

# SILK AFRICAN & FRONTIER MARKETS FUND

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Quarterly Update - Q3 2019



# Silk African & Frontiers Fund



## Quarterly Update Q3 2019

### INVESTMENT OBJECTIVE

The Silk African and Frontier Markets Fund invests primarily in equities and equity underlying stocks issued by entities in Africa, frontier and emerging markets. The fund focuses on consumer opportunities within the designated countries and concentrates on the more populous countries or markets that attract substantial foreign direct investments. We focus on stocks that are leaders in their respective sectors and that outperform their local peer group.

### GLOBAL ENVIRONMENT

The continued slowdown of global economies in Q3 '19 led the World Bank to revise down its 2019 world growth projection to 2.6% from their earlier estimate of 3.0%. Global risks have significantly increased due to:

- Escalation of the trade dispute between the US and China;
- Heightened geopolitical tensions between US, Iran and Saudi Arabia post terror attacks on Aramco's refinery that impacted the entire oil supply channel;
- Prolonged uncertainty surrounding Brexit.

The major global central banks have opted for monetary easing led by the US Federal Reserve's 50 bp cumulative cut. The European Central Bank (ECB) cut the interest rates into negative territory and will further stimulate the economy with bond purchases of EUR 20 billion per month from November 2019 onwards. China's Manufacturing PMI stood at 49.8 in September 2019, marking the fifth consecutive month of contraction which compelled the country to adopt a more accommodative stance. The central bank reduced the reserve requirements for banks to increase liquidity in the system.

The U.S. dollar, as measured by the DXY index, rebounded 3.38% in Q3 as Brexit related uncertainty and deteriorating European exports weighed on developed markets peers. Against all major emerging markets currencies, the USD was stronger except for the Turkish Lira.

Broad commodities declined 1.8% on falling energy and agriculture prices while precious metals surged by 5.3% QoQ due to the rally in gold. The S&P 500 closed the quarter positively after the rate cuts and monetary stimulus. Other developed markets also posted positive gains during the Q3 with Japan ending the quarter with the highest return of 3.4%. Global equities added 0.5% while global emerging and frontier markets closed down 4.3% and 1.1% respectively. Global bonds continued to perform well and added 1.2% while high yield spreads tightened.

### PERFORMANCE REVIEW AND PORTFOLIO ACTIVITY

The Silk African and Frontier Markets Fund had a negative return over the quarter from June 28<sup>th</sup> 2019 to September 30<sup>th</sup> 2019. The Fund lost 2.02% in USD terms, compared to the -1.10% (net) returned by its benchmark, the MSCI Frontier Markets Net Return USD Index and compared with -9.20% for the FTSE Frontier Markets Index.

The fund's under-performance vs its benchmark in Q3 is attributable to allocation effects, especially the positions in Egypt and Qatar. Underweight positioning in Kuwait, nevertheless, helped the fund in relative terms. Sector wise, materials (Cement) provided the best performance, which was led by a strong selection effect. Although banking sector was the main detractor to fund's performance in absolute terms, the sub 30% exposure to banking equities led to the fund to outperform considering the significant banking weight in the index.

Stock selection in materials was positive during Q3, supported by the fund's holding in Lafarge Africa (Nigeria) which rebounded strongly following management's announcement to exit their South African operations. Out of benchmark allocation to UAE and specifically stock selection in Emaar Properties contributed positively to the fund's performance.

On a monthly basis, the fund's NAV declined by -0.2% in July, -2.5% in August and then increased by +0.9% in the month of September.



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## AFRICA

Sub-Saharan African equity markets posted mixed returns in Q3 '19 with **Nigeria** being one of the weaker performers despite the announcement of a new cabinet from recently elected President Buhari, which had been a source of uncertainty. The NGSE All Shares Index declined 7.3% QoQ (in USD terms). Nevertheless, on a portfolio level, the country was the top positive contributor to the fund's performance attributable to exposure in **Lafarge Africa**, which gained 31.9% QoQ, following the management's decision to sell its South Africa based operations and use the proceeds to reduce debt.

In **Kenya**, despite a narrowing of the twin deficits, stable inflationary pressures, and a sharp upturn in the local PMIs the equity market drifted lower in Q3. **KCB Group**, however, closed up 11.0% QoQ after posting 5.0% growth in both top and bottom lines while NIMs stood at 8.2% during H12019.

In North Africa, **Egypt's** local stock market performed well initially but tumbled towards end of the Q3 amidst political protests demanding that President Abdel Fattah El-Sisi step down. Equity markets partially recovered following a 100 bp cut in the interest rates that was announced by the Central Bank on 26<sup>th</sup> September. The USD also depreciated by 2.4% vs the EGP QoQ, which led to the EGX 30 Index gaining 3.7% QoQ (in USD). **EFG Hermes** returned 15.6% QoQ as cut in the interest rates would invite more interest in the local equities and the company being the top broker would benefit from potential high trading volumes. **Telecom Egypt**, on other hand, was most negatively impacted by the temporary political uncertainty and lost 19.1% QoQ owing to the selling pressure.

## Middle East

In the Middle East, the **UAE** was the best performing market gaining 4.8% QoQ. **Air Arabia** rose 20.1% QoQ after it reported growth of 82% YoY in earnings during Q2 2019 on strong operational performance and improving margins. **Emaar Properties** launched two new projects: a streamlined short-term rental concept targeting people coming for holidays and the development of 'South Beach', a premium residential beachfront development. Investors bought into the new projects and pushed the stock up 4.3%.

**Kuwait**, following two consecutive quarters of strong gains associated with MSCI rebalancing and potential upgrade to the EM Index, fell 2.9% in the quarter on profit taking. The financials absorbed the biggest hits with **Gulf Bank** closing 9.9% down.

