Global Trends

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WELCOME TO MAGNI'S GLOBAL TRENDS, a monthly commentary that discusses major trends occurring globally and the impact on Magni's country rankings. Because at Magni, "Countries Matter^{TM}".

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GLOBAL TRENDS: Analysis

The month of August tested investors' resolve in emerging markets as the prospect of Fed tapering and structural deficiencies in some emerging market countries weighed on equities. Magni commented that the reaction in the emerging markets was overblown and we have subsequently experienced a strong correction to the upside in September, specifically in those countries that were hardest hit. Indonesia, Turkey, Philippines, Thailand and India underperformed the index substantially in August. We made the case that the magnitude of the selloff was unwarranted given the strong underlying economic factors in those countries. This issue focuses specifically on those five countries.

Investing in emerging markets is complicated because of the wide divergence in fundamentals amongst countries. Over the last decade or so, all emerging market countries experienced superior growth as investors searched for excess return. On a global scale, we expect that trend to continue, but not all countries are created equal and we expect a divergence in country performance to increase going forward. It is clear that emerging markets are no longer a global play and the key to investment success is the underlying economic structure of a country.

Indonesia was the hardest hit emerging market country in August, triggered by a falling currency and an interest rate hike by the central bank. Despite the recent correction, it is still one of the best performing countries over the last five years and sports an array of strong fundamentals that work in its favor. Along with good GDP growth, Indonesia has a strong financial infrastructure, which limits systemic risk and increases liquidity. The Philippines has also had strong GDP growth and is one of the few emerging market countries with a current account surplus. It also has above average securities market regulation, which provides for greater investor protections and transparency. Turkey has also been very progressive in developing its banking and securities markets. Despite the current political unrest, Turkey has more transparent markets than most of its peers. While Turkey significantly outperformed the index last month, Indonesia and the Philippines trailed slightly behind. That is partly why we consider them to be relative bargains at their current price levels.

India and Thailand, however, have more obstacles and may continue to struggle in the short-term. Thailand is in the midst of a recession and India's self-inflicted wounds have hurt its immediate growth prospects. Both Thailand and India have poor adherence to international accounting standards making the data available to investors unreliable. India has a weak banking sector which impedes its ability to stimulate economic activity at the street level. Thailand's ambiguous political structure fails to hold policy makers accountable and lacks the financial infrastructure necessary to generate growth internally. Magni identified these countries as bargains going into September. With the strong September performance we have less conviction in their relative investment prospects going forward.

Emerging Market Country	Ticker	August Performance	September Performance	Magni Allocation versus MSCI in Emerging Markets
Emerging Markets	EEM	-2.5%	7.2%	
Indonesia	EIDO	-20.6%	2.5%	Overweight
Turkey	TUR	-13.8%	13.9%	Overweight
Philippines	EPHE	-13.4%	5.6%	Overweight
Thailand	THD	-11.9%	11.5%	Overweight
India	INDA	-10.6%	9.4%	Underweight

A DEEPER LOOK: Indonesia, Turkey, the Philippines, Thailand and India

INDOESIA

- Indonesia equity markets suffered during the month mostly due to their current account deficit, which resulted in a falling currency forcing the central bank to increase interest rates by 50 basis points.
- After 14 years of running a current account surplus, Indonesia recorded a deficit for the first time in 2012.
- Consumption has accounted for two-thirds of GDP growth over the last few years. While this has helped insulate them from the financial turmoil that plagued many countries following the

financial crisis, it may hinder future growth going forward as the global recovery in developed markets further materializes.

- The central bank has raised its benchmark interest rate by 150 basis points since June and hiked its benchmark repo rate to combat inflation. Inflation for the month of September eased to 8.4% from 8.8% in the previous month.
- Indonesia's trade account recorded a small surplus in August after a massive deficit of $3.2 billion the previous month.
- Currency depreciation has subsided during the past month and the equity market has recovered from some of the losses sustained in August.

TURKEY

- Stocks in Turkey plunged in the second quarter due to political unrest in Syria and at home, along with a weakening currency.
- However, the market has rebounded strongly through the month of September gaining 13.9%, recovering from the 13.8% loss for August.
- The Turkey ETF (TUR) is trading at a PE of 10, well below historical valuations.
- The underlying strength of the Turkish economy was highlighted in the form of July exports and good Q2 GDP data.
- The political environment stabilized as Turkish leaders unveiled a set of reforms to ease domestic tensions and the situation in Syria has seemed more contained for the time being.

