



FRONTIER MARKET
ASSET MANAGEMENT

“The Water is Wide” ***Wading Around in Egypt & Romania***

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An ancient felucca with tattered sails glides slowly across the dark sluggish waters of the Nile in light zephyrs from the North. If only this vessel could speak, it would tell of turbulent times. And it would also tell of its ancestors who plied these waters at the same measured pace more than 2,000 years ago, carrying cargos of incense, spice and elephants. The sisters of these feluccas are the Arab

dhow that travelled as far as China. These vessels with lateen sails pioneered close winded sailing years before Europeans converted from square riggers. They could sail upwind, so they shifted trade from the old route through Petra to a new route up the Red Sea and the Gulf of Suez.



Felucca Boatman, Nile River, Cairo

Photo Larry Speidell

The Nile is not wide in the heart of Cairo, but the 30 minute evening crossing provides ample time to reflect... on the trendy blue light from a power yacht behind the boatman in the picture above, on the blaring music from gaudy tourist barges that ply the river and on the contrast between lavish hotels that line the Nile and the real Cairo of 22 million people who battle traffic and pollution every day.

This trip was itself a study in contrasts, beginning at a conference with government officials and companies in the Four Seasons Nile Plaza Hotel and then a dusty day visiting factories and development properties around Cairo and next off to Romania for a day of six meetings in Bucharest.

Frontier Contrast

The table below compares conditions in Egypt and Romania along with those of Argentina and Vietnam, two countries that our team has visited recently.

Egypt stands out for both its low literacy for women, 65%, and its young population, with 33% of residents under age 15. It is said that the birthrate in Egypt rose significantly during the violence of 2011-2013, when it became dangerous for women to work outside the home.

Romania is remarkable for a low rate of inflation, 1.0%, high per capita income, \$23,200 per annum, and relatively small percentage of children under age 15, at 14%.

	Egypt	Romania	Argentina	Vietnam
GDP Growth (2015 est)	3.8%	4.0%	0.0%	6.0%
Inflation	30% +	1.0%	20.0%	2.0%
Population (mil)	94.7	21.6	43.0	94.3
People / km sq	95	91	15	285
% Literate	74%	99%	98%	95%
% Literate Female	65%	97%	98%	93%
% under age 15	33%	14%	25%	24%
Life expectancy	72.7	74.5	77.5	72.7
% Urban	43%	56%	92%	34%
GDP / cap (PPP)	\$12,100	\$23,300	\$18,600	\$5,600
Electricity/cap kWh	1,511	2,222	2,584	1,125
% Unemployed	13%	7%	8%	2%
Land (km sq)	1,001,450	238,391	2,780,400	331,210
Market Cap (\$ bil)	\$55.2	\$36.5	\$34.2	\$38.2
Market Cap/GDP	16%	42%	5%	28%
GDP (Official Exch Rate)	\$342.8	\$86.5	\$709.7	\$186.0
GDP % Agriculture	11%	3%	9%	18%
GDP % Industry	36%	35%	30%	38%
GDP % Services	53%	61%	61%	44%
Military exp % GDP	1.8%	1.4%	0.9%	2.4%



Egypt

Egypt is only 43% urban, but 95% of the population lives within 20 km of the Nile and some 22 million people, a quarter of the country's population, live in Cairo. In the time of the Pharaohs, two million people lived on 3% of Egypt's land. Today 95 million live on 7%.

Since the airliner crashes, airport security has been tightened significantly, but perhaps irregularly. The screening team confiscated four AA batteries from my camera, saying "no camera batteries!" But then I managed to get through customs and screening to the departure gate with a boarding pass that was for a woman named Fiona...

On the ground there are reports that innocent bystanders to any protest may be arrested or even killed by random shots. These deaths will invariably be blamed on the Muslim Brotherhood, but the police are also distrusted. They have been called a million man mafia that even President al-Sisi is reluctant to touch.



While political Islam has been discredited by Morsi's authoritarian attempt to hijack the government into an Islamic state, there remain hundreds of thousands of angry Brotherhood supporters, while ISIS is also present to make mischief.

Egypt's economic troubles have been brewing for decades, but with the ouster of Mubarak, the currency reserves became depleted and:

- 1) The government stopped paying for the oil and natural gas it received from its international oil company concession partners under production sharing agreements (PSAs). Between 2011 and 2014, Egypt built up arrears totaling \$12 billion.
- 2) To pay the arrears, Egypt began borrowing from Gulf Cooperation Council countries (GCC) and by 2016 the PSA arrears had been paid down to \$3 billion, but GCC borrowings now total \$25 billion. In a secretly recorded tape released on Turkish television in 2014, al-Sisi was heard saying "we need ten [billion] to be put in the account of the Army. Those ten, when God makes us successful, will work for the state.... They [the GCC] have money like rice, man."¹
- 3) Commercial banks were encouraged to buy government debt, increasing banking sector government debt holdings from 25% to 50%. In our meeting, Commercial Industrial Bank said that government securities are 60% of interest earning assets while the loans are only 40%. Now with T-bill rates at 18.5%, CIB should do alright.
- 4) In October 2016, the GCC countries ceased funding Egypt. The country's last resort was the IMF, which granted a \$12 billion financial support package but with strict terms for reform.

