FRONTIER MARKET
ASSET MANAGMENT

The Winter of Trade Discontent

The Potential for Trade and Currency Upheaval From Shifting Geopolitical Sands

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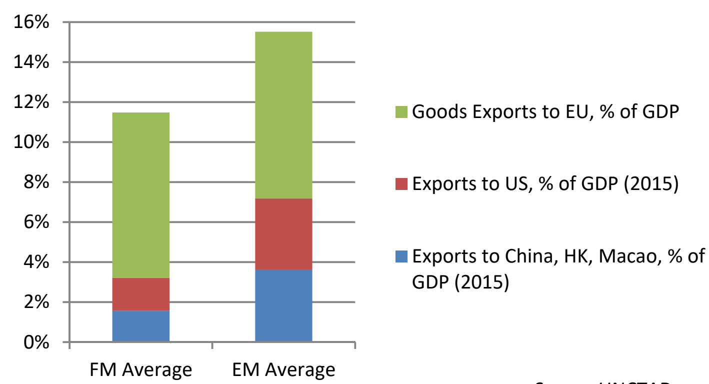
Now is the winter of trade discontent with high talk of tariffs, border taxes, failed treaties, broken partnerships and reprisals.

As London begins the process of Brexiting, the end of European Union trade privileges for the United Kingdom looms as a real possibility. In the US, newly inaugurated President Donald Trump wasted no time in walking the world's largest economy back from the Trans Pacific Partnership, which would have liberalized trading between Australia, Brunei, Canada, Chile, Japan, Malaysia, Mexico, New Zealand, Peru, Singapore, Vietnam and the United States. The US exit from TPP effectively scuttled the pact for all. In addition, President Trump has been making sounds that he's spoiling for trade fights with China, the world's second largest economy, and with Mexico, America's erstwhile manufacturing partner to the south. On the campaign trail last fall, Trump threatened tariffs of 45% on Chinese products. By comparison, under the ruinous, Depression-era Smoot-Hawley Tariff Bill the country's free and dutiable tariff rate peaked at a mere 19.8%.

Winners and Losers

Who would win and who would lose in an overhaul of the terms and conditions of international trade? That remains to be seen, or unseen if cooler heads prevail. For frontier market countries the potential for loss appears to lie more in the loss of future export potential than in reductions in current export volumes. A far greater potential for Trump-era disruption on the frontier lurks in the possibility of continued strengthening of the US dollar.

Current Export Effects on National Income



Source:UNCTAD

As the exhibit at right shows, export volume is typically not as important to the national income of frontier economies (defined here as the Russell Frontier Markets ex-GCC Index) as it is to that of emerging and developed economies. On average, countries in the frontier markets group rely on exports to the US, China and Europe for less than 12% of GDP. The likelihood for damage to frontier markets' exports from Brexit or trade wars between the US and China or the US and Mexico would be limited. Exports to the US and China, on average, account for less than 4% of frontier market countries' GDP. Trade with Europe is more significant, although these figures may be a bit skewed as frontier market countries within the European Union — Slovenia, Estonia, Lithuania, Romania and Croatia — all trade freely within that trading bloc's

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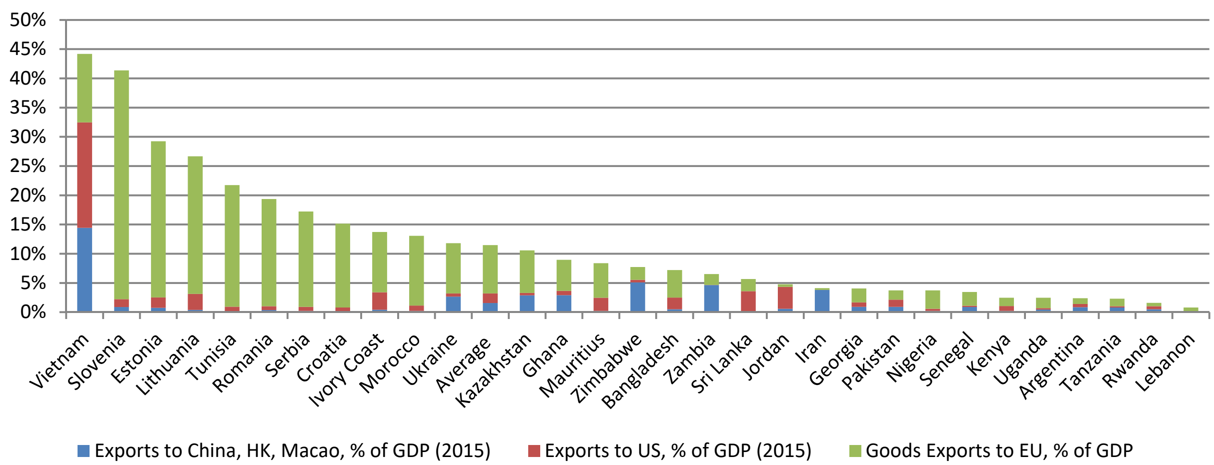
single home market (presumably more to central European countries than to the UK). As a result, these countries account for a disproportionate share of the European "export" trade by frontier markets.

