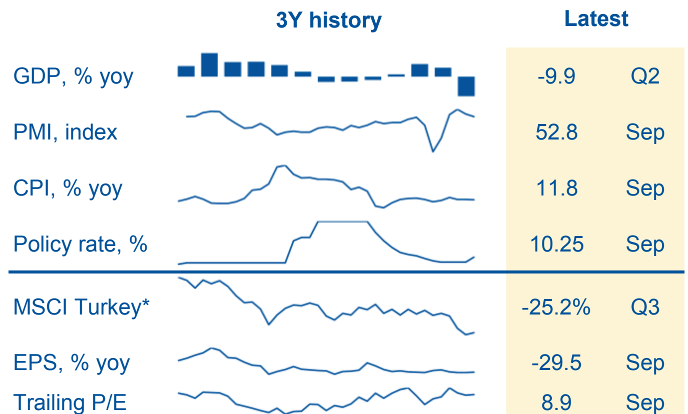
Success on this front would indeed be welcome. The persistent weakness of oil prices is putting a strain on Russia's fiscal accounts while at the same time depressing activity: oil output contracted 16% yoy in July, easing only slightly in August, to -13% yoy. Elsewhere, the economy fared better as the manufacturing PMI rose to 51.1 (the first above-50 reading since April 2019) and the services PMI remained at a high 58.2 in August. As a result, following a 1.6% yoy expansion of GDP in Q2 and a limited 8.0% yoy decline in Q2, the overall impact on growth in 2020 is likely to be more limited than elsewhere (consensus expects -4%). Inflation remained moderate at 3.7% yoy in September, which will allow the central bank to ease rates further, from the current low of 4.25%.

Market Strategy: In light of these developments, why the sudden turn in sentiment towards Russia? Following a 67% gain between March 2018 and January 2020, the Russian market has lagged MSCI EM by 26.8% points ytd, of which 14.3% points were incurred in Q3. Several factors contributed to this: 1) the persistent weakness of oil prices, 2) the increasing prospect of a Biden victory in the US presidential election with the possibility of a ratcheting up of economic sanctions and 3) increasing geopolitical and domestic tensions in the wake of the suspected poisoning of opposition leader Alexei Navalny. In recognition of these risks and their uncertain nature, we downgrade Russia to *neutral*. Its cheap valuation provides significant upside should one of these factors dissipate, though.

Turkey

Neutral (↑)

Turkey gears up for another policy U-turn but has yet to deliver in full to stabilise the currency.



	3Y history	Latest	
GDP, % yoy		-9.9	Q2
PMI, index		52.8	Sep
CPI, % yoy		11.8	Sep
Policy rate, %		10.25	Sep
MSCI Turkey*		-25.2%	Q3
EPS, % yoy		-29.5	Sep
Trailing P/E		8.9	Sep

**US$ total return relative to MSCI EM.* *Source: Bloomberg*

Turkey's monetary authorities finally began to reverse course from the pro-growth stance they had adopted under pressure from President Erdogan as they faced ongoing capital outflows, a slide by over 30% of the lira versus the US dollar year-to-date and a rapid decline in FX reserves. In late September, the central bank surprised markets with a sudden 200bps hike in the policy rate to 10.25%. It later made a series of regulatory changes, which also brought it more in line with orthodox policies.

Should this be regarded as the end of Turkey's economic troubles, the 30% ytd slide in its equity market and the return to more traditional policymaking? It depends. This first move is welcome and takes place earlier than the previous emergency rate hikes in 2018, which came only after an 80% fall in the value of the lira. But the scale of the hikes was much bigger then (24% points) and took real interest rates sharply higher. At present, the real rate of interest remains negative, with September CPI recording 11.8% yoy amidst ongoing FX pass-through.

