

# Magni Client Commentary

## Talking Points on International Governance Research and Investing

June 2016

### Country Ranking Trends

- As a result of a Magni review of adherence of the Economic Standard on Accounting, 5 countries (Colombia, Japan, Spain, Switzerland, and Thailand) were upgraded, while 3 countries (Brazil, Korea, and Philippines) were downgraded.
- The changes to accounting scores do not impact the temporary stall of governance improvements. If anything, the most recent month has provided more evidence that populism is increasing and that populism is mostly detrimental to good governance.

### Brexit is More Significant for the Continent

- The previously discussed populist wave continues with Britain's "Leave" campaign winning a surprise victory and precipitating a British exit from the European Union. Odds makers had forecast that British voters would choose to remain in the EU. The surprising vote unleashed high market volatility across the globe, though there are early signs that some stability has begun to return. The exit vote will start a multi-year process with an unclear end result, so Magni expects some level of market volatility to persist.
- One question to be answered is whether the remaining EU members push for closer integration or if instead more power is devolved back to individual member states. Poland is firmly in the latter camp arguing for a new EU treaty that shifts power away from the unelected European Commission. Poland's current government has itself been in conflict with the EU over the actions of its ruling party. The disparate views of the future EU create friction within among the members and represent yet another challenge for the union.
- While much remains unknown and tough to forecast, there are some matters where there is clarity. Ultimately, Britain and the EU may find a way to move forward under some revised terms, though such a scenario currently looks unlikely. The EU may reform or not. Whether the EU reforms or not, it provides far more benefit to countries with weaker governance, such as Greece or Spain, than countries with strong governance, such as Germany or Denmark. Hence a potential unwinding of the EU is likely to have a far more negative impact on the countries with weaker governance than the ones with stronger governance.

### Can India Continue the Reforms?

- The widely respected Governor of the Reserve Bank of India, Raghuram Rajan, has said he will step down when his term ends in September. During his three-year term, Rajan has been credited with taming India's high inflation, establishing a system for inflation targets, and kick-starting a long overdue clean-up of state banks burdened with high levels of bad loans. In addition, Rajan has further solidified the central bank's independence. While his predecessors had been granted two-year extensions after their initial three-year terms, it is widely believed his lack of an extension related to his hawkishness on inflation and his speaking out on a number of topics. It will be important to ensure Rajan's successor is strong enough to uphold the bank's autonomy and carry forward his reforms.

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- These reforms have the promise to strengthen India's governance score. Magni will be watching to see if the reforms enable India to better adhere to behavior standards on good governance. Relatively small changes in its Magni Country Score could change India's attractiveness relative to the other countries in the emerging markets.

### MSCI index changes

- MSCI decided against adding a second Chinese equity market (i.e., the local-currency shares) to its benchmark emerging markets index. Despite the significant improvements for global investors, MSCI said additional improvements and reforms are required before reassessing their decision. These additional improvements and reforms would strengthen China's adherence to good governance and would result in a higher Magni Country Score.
- MSCI also announced that in 2017 Pakistan will be included in their emerging market index and that they will begin the review process for Argentina's inclusion. Conversely, Peru is at risk of a downgrade to frontier market status in 2017 due to the limited number of constituent equities in its country index. Korea's potential upgrade to the developed market was delayed based on a lack of Korean Won convertibility and other restrictions placed on international investors. Magni will adjust its portfolios as these changes become effective.

### Could Peru be a Bright Spot?

- While Peru may have a small market that barely qualifies for emerging market status, it has been one of Latin America's fastest-growing economies and its Magni Country Score is higher than the much larger economies of either Russia or China.
- Going against global trends, their most recent election has elected the center-right economist Pedro Pablo Kuczynski, who campaigned on a platform of increased transparency in government. He defeated Keiko Fujimori, the populist daughter of the imprisoned former President, by a very narrow margin. While she lost the Presidency, she retains considerable political power through her party's control of Congress.
- Faced with a slowing economy, his plans to stimulate growth through tax cuts and public investment. He argued that by cutting taxes and reducing the regulatory burden he could bring entrepreneurs into the formal economy and boost government revenues. He has called for a consensus approach to governing the country where the opportunities of a more open and transparent economy can spread prosperity to even the poorest parts of the country. If his new government is successful it could provide an important counterpoint to the currently prevalent populist sentiments.