Vietnam: Export Leader of the Frontier

Among frontier economies, Vietnam stands as a notable exception in terms of its dependence on exports to fuel national income. As shown in the chart below, the monetary value of the country's export sector is high and relatively evenly divided between destinations in China, the US and Europe. In combination, exports to these three trading partners account for more than 44% of Vietnam's annual GDP. While US withdrawal from the Trans Pacific Partnership has effectively stymied plans to further liberalize trade between the US and Vietnam, that development is unlikely to reduce existing levels of

Export Levels of Frontier Market Economies



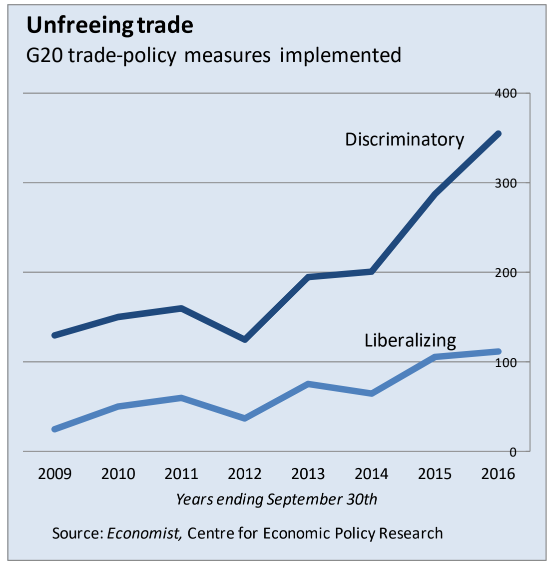
Source:UNCTAD

Vietnamese exports to the US. In addition, Vietnam has been adept in courting global trade partners, rather than relying on just one. The country has aggressively pursued free trade agreements, with nine in place and seven more under negotiation. Likewise, the potential for a US-China trade war appears unlikely to depress Vietnamese exports to China. Unlike the Asian countries of Malaysia, Korea, Taiwan and Thailand, which play a vital role in China's manufacturing supply chain, Vietnam's biggest exports to China are more domestically oriented, consisting of refined petroleum, rice, rubber, wood, footwear and clothing.

Limited Frontier Effects from Western Hemisphere Trade Tumult

The potential effects of a US trade war with Mexico would likely have limited impact on frontier economies. Within the Americas the frontier markets of Argentina, Trinidad and Tobago and Jamaica have scant export exposure to Mexico. Only 1.5% of Argentina's entire export value is shipped to Mexico with trucks, leather and patent leather serving as the leading outputs. Trinidad and Tobago's exports to Mexico account for 2.2% of that country's total export value with shipments primarily comprising petroleum and ammonia. Jamaica's exports to Mexico account for less than 1% of that country's export value with recycled paper and hard liquor leading the trading log.

The trend toward restrictive trade policies is well established with G20 countries having advanced more protectionist trade policies than liberalizing ones over the past decade (see chart, right). A more important issue to frontier markets in the current geopolitical dustup may be foreign exchange rates and, most importantly, the strength of the US dollar. The dollar's rise — up roughly 40% since 2011 — has had the effect of a liberalizing trade policy. It reduces the costs of foreign made products for US customers, giving it the effect of a reverse tariff. A strong dollar holds great potential to improve pricing power and profit margins for companies exporting to the US from countries like China, India or Vietnam. As one publication noted "a strong currency squeezes exports and sucks in imports."



Negative Effects of Strong Dollar

For certain frontier market countries, there is downside to continued sharp advances in the US dollar. The costs of debt service and commodity imports rise with dollar strengthening. As illustrated in the chart on the next page, dollar-denominated sovereign debt is often common in frontier economies. It typically finances commodity and capital equipment imports to meet the demands of a rising middle class and to develop infrastructure and support industrialization. UNCTAD[1] research shows that national debt levels throughout the emerging world and frontier have been trending upward since the 1980s and much of that debt is dollar denominated. However, external debt – in and of itself – may not indicate a higher level on currency risk. Other factors should be considered when evaluating the impact of a steep move in the US dollar, such as the level of foreign currency reserves relative to external debt and overall public sector debt to GDP. In some cases a high level of US denominated debt might be absorbable when considering the level of FX reserves, in Lebanon for example, or overall debt to GDP, as is the case in Kazakhstan.