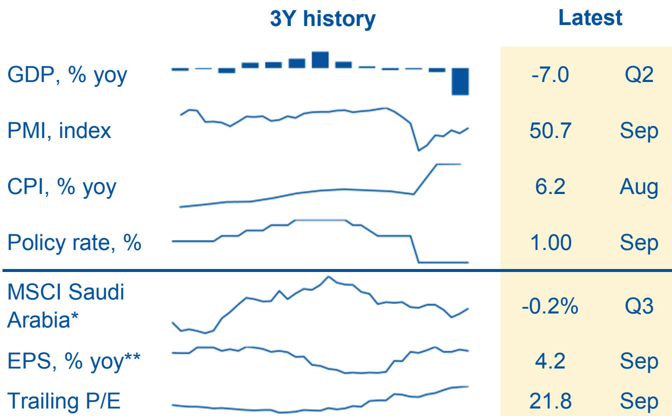
Turkey witnessed a sharp slump during Q2 with a near 10% yoy decline in GDP. But thanks to the pro-growth policies of the government, its H1 output performance approaches that of the more successful Asian peers (see Chart 2). New COVID-19 cases slowed to 118K in Q3, a 36% decline relative to the previous quarter.

Market Strategy: Valuations remain very attractive for Turkey and the recent rate hike could presage an overdue return to more orthodox economic policymaking. However, real interest rates would have to move sharply higher in order to stabilize the currency and the government would be expected to express its support for the policy stance. As these issues remain shrouded in a fog of uncertainty for the moment, we shift our allocation to *neutral*, from a short-lived *underweight* initiated in August, awaiting further developments.

Saudi Arabia

Underweight

Low oil prices are likely to remain a significant headwind to growth, fiscal stimulus notwithstanding.



**US$ total return relative to MSCI EM.*
***Tadawul All Share Index.* *Source: Bloomberg*

The gradual reopening of Saudi Arabia's economy in Q3 has predictably supported activity. This included the reopening of land borders with Kuwait, Bahrain and the UAE and public sector workers returning to the workplace. Certain indicators suggest strong activity, with cement consumption in the first eight months of 2020 up by 24% yoy and point of sale transactions rising by 19% yoy. Real estate loans also rose by 36% yoy in 1H. Nevertheless, the impact of COVID-19 restrictions and oil prices at only around half the budget breakeven point of $80 per barrel, consensus expects GDP to fall by 4.6% yoy this year. The low oil price and reduced output under OPEC+ agreements imply only a mild rebound of 3.2% in 2021.

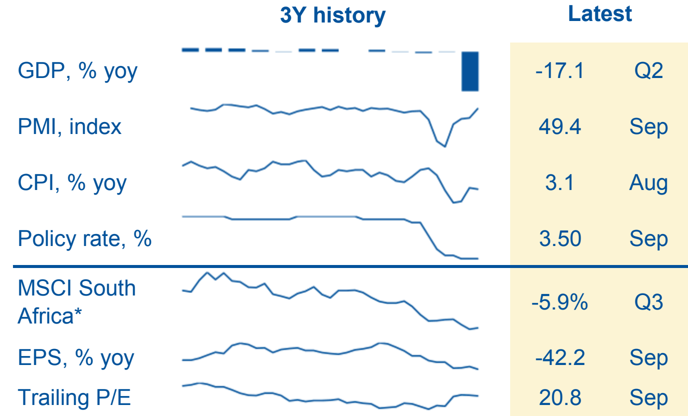
Fiscal and monetary policies provide only weak support to the struggling economy. Indeed, weak oil and non-oil revenues are expected to double the budget deficit to some 12.4% of GDP this year. The rise in VAT from 5% to 15% in July may help bolster revenues in H2, but could also sap demand. This justifies a loose monetary policy stance which is being imported from the US Fed via Saudi Arabia's peg to the US dollar.

Market Strategy: MSCI Saudi Arabia's valuations are not especially attractive, but the risk of being underweight is rising. The 10-year government bond yield is now below MSCI Saudi Arabia's dividend yield and makes equities increasingly attractive. Hence, while weak economic fundamentals and average valuations keep us negative, we reduce the size of our *underweight*.