Under pressure from the IMF, Egypt floated the pound on November 3, 2016. It immediately dropped 50%, from 8.5 EGP/\$ to 18 EGP/\$, blowing through their initial target of 13 EGP/\$. There is pain in the streets because wage growth has been held to only 15-20%. A positive is that in January, Egypt issued \$4 billion in Eurobonds over 5-year, 10-year and 30-year terms at 6.125%, 7.5% and 8.5%. The issue was oversubscribed, so more could be in the pipeline.

¹ The Shadow General, The New Yorker, January 3, 2017

The terms imposed by the IMF include the following:

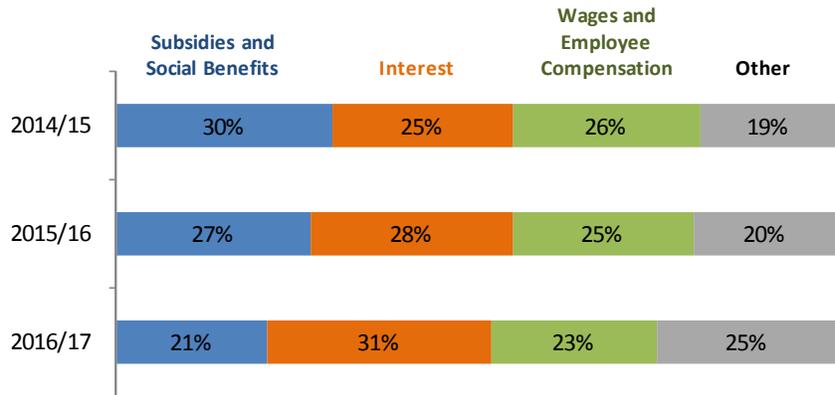
- 1) Sustain the currency float. There is not full liquidity in the EGB at this point, and CIB says that multinational company FX demands are not being met.
- 2) A cap on liquidity expansion. This will most likely begin with a 200 BP rate increase by the Central Bank.
- 3) Eliminate subsidies on fuel by 2019 and electricity by 2021. Gasoline, for example, was hiked from 2.6 EGP / liter to 3.5 in November, yet, with subsidies, it is presently at only 56% of the world price. Another hike in July is likely in order to meet the IMF's subsidy cap in FY 2018, but by July 2019 (FY 2019), gasoline must reach 6.25 EGP / liter assuming no further increase in world energy prices or weakness in the EGP/\$ rate.

Following devaluation, inflation is now "officially" 20% but it actually could be closer to the 50% inflation figure cited by a respected source at Commercial Industrial Bank. This is reminiscent of Argentina in 2014, when inflation was 40% but everyone was forbidden from saying that. Vietnam went through its own inflation bubble (nearly 30%) in 2008, but has emerged into a high growth recovery. Now perhaps Egypt can do the same.

At right below is an exhibit from the Egyptian Finance Ministry in a Stratfor report² issued just prior to the currency float. Given the source, the projections of subsidy reduction may be optimistic. Nonetheless, they show the size of the subsidies at 30% of government expenditures in 2014/15.

Government Expenditures

The Egyptian government is trying to cut subsidies to free up funds for investment and for payments on domestic and foreign debt. But reducing subsidies without causing social unrest is difficult to do.



Source: Stratfor

Also included in the subsidies are nearly \$1 billion of wheat subsidies under a program where Egypt, the world's largest wheat market, subsidizes its farmers to grow wheat and also buys it on the international market. Then the government subsidizes the price of bread - to avoid recurrence of the disastrous 1977 bread riots when subsidies were ended under an agreement with the IMF.

Unfortunately, Egypt's subsidy programs are corrupt. The Economist reported: "Farmers mix foreign wheat with their own and sell it at jacked up prices"³ and "Investigating MPs say that some 40% of this year's supposedly bumper harvest may be missing, or may never have existed in the first place."⁴

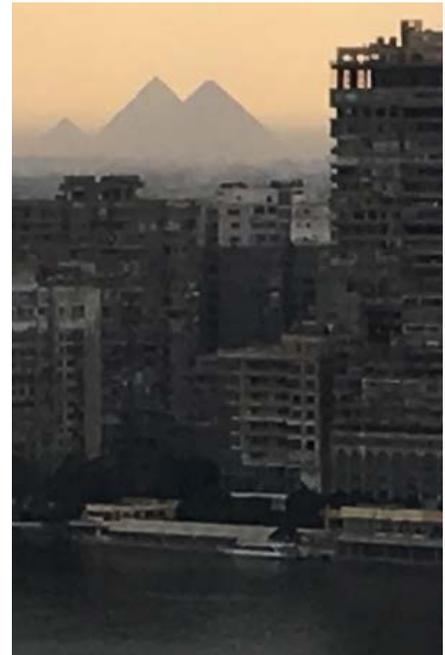
² Egypt Hopes the Benefits of Economic Reform will Outweigh the Risks, Stratfor, October 28, 2016

