Megatrends: Frontier markets

For risk-tolerant investors, frontier markets are an attractive source of diversification. Low liquidity, impaired market access and political risks remain a challenge.

Diversified equity and fixed income funds that offer frontier market exposure Frontier markets will likely enjoy high growth and reduced risk premia in the coming years.

Megatrends are major economic, social and political forces, which are relevant across decades. The Emerging World megatrend represents the shifts that are taking place in developing economies and that are changing the global economic balance. Recently, some of the large emerging economies have started to lose their appeal as investments due to rising correlations, while growth rates have come down. Investors need to look beyond the traditional emerging market economies to frontier markets. Frontier markets constitute one of the Megatrend Investments within the Emerging World megatrend. -see MegaTrends Investment Themes-

What are frontier markets?

Frontier markets are economies with small and illiquid capital markets, but high growth potential. The market capitalization of the group is just 0.5% of the MSCI AC World, compared to emerging markets, which account for 11.7%. They are a disparate group, with great variations in GDP per capita and population sizes. While poor, they enjoy high growth, demographic tailwinds, improving governance, diversification and attractive valuations. Gulf economies account for a high share of equity capitalization, but the group includes countries, such as Kenya, Nigeria and Bangladesh.

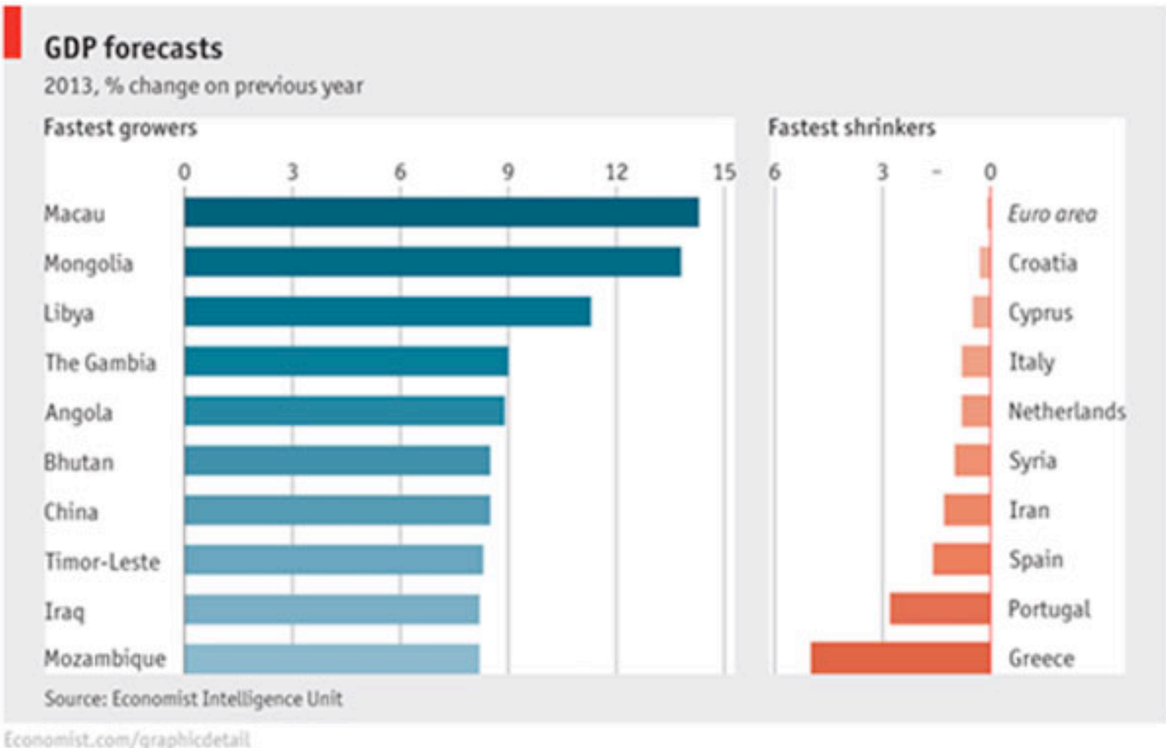
Benefits of Frontier market investing

On aggregate, frontier markets account for 13.4% of the global population, but just 4.9% of global GDP. IMF forecasts indicate that in real terms they will grow by 4.2% p.a. over the next 5 years, i.e., double the rate of developed markets. Frontier markets' populations are still young, while the rate of population growth there is expected to be twice that of emerging markets in the coming decades.

Governance in the frontier markets is improving, with sever- al countries having democratically elected governments. Africa exemplifies some of these changes, as fiscal and monetary policies are becoming more stable and exchange rates increasingly market-determined. Governments are retreating from their involvement in industry, while the debt write-downs completed in the middle of the last decade have provided relief.

The diversification potential of frontier market investments is stronger than with emerging market investments, which now tend to increasingly move in tandem with global equities; the correlation coefficient of frontier markets is much lower than that of emerging markets (0.54 and 0.88, respectively).

Additionally, frontier markets also offer a good pick-up in yield (4% against 2.7% for emerging markets) and trade at a discount on a price-to-book basis. Opportunities exist in both the equity and fixed income space. Investors can access local currency bonds via dedicated frontier market debt funds. Africa has some relatively liquid and growing local currency markets, with Nigeria the largest in terms of size (USD 33 bn) and accessibility.



Frontier Markets belong in any portfolio where growth is an objective, period.

Not all Frontier markets are alike and each needs to be researched thoroughly in its own right, with the risks and rewards quantified. Many Frontier Markets will likely outperform developed markets for the next decade due to favourable demographics, favourable fiscal setups, ability to take advantage of technology and grow faster than their predecessors did during the Industrial Revolution.

In addition, Frontier Markets tend to be relatively uncorrelated to the indebted, developed world which is in a period of nominal growth but real decline, or stagnation. Sometimes being disconnected from “progress” is an advantage.

We are rapidly approaching a day when the inflation exporting nations of the world, namely Japan, through the BOJ, Europe through the ECB and the US through the FED, will see reversals of money flows. This is what typi- cally happens when bond markets revolt. Inflation that has been baked into the cake for decades, but not been felt in those particular countries suddenly becomes far more acute as the Yen, Euros and Dollars that have been exported come home in a flurry of bond selling.

At the same time, we find that the net beneficiaries of these setups are typically the countries with their fiscal house in order. They are also often the strongest growth prospects. Many Frontier markets today boast both at the same time. They are relatively uncorrelated to the aforementioned countries and problems lurking on the horizon.
An investor can gain exposure to Frontier Markets through index funds, ETF’s, actively managed hedge funds and private equity funds; there is a relative dearth of these investment products and managers. However, there is limited institutional participation in these markets, which is both an opportunity as well as a problem for many investors.

Bubble in high yield – we remain constructive

Given the continued relaxation of bank lending standards, expectations of a sustained economic upturn, as well as sound corporate balance sheets, we forecast essentially stable default rates globally 12 months from now. Further, we expect strong demand technicals to remain intact, as real short-term rates are likely to remain negative in most major currencies and investors continue their hunt for yield. Although absolute yields are at record lows, corporate high yield remains our preferred fixed income asset class, as credit spreads still more than compensate for expected default risk on a strategic horizon.