South Africa

Overweight (↑)

South Africa's recovery is gaining traction, while structural reforms have also progressed.



**US$ total return relative to MSCI EM.* *Source: Bloomberg*

The vast majority (95%) of South Africa's economy has reopened after a stabilisation in the COVID-19 infection rate led to a gradual easing of restrictions. The impact of the lockdown will still likely lead to a GDP contraction by 8.5% this year, before a projected rebound of 3.5% in 2021. These consensus estimates have been revised upwards by some 1-1.5% points over the past three months.

There have also been other positive developments. The current account deficit has narrowed, both due to improved mining and non-mining exports as well as reduced imports. This should reduce the country's reliance on capital inflows. Consensus expects the current account deficit to fall to 0.9% of GDP this year and rise to just 1.7% in 2021, just half the 2015-19 average of 3.3%.

This is not to ignore the many challenges that remain, including rising public debt, its impact on sovereign ratings as well as structural weaknesses such as high unemployment. Indeed, the October budget statement is expected to set out revenue-raising measures and spending cuts to ensure that public debt peaks at 87% of GDP in three years' time.

Meanwhile, some structural issues are also being addressed. At the meeting of the ruling African National Congress in August, a resolution adopted for the first time determines that politicians found guilty of corruption or other serious crimes will have to step down from office.

Market Strategy: Valuations of the MSCI South Africa are low, with the P/E premium over EM two standard deviations below the five-year average. Given the improving economic and political backdrop, we upgrade South Africa to *overweight*.

The information contained herein is obtained from sources believed by CLIM to be accurate and reliable. No responsibility can be accepted under any circumstances for errors of fact or omission. Any forward looking statements or forecasts are based on assumptions and actual results may vary from any such statements.