## ASIA

Asian equity markets were mixed in the third quarter with many undermined by the economic slowdown and contractionary/status quo policies adopted by their central banks.

**Vietnam's** Central Bank moved differently and reduced rates by 25 bps, the first cut in almost two years. Vietnam's economy expanded by 6.8% in the first half of 2019 (the second highest GDP increase since 2011). Vietnamese companies continued to tap global capital markets with debt offerings. **VINGROUP**, the parent company of two real estate holdings in our portfolio, announced plans to offer USD 750 million in corporate bonds and **MASAN Group** also floated bonds worth USD 65 million in the last quarter. The Ho Chi Minh Index rose 5.6% QoQ and was the best performer in the region in Q3. However, due to comparatively lower turnover on yearly basis and with absence of any privatization deal happening the brokerage houses are not expected to have healthy earnings growth and hence **Saigon Securities** closed the quarter down 6.9%.

**Pakistan** successfully entered an IMF Extended Fund Facility (EFF) to reduce "economic vulnerabilities" that will disburse USD 6 billion over 39 months, subject to regular review. Government implementation of aggressive tax collection as part of the FY20 budget was seen as a negative by the market which corrected sharply, but the subsequent yield curve inversion triggered a late quarter rally. The market ended the quarter with a loss of 5.4% in local currency (3.8% in USD). **Nishat Mills** declined by 8.4% as it was affected by the newly implemented tax regime on exports. **Engro Corp.** gained 5.5% QoQ following an earnings release that highlighted double digit topline and bottom-line growth (despite a hefty surge in the effective tax rate from 32% to 50% in Q2-2019 and a 168% hike in the admin expenses).

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**Bangladesh** equities continued their contraction for another quarter. The DSE all share Index closed 8.7% lower in USD terms as the regulatory issues in banking and telecom sectors suppressed any positive sentiment in equities. **Brac Bank** lost 7.7% QoQ as the banking sector continued to face growth constraints due to the lack of growth in fresh deposits and the limited increase in lending capacity of most banks.

## PORTFOLIO ACTIVITY

We remain overweight in Sub-Saharan Africa, with the largest allocation in our portfolio to Egypt, at 14.1%, followed by Nigeria at 11.7%. Within the GCC we remain underweight in Kuwait versus the benchmark but have the highest exposure in the region at 12.4%. For Egypt the strong rally led to the highest weight in the portfolio, we have exited **Obourland**, reduced **EFG Hermes** and invested in **Telecom Egypt**. Post healthy rally in the UAE names we preferred profit taking and hence reduced our exposure in **Air Arabia**. In Kenya we also reduced banking sector exposure by partial profit taking in **KCB Group** due to low visibility of NIMs accretion in future.

In Asia region, we lowered our country weight in Vietnam by reducing **Masan Group** as we are of the view that for the company the minerals segment possess a short term threat to sustainable earnings as the global prices are stagnant for tungsten, however in the medium to long term we hold positive view on the company's earnings outlook. This also facilitated us in generating liquidity for the fund.

## PORTFOLIO OUTLOOK AND STRATEGY

The fund continues to be positioned to fully benefit from a continued recovery in macro-economic drivers across our regions combined with a supportive global monetary easing cycle. The combination of lower interest rates, rich equity markets valuations and increased political risks in developed markets will further increase the relative attractiveness of Frontier Markets. Silk Invest African and Frontier Markets Fund continues to offer access to attractively priced companies that are among others selected for their solid earnings outlook in their respective markets. **The current Price to Earnings (P/E) of the Fund stands at 8.5x and Price to Book (P/BV) is at 1.1x.**

In Asia we have increased our overweight to **Pakistan**. The combination of implementation of prudent fiscal policy, IMF commitment, attractive valuations and the scope for monetary easing will support

positive equity performance, especially in cyclical sectors like cement. Today, Pakistan is among the cheapest emerging markets with an average PE ratio for our portfolio companies of 6.4x. Investors have begun to take notice. In **Vietnam and Bangladesh**, macro fundamentals remain strong with the respective economies expected to grow by 6.5% and 7.3% during 2019. We are, however, concerned about their exposure to exports coupled with structural weaknesses in some sectors and their rich valuation levels.

In **Sub Sahara Africa**, the Nigerian government is trying to implement new policies to spur growth. Some of these policies are questionable and include pressuring banks to increase their loan to deposit ratios to 65% from 60%. **Kenya** is working with the IMF to renew its USD 1.5 billion standby credit facility to support the Kenyan Shilling. **Egypt** remains our favorite in North Africa due to its attractive valuations and its robust economic growth. We do not believe that the recent increased political tensions will derail the economy and hope it will push the government to reduce corruption. Egypt has reduced interest rates twice this year and we believe that it has still a lot of room for further cuts. Economic growth in the country will continue to be driven by a strong pick-up in capital spending, a continued recovery in the tourism sector and continued increases in natural gas production. We have a broad portfolio in Egypt that enables us to fully benefit from the continued upgrade in fundamentals.

We are conservatively positioned in the **Middle East** with a focus on valuation and dividend yields. The financials in the GCC region will be affected by the Fed's interest rate cuts and investor sentiment will continue to be impacted by political instability. Any reduced tension in the Yemen/Iran axis could however be a big positive for these markets. Valuations continue to be attractive, especially in the UAE where we have our largest overweight positions. We think companies like EMAAR, Aramex and Air Arabia continue to be best in class regional players and are selling at depressed valuation levels.

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# Silk African & Frontiers Fund



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We invest in sustainable businesses, serving a rapidly rising consumer base in frontier markets