PHILIPPINES

- Many emerging markets countries are battling large current account deficits and depreciating currencies. However, the Philippines isn't one of those countries. The Philippines is the rare emerging market country with a current account surplus.
- The Philippines equity market rebounded in mid-August and continued to perform well through the middle of September, before finally giving back some gains to finish the month up 5.6%.
- The country is in a stronger position than other emerging market countries to withstand the Fed-induced market turbulence due to its higher levels of GDP growth and foreign exchange reserves, low foreign currency debt, to go along with the current account surplus.

THAILAND

- Thailand's equity market has been one of the worst performers since Fed tapering became a legitimate fear in May 2013, losing 27% from May 22nd to August 30th.
- THD has rebounded since then gaining 11.5% for the month of September.
- High leverage and higher levels of non-performing loans is drawing skepticism whether these elevated levels of performance will continue.
- The combination of a weakening economy and the potential for bad loans is problematic because Thailand is heavily allocated to the financial services sector, which accounts for 34.8% of the THD ETF.
- Further, Thailand is still mired in a recession due to weak exports, sluggish domestic demand, falling currency, and decreasing consumer confidence.

INDIA

- India, like other emerging markets countries, benefited from the Fed's surprise move to delay tapering efforts. Both India's equity market and currency benefited from the Fed's action.
- However, the rebound was short-lived as soon after the Reserve Bank of India surprised with an unexpected rate hike of 25 basis points to 7.5%.
- India's financial markets were roiled, triggering big moves in the country's currency, stock, and bond prices.
- Much of India's problems are self-inflicted as they suffer from poor infrastructure, stubborn inflation that keeps interest rates high, a high dependence on foreign fuel, a current account deficit, and low consumer confidence which has deterred business investment.
- Over the last decade, India leveraged its rising middle class to increase consumption and stimulate GDP growth at an average rate of 8%. Last quarter Indian GDP only grew at an annualized rate of 4.4%. With a slowing economy, high inflation, and a banking sector that struggles to provide credit to the masses, it will be difficult for India to return to the former days of eight percent GDP growth.

Emerging markets have been at the whim of the tapering trade. In August, investors grew skittish at the prospects of a Fed reduction in quantitative easing. When the Fed turned more dovish in September and declined to scale back its bond-buying programs, investors poured back into emerging markets. While this back-and-forth is likely to play out for some time, Magni believes the underlying strong fundamentals of certain emerging market countries will prevail over time.

STANDARDS SPOTLIGHT: The Importance of Effective Banking Supervision

The need for strengthening supervision of banks has been stressed as a major priority since it is now widely recognized that weaknesses in banking systems have been at the core of financial crises in many countries over the last decade. As banking crises have affected many countries, the monitoring of banking systems becomes both more critical and more challenging for supervisors. As a result, and in order to minimize the risk of contagion, developed and emerging countries are being strongly urged to adopt and effectively implement sound supervisory methods.

Modern methods of banking supervision includes better management of risks through internal controls, on-and-off site supervision, and early warning systems — tools that allow for the better detection and prevention of bank failures. Risk management and capital adequacy, therefore, have now become crucial to effective banking supervision. In addition, sound corporate governance underpins effective risk management and public confidence in individual banks and the banking system. Robust market discipline is also critical in fostering a safe and sound banking system.

In order to judge the effectiveness of banking supervision, qualitative information on the risk environment, the responsiveness of the supervisor, and the overall effectiveness of risk management in banks is assessed. Supervisors should review the risk profile of banks, in terms of the risks they run, the efficacy of their risk management and the risks they pose to the banking and financial systems. It is critical that supervisors have adequate powers to address weaknesses or deficiencies once they are identified. The promotion of safety and soundness of banks and the banking system should be the primary objective for banking supervision.

RECOMMENDED READING

“When Genius Failed: The Rise and Fall of Long-Term Capital Management” by Roger Lowenstein.

“When Genius Failed” is the story of the success and failure of Long Term Capital Management. LTCM bet on bond spreads that deviated from traditional patterns. It’s unprecedented use of leverage yielded returns on a massive scale. Of course, it was this use of leverage that ultimately spelled the doom of the firm. While it is the classic Wall Street tale of greed and fear, it is also a human story that shows how egos can cloud the fact that we can’t predict the future, even with Nobel winner Myron Scholes. This story compliments Magni’s view investment philosophy in that past trends do not always persist over the time and the largest driver of investment returns is the underlying fundamentals.