

EXPLORING THE FRONTIER OF EMERGING MARKETS

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Last week, Professor Jeremy Siegel and I chatted with Gavin Serkin, head of emerging markets at Bloomberg and author of “Frontier: Exploring the Top Ten Emerging Markets of Tomorrow,” as well as Kevin Daly, portfolio manager at Aberdeen Asset Management. Our conversation revolved around the frontier markets and the opportunity set they present.

Lower Correlation through Frontier Exposure Although [frontier markets](#) can be considered a subset of [emerging markets \(EM\)](#), they also have low correlations to the rest of the investable marketplace. This is partly because investing in frontier markets tends to be highly idiosyncratic and subject to headline risks. In addition, the legal system in such countries is less developed and hence the rule of law is weaker, and investors have less assurance where preservation of capital is concerned.

USD Strength and Its Impact on EM The U.S. dollar has strengthened significantly against various frontier, emerging and developed markets. In the frontier markets, U.S. dollar strength has been particularly forceful in sub-Saharan Africa, and there continues to be a large risk of further strengthening. Daly believes that the U.S. dollar is likely to continue to strengthen, especially when we get closer to [Federal Reserve \(Fed\)](#) liftoff, most likely in September of this year.

Spillover Impact of September Fed Liftoff Daly believes the Fed liftoff will not be as detrimental as many others expect. In contrast to the “taper tantrum” in 2013, this time around, the liftoff is well anticipated. The Fed’s chairman, Janet Yellen, has also been consistent in reiterating that the liftoff will be a gradual process. As a result, Daly believes emerging markets will not be spooked by a move of 25 [basis points \(bps\)](#) in September. The risk is if economic activity picks up materially, and markets are forced to reassess the “gradual” pace of [tightening](#). For now, expectations are benign, and we have not seen material wage inflation or general [inflation](#) pressures, so Daly does not expect a huge shakeout.

Importance of Market-Friendly Policy Investing in frontier markets is particularly difficult due to the information asymmetry it presents. One important factor in making frontier markets accessible to investors is their inclusion in various indexing strategies. For example, when Nigeria first was included in the [J.P. Morgan GBI-EM Index](#) in 2012, it experienced a sharp reduction in its government [bond yields](#). Within a matter of months, yields declined by 300 to 400 bps. This speaks to the positive effect index inclusion can have on frontier countries, as lower yields imply the ability to finance yourself at lower interest rates. Today, J.P. Morgan is reconsidering Nigeria’s inclusion in the GBI-EM Index. This comes on the back of government-imposed restrictions on local banks that trade Nigeria’s currency—that is, non-market-friendly policy. *Note: It is interesting that China’s Shanghai market also peaked in 2015, very close to the day MSCI announced there would be further delays before the A-shares China would be added to its benchmark indexes. There is large event risk surrounding the inclusion of various countries in popular indexes.*

Frontier Market Highlights Nigeria: This was the top-rated country in Serkin’s book. In 2014, oil prices were higher, and the growth outlook was strong. The central bank governor at that time also had significant credibility, its exchange rate was stable and Nigeria presented attractive double-digit yields on its local bonds. However, 2015 has presented significantly different circumstances—primarily, lower oil prices have led to sharp growth declines. Further, the new central bank governor has yet to establish the same credibility as the previous governor. On a more positive note, election results provided a welcome outcome, with the country having managed a peaceful election and the opposition party winning a strong mandate.

Saudi Arabia: This was the fourth-rated country in Serkin’s book. Saudi opened its markets to investors in June 2015, but markets have fallen since then. This is in part due to great anticipation of the market opening, creating a letdown after it actually occurred. Saudi has promise because it has incredible wealth per capita, high education standards and proper policies being put in place to encourage workforce participation. It is also considered the biggest market yet to be included in major benchmarks around the world.

Argentina: This was the third-rated country in Serkin’s book. While it’s been perennially beleaguered by crisis, this presents an opportunity for Argentina to start over with a clean slate as a low-indebted country. President Cristina Fernández de Kirchner will not be able to stand for election again, and there is potential for new leadership. Serkin thinks Daniel Scioli, who is leading in the polls, has promise. Read the Conversations with Professor Siegel Series [here](#).

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DEFINITIONS

Correlation : Statistical measure of how two sets of returns move in relation to each other. Correlation coefficients range from -1 to 1. A correlation of 1 means the two subjects of analysis move in lockstep with each other. A correlation of -1 means the two subjects of analysis have moved in exactly the opposite direction.

Frontier market : Typically characterized by a higher degree of potential risk, including issues that may inhibit the flow of assets across national borders and awareness of potential difficulties for foreigners to establish accounts.

Emerging market : Characterized by greater market access and less potential for operational risks when compared to frontier markets, which leads to a larger base of potentially eligible investors.

Federal Reserve : The Federal Reserve System is the central banking system of the United States.

Basis point : 1/100th of 1 percent.

Tighten : a decline in the amount of compensation bond holders require to lend to risky borrowers. When spreads tighten, the market is implying that borrowers pose less risk to lenders.

Inflation : Characterized by rising price levels.

JP Morgan Emerging Markets Bond Index Global (EMBI Global) : The JPMorgan Emerging Markets Bond Index Global (EMBI Global) tracks total returns for US dollar-denominated debt instruments issued by emerging market sovereign and quasi-sovereign entities including Brady bonds, loans, Eurobonds.

Bond yield : Refers to the interest received from a bond and is usually expressed annually as a percentage based on its current market value.