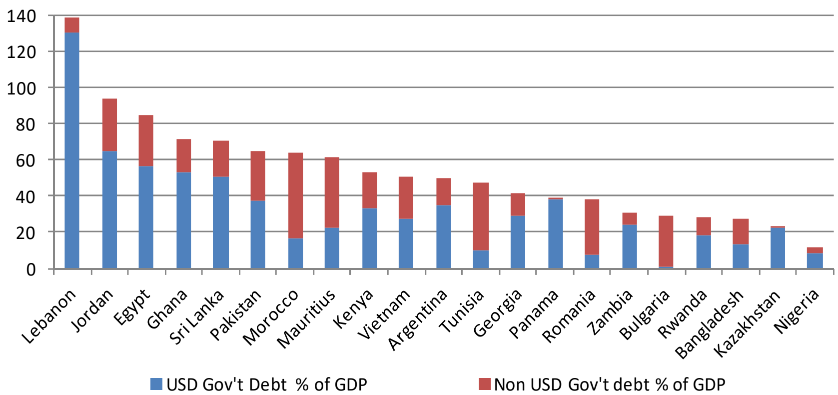
We can take this one step further by evaluating the fiscal and current account balances. High “twin deficits” combined with external debt would clearly add further pressure to some currencies if the USD strengthens further than the post-election move. However, many countries are actively adjusting to FX pressure through reduced spending and/or broadening revenue collection, by force in some cases due to IMF support. Ukraine and Egypt are both involved in IMF support programs, as is Sri Lanka. Others should stabilize with improving commodity prices – Zambia with copper, Nigeria with oil. That said, the recent oil price rally might not be enough to forestall another “managed” devaluation in Nigeria. It appears as though monetary authorities are waiting for replenishment in reserves before allowing the currency to move closer to a value that might actually attract foreign investment.

The ultimate direction of the dollar remains unclear. President Trump's utterances have triggered confusion about what the policy direction will be for the US regarding its currency. The president told the Wall Street Journal: "Our companies can't compete with (Chinese companies) now because our currency is too strong. And it's killing us."

[1] United Nations Conference on Trade and Development, http://unctad.org/en/Pages/Home.aspx

During the election campaign he criticized Fed Chairman Janet Yellen for keeping interest rates low for "political" reasons. Higher interest rates for US Treasury securities correlate to dollar strength. Subsequent to his inauguration Trump is reported to have called the country's national security adviser late one night to ask which is preferable: a strong dollar or a weak one. With Fed vacancies looming, the president will be faced with a decision that will have a profound impact on the dollar. Will he appoint governors in the style of Yellen or more hawkish Fed governors who would be expected to favor higher interest rates, triggering an even stronger dollar?

Government Debt to GDP of Select Frontier Economies



Source:UNCTAD

Year	Country	Gov't debt % of GDP	USD Gov't Debt % of Total	Total reserves % of External Debt	Current Account % of GDP	Fiscal Budget Deficit/Surplus % of GDP
2015	Lebanon	139.0	94.3	157.1	-17.3	-12.3
2015	Jordan	93.4	69.4	64.4	-8.9	-6.5
2015	Egypt	85.0	65.6	34.0	-5.1	-11.3
2014	Ghana	71.8	73.9	30.2	-7.5	-5.8
2014	Sri Lanka	70.7	72.4	16.6	-2.4	-5.5
2015	Pakistan	65.0	58.5	30.6	-0.6	-4.7
2014	Morocco	64.0	26.3	53.5	-2.1	-4.5
2015	Mauritius	61.6	36.8	29.1	-4.8	-1.8
2015	Kenya	52.8	63.1	39.4	-11.4	-7.2
2015	Vietnam	50.5	54.6	36.3	0.5	-4.6
2015	Argentina	48.4	70.4	16.0	-2.7	-6.1
2014	Tunisia	47.5	20.7	28.4	-8.9	-4.3
2015	Georgia	41.4	70.5	17.0	-12.0	-0.6
2015	Panama	39.0	96.7	3.9	-6.5	-0.6
2015	Romania	38.0	19.9	40.3	-1.2	-0.7
2014	Zambia	31.0	77.1	33.8	-3.6	-8.1
2015	Bulgaria	29.4	2.9	59.1	0.4	-2.3
2014	Rwanda	28.0	66.5	45.9	-13.6	-5.0
2015	Bangladesh	27.5	49.1	71.2	1.4	-5.1
2015	Kazakhstan	23.3	97.3	18.1	-3.0	-7.5
2015	Nigeria	11.5	70.8	107.9	-3.3	-2.4

Source: World Bank, CIA World Factbook

Conclusion

While frontier market economies should be largely spared disruption from the trade sparring of the world's leading economies, they are not immune to shocks from currency dynamics. The combination of fiscal policy by the Trump administration and monetary policy by the US Federal Reserve holds great potential to affect the market environment along much of the frontier. Uncertainty tends to be a hallmark in frontier market investing. As always, we are working to stock pick around today's unknowns, recognizing that this could be an interesting entry point in several markets where currency has been an overhang. The characteristics that support secular long-term growth in frontier markets remain unchanged: young, growing populations, a low base in per capita GDP, ongoing – albeit – sometimes slow economic reform, undiscovered, inefficient capital markets. For investors considering the frontier, today's unknowns could also be an interesting entry point.

About Frontier Market Asset Management

Founded in 2006, Frontier Market Asset Management holds more than 35 years' worth of investment experience including work in Emerging and Frontier Markets since 1987. For more information, please contact us at (858) 456-1440.

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