KEY ECONOMIC AND FINANCIAL INDICATORS

	Emerging Market	Annual GDP Growth*	Industrial Production*	Consumer Price Index*	Trade Balance*	Current Account Balance*	Foreign Reserves 2020 Latest*	Foreign Reserves 2019 Year ago	Currency vs $ 2020 Latest*	Currency vs $ 2019 Year ago	Short-Term Interest Rates*	Sovereign Rating S&P*	% S&P/EM Frontier Super Composite BMI	Stock Market Index S&P/EM Front. Super Comp. BMI US$	Change since 12/31/19 US$	Change since 12/31/19 Local Currency	2020 P/E Forecast*	EBIT Margin 2020 Forecast*	6 month Stock Market Index Estimate (Front Super Comp. BMI) US$*	3 month Currency vs $ +/-*
		Macroeconomic Data											Market Data							
		% change on year ago			Latest 12 months								Performance				Forecast (Bloomberg)†			
		%	%	%	$ Bn	$ Bn	$ Bn	$ Bn			%		Sep. 30, 2020	Sep. 30, 2020	%	%		%		
Overweight	VIETNAM	2.6	3.8	3.0	6.9	15.0	84.1	64.4	23192.0	23203.0	4.7	BB	0.3	205.0	-4.4	-4.4	16.5	17.5	196	-
Overweight	MALAYSIA	-17.1	1.2	-1.4	35.1	8.6	99.8	99.4	4.2	4.2	1.6	A-	2.0	364.0	-4.5	-3.0	17.9	18.1	351	-
Overweight	SOUTH AFRICA	-17.1	-10.6	3.1	10.2	-19.7	44.8	40.8	16.6	15.3	4.2	BB-	3.2	575.1	-23.4	-8.9	12.8	16.7	560	-
Overweight	SOUTH KOREA	-2.7	-3.0	1.0	38.4	59.1	404.2	392.3	1152.4	1198.9	0.6	AA	12.3	552.2	7.6	8.8	16.0	7.8	481	-
Neutral	ARGENTINA	-19.1	-13.3	40.7	19.2	4.6	36.9	47.8	77.1	57.8	28.8	CCC+	0.7	903.8	46.1	85.8	n.a.	-4.4	846	-
Neutral	BAHRAIN	-8.9	n.a.	-3.6	n.a.	n.a.	1.6	3.4	0.4	0.4	1.1	B+	0.1	179.5	-10.1	-10.1	n.a.	n.a.	155	uc
Neutral	CHILE	-14.1	-4.9	2.5	12.4	-5.0	35.6	37.9	795.4	725.4	0.7	A+	0.5	296.4	-26.0	-22.5	20.0	11.7	317	+
Neutral	CHINA	3.2	5.6	2.4	540.5	157.2	3154.4	3103.7	6.8	7.1	1.1	A+	38.0	1075.6	16.6	15.8	16.8	10.7	997	-
Neutral	COLOMBIA	-7.3	-10.8	2.0	-10.7	-11.6	54.8	50.1	3842.3	3454.9	2.0	BBB-	0.2	3931.8	-40.1	-29.7	13.8	10.2	3929	+
Neutral	CZECH REP.	-10.9	-8.0	3.3	21.8	2.4	157.2	143.1	23.1	23.6	-0.1	AA-	0.1	692.3	-25.4	-23.9	11.4	n.a.	753	+
Neutral	EGYPT	5.6	-10.1	3.4	-34.9	-7.9	32.0	39.5	15.7	16.3	8.8	B	0.1	1430.7	-17.4	-18.8	8.8	n.a.	1421	-
Neutral	GREECE	-15.2	-0.2	-1.9	-22.5	-8.8	3.4	1.9	1.2	1.1	0.1	BB-	0.2	23.9	-32.3	-35.0	13.7	9.7	24	+
Neutral	HUNGARY	-13.6	-0.2	3.4	3.9	-1.7	33.4	29.8	304.1	305.0	0.9	BBB	0.2	413.1	-36.1	-32.8	11.9	n.a.	465	+
Neutral	INDONESIA	-5.3	2.0	1.4	9.5	-22.2	129.4	119.9	14707.0	14200.0	5.0	BBB	1.2	1058.0	-31.4	-26.5	17.4	22.5	1176	+
Neutral	KENYA	4.9	n.a.	4.2	-10.3	-45.9	9.6	9.5	108.6	103.7	6.8	B+	0.1	668.5	-22.1	-16.6	12.4	29.1	685	-
Neutral	KUWAIT	1.2	n.a.	2.2	57.2	20.3	41.8	36.9	0.3	0.3	1.9	AA-	0.6	99.5	-11.0	-10.0	25.8	n.a.	94	-
Neutral	MOROCCO	-14.9	-0.6	0.9	-19.7	-4.0	30.0	22.4	9.2	9.7	3.1	BBB-	0.2	547.7	-15.6	-18.4	19.0	25.3	532	-
Neutral	PAKISTAN	0.5	5.0	9.0	-23.3	-15.2	13.9	10.1	163.8	156.3	5.9	B-	0.1	482.1	-12.7	-6.6	6.7	n.a.	434	-
Neutral	PERU	-30.2	-18.1	1.8	5.0	-1.7	64.6	60.9	3.6	3.4	0.2	BBB+	0.2	1571.1	-26.3	-25.9	38.3	n.a.	1543	+
Neutral	PHILIPPINES	-16.5	-11.9	2.3	-29.1	5.4	84.0	75.4	48.5	51.9	1.8	BBB+	0.7	692.4	-20.8	-24.2	20.6	17.0	731	-
Neutral	POLAND	-8.2	1.5	3.2	8.3	13.4	121.5	104.6	3.8	4.0	0.3	A-	0.7	260.8	-20.3	-18.5	12.5	12.0	270	+
Neutral	QATAR	0.9	n.a.	-4.1	39.4	3.6	36.9	36.3	3.7	3.7	1.0	AA-	0.8	278.0	-2.5	-2.5	15.8	n.a.	257	uc
Neutral	ROMANIA	-10.5	-9.9	2.7	-19.7	-66.1	41.2	38.0	4.1	4.3	1.9	BBB-	0.1	142.2	-8.8	-11.1	13.2	23.7	135	-
Neutral	RUSSIA	-8.0	-7.2	3.7	0.1	43.6	438.1	409.0	78.1	65.2	4.1	BBB-	2.8	517.6	-24.2	-9.0	11.4	11.4	531	+
Neutral	SRI LANKA	-1.6	2.4	4.0	-7.2	n.a.	6.6	7.4	184.3	180.5	7.9	B-	0.0	191.6	-12.7	-10.9	14.3	1.9	175	-
Neutral	THAILAND	-12.2	-9.3	-0.7	34.2	28.2	242.3	210.5	31.2	30.4	0.6	BBB+	1.6	1001.4	-25.6	-21.4	21.0	7.2	1148	+
Neutral	TURKEY	-9.9	4.4	11.8	-43.1	-14.9	38.7	74.3	7.9	5.8	11.5	B+	0.5	230.1	-23.8	-1.4	8.5	8.9	278	+
Neutral	UAE	1.3	n.a.	-2.3	74.8	29.6	94.3	100.9	3.7	3.7	0.5	NR	0.6	104.4	-15.4	-15.4	12.4	n.a.	101	uc
Underweight	TAIWAN	-0.6	4.7	-0.6	51.0	70.5	499.6	469.5	28.8	30.8	0.5	AA-	12.1	375.2	11.6	7.8	18.4	7.6	340	-
Underweight	INDIA	-23.9	-10.4	6.7	-100.7	10.2	498.9	396.0	73.2	71.2	4.9	BBB-	10.7	1063.1	-5.3	-2.1	26.1	12.0	973	-
Underweight	SAUDI ARABIA	-7.0	n.a.	6.2	117.1	-18.0	435.8	502.6	3.8	3.8	1.0	A-	2.4	114.3	-0.6	-0.6	22.9	n.a.	103	uc
Underweight	BRAZIL	-11.4	-2.7	2.4	54.5	-25.0	343.5	376.1	5.6	4.1	2.1	BB-	4.5	555.4	-39.3	-15.9	31.4	14.6	572	+
Underweight	MEXICO	-18.7	-11.4	4.1	17.6	-26.5	185.3	170.5	21.4	19.6	4.5	BBB	1.4	317.0	-25.3	-12.7	22.5	13.2	307	-
Underweight	NIGERIA	-6.1	n.a.	13.2	-3.4	-18.5	33.5	41.9	384.7	362.8	4.8	B-	0.1	139.5	-4.2	1.7	6.8	20.4	127	-

