

Magni Client Information

Talking Points on International Equity Research and Investing

December 2015

Country Ranking Trends

- As noted in last month's commentary, the United Kingdom was at risk of an additional downgrade. Magni's assessment is complete and the country was downgraded (see below).
- As the year comes to a close, a little less than half of the countries in the developed and emerging markets increased their Magni Country Score. A relatively smaller number of countries decreased in score, though the number of countries where the scores decreased was a little larger than the number in prior years. The remaining roughly 30% of countries ended the year with the same score as the beginning of the year. When the scores across all countries were combined, the annual increase in average Magni Country Score was typical of prior years as a few countries improved so significantly that the impact of the increases more than offset the impact of countries with decreased scores.
- The scores of Japan and Spain increased the most, while the score of United Kingdom decreased the most. Australia, Brazil, Egypt, Peru, Philippines, Switzerland, and the United Arab Emirates joined Japan and Spain in having significant increases in score. All of the remaining increases and decreases were noticeably smaller in absolute amount.

United Kingdom has a "High End" Problem

- Previously the United Kingdom had received relatively high marks for its actions to prevent money laundering. The relatively high marks were concentrated in the government actions to assure money is not laundered through banks and other financial services organizations.
- Magni Research has identified several important gaps in the overall program. These gaps mainly relate to non-financial services organizations and, in particular, to professional services firms. This type of money laundering is considered a "high end" problem where the proceeds can often be held in something other than cash (e.g., real estate, art). The government's problems are caused by a fragmentation of regulatory and compliance responsibilities.
- Based on this research, the United Kingdom was downgraded for its deficiencies in Market Integrity. Market Integrity is the ability of businesses in a country to conduct routine financial transactions in a safe, open, stable, and efficient manner. Countries with strong and effective controls to prevent money laundering tend to have strong Market Integrity.

Emerging Market Concerns - Can They Service the Debt?

- Public sector debt in the emerging markets has been a concern for a while. With rising US interest rates there have been concerns about the ability of governments to repay debt, particularly the debt denominated in US dollars.

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- Private sector debt is now coming into focus as an issue as well. This debt has increased rapidly over the past 10 years and now exceeds government debt levels. Private sector debt could also potentially create downside risks for emerging market economies, financial systems and sovereign creditworthiness. These vulnerabilities are exacerbated by the slowdown in economic activity, currency volatility and the fall in commodity prices. Seven emerging market economies are at the greatest risk: Brazil, India, Indonesia, Mexico, Russia, South Africa and Turkey.

South Africa's Musical Chairs

- Within one week South Africa has gone through three finance ministers which in turn added to a sense that South Africa's macroeconomic policy is growing increasingly erratic. Nhlanhla Nene was widely respected by the markets, but he was dismissed by President Jacob Zuma after he objected to the government's spending plans. His replacement, David van Rooyen, was a relatively obscure figure and market reaction was swift with the rand falling over 9% after his appointment. In recognition of the resulting turmoil, van Rooyen was quickly let go and Pravin Gordhan was announced as the new finance minister. Gordhan had been widely praised when he had previously served in that role. The latest choice has stabilized the markets and led to a partial recovery of the rand.
- These events do not directly impact the Magni Country Score for South Africa, however they could be a foreshadowing of future changes. Some key factors to precipitate a Magni downgrade could include: (1) a deterioration of the monetary policy and/or fiscal policy or (2) changes to regulatory and/or supervisory regimes that would create room for greater cronyism and/or corruption.

Venezuela's Promising Election

- In recent elections, Venezuela's democratic opposition won a supermajority in the legislature. The fact that the opposition won such a sweeping victory, despite an election environment that was far from free and fair, is a testament to the depth of economic problems.
- Venezuela is currently in the frontier markets. While the recent election could be very helpful, a lot of changes are required to consider Venezuela ready for the emerging markets.