Note: All data shown are as at 30 September 2020 unless stated otherwise. UC is unchanged (currency versus US dollar). S&P sovereign rating shown is long-term foreign currency rating. Data for countries in the Middle East and North Africa region are the latest available, but in certain cases relate to periods more than one year ago. The 34 countries shown in the table accounted for 99.2% of the S&P/EM Frontier Super Composite BMI on 30 Setpember 2020. An additional 22 countries accounted for the remaining 0.8% of the index on the same date. These countries, which can be accessed via City of London's Frontier Markets strategy, are: Bangladesh, Botswana, Bulgaria, Cote d'Ivoire, Croatia, Cyprus, Ecuador, Estonia, Ghana, Jamaica, Kazakhstan, Latvia, Lebanon, Lithuania, Mauritius, Namibia, Panama, Slovakia, Trinidad & Tobago, Tunisia, Ukraine and Zambia. †Any forecasts are based on Bloomberg consensus forecasts, where available, and assumptions. Actual results may vary from any such statements or forecasts. Past performance is no guarantee of future results. †Any forecasts are based on Bloomberg consensus forecasts, where available, and assumptions. Actual results may vary from any such statements or forecasts. Past performance is no guarantee of future results.

**Key Criteria*

Source: Bloomberg, CLIM

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Investment Management Company Limited

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