³ State of Denial, The Economist, August 6, 2016

⁴ Of bread, bribes and fungus, The Economist, September 3, 2016

Egypt Timeline

7000 BC	Settlement in Nile Valley
3000 BC	Kingdom of Egypt under the pharaohs
2500 BC	Pyramids constructed
1323 BC	Tutankhamen's tomb
669 BC	Assyrian conquest
525 BC	Persian conquest
332 BC	Alexander the Great founds Alexandria
31 BC	Octavian defeats Mark Anthony & Cleopatra
642 AD	Arab conquest
969	Cairo becomes capital
1517	Becomes part of Turkish Ottoman Empire
1798	Napoleon Bonaparte invades
1805	Ottoman rule
1869	Suez Canal opens
1882	British takeover
1922	Independence under King Fuad
1928	Muslim Brotherhood founded
1952	King Farouk overthrown
1954	Nasser becomes president
1956	Suez Canal seized
1956	British/French invasion fails (US opposed)
1967	Israel defeats Egypt, seizes Sinai
1970	Nasser dies, succeeded by Anwar Sadat
1971	Aswan Dam completed with Russian funding
1973	Egypt & Syria attack Israel and are defeated
1975	Suez Canal reopened after 8 year closure
1979	Camp David Peace Accord, return of Sinai, US financial aid to Egypt
1981	Sadat assassinated by Islamist extremist, Mubarak becomes president
1997	Islamic terrorists kill 62 tourists at Luxor
2005	Islamic terrorist attacks at Sharm El Sheikh on Red Sea
2011.	January 25, Police Day protests in Tahrir Square, Mubarak deposed in February as protests continue and demonstrators are killed by police thugs and snipers
2012	June, Muslim Brotherhood candidate Morsi narrowly wins presidency
2012	December, draft constitution boosts role of Islam
2013	January, 50 killed in protests
2013	June, Morsi appoints Islamists to governorships including one linked to 1997 Luxor massacre
2013	July, Morsi overthrown by the Army
2013	August, security forces kill a thousand pro-Morsi protesters
2014	May, former Army chief al-Sisi elected president
2015	May, Islamic terrorists assassinate the Prosecutor-General and three others with car bomb
2015	October, Islamist terrorists bomb Russian airliner in Sinai killing crew and 224 passengers
2016	March, Egyptian Pound devalued 20% to 8.5 EGP/\$
2016	May, EgyptAir flight from Paris crashes in Mediterranean
2016	November, IMF \$12 billion loan contingent on reforms and free floating currency, EGP rate drops 50% to 19 EGP/\$



Pyramids loom beyond the west bank of the Nile)

Photo Larry Speidell

The timeline reveals that Egypt has been making turbulent history for 9,000 years, so perhaps hopes for a new period of peace, reform and economic growth are naïve. We hope that economic reforms will be swift and significant and that the government's efforts to suppress terrorism will be successful.

Another tricky area for reform is the civil service. Beltone Financial has estimated⁵ that there are 25 million employees in Egypt of which 5.5 million work as civilians for the central government. In addition there are 1 million in the army, plus 500,000 police. And there may be another 1-2 million employees of local governments. Altogether, a third of workers are employed by the state, and unfortunately a lot of them are bureaucrats - who probably subtract value.

A related issue is the role of the army. Al-Sisi seems to view the future of Egypt through the lens of the army and its projects rather than through the private sector. Overall, the army may control more than 20% of GDP. Since the army pays no taxes and has free labor, it can easily take on construction jobs. Recently, for example, the army rebuilt the bombed Coptic Church in Cairo in record time (that was after the first bombing in December, not the latest one in April). In other activities, the army has bypassed local pharmaceutical suppliers and gone directly to Europe to buy medical supplies for its hospitals. Last year, when there was a shortage of baby formula, the army stepped in and supplied it at a low price. Evidently, significant fortunes are made as a result of the army's commercial activities.



Police “at the ready”

Photo by Larry Speidell

When we travelled to visit factories outside Cairo, our minibus suddenly swerved to the side of the road. We were greeted by a black SUV and two police pickup trucks. Police officers in black with mirrored sunglasses were backed up by young soldiers in the back of the pickup trucks holding AK47s with long clips. They escorted us for the rest of the day... It was hard to tell if we should feel comforted or concerned. If we needed this protection for company visits it was alarming, if not, it was wasteful.

While al-Sisi and his ministers have a delicate balancing act in the coming months, bold steps will be rewarded by sizeable IMF loan tranches, leading to more access to international borrowing and rising foreign direct investment.

Thanks to the devaluation, labor costs are low, ranging from \$100 to \$300 / month even after the 15-20% wage hikes. Although the manufacturing sector is woefully small at 16% of GDP⁶ (versus 40% in China), exporters of manufactured products such as carpets and cables should prosper. An offset is that the cost of imported items is now doubled (at least the government has agreed to remove its 60% emergency tariff on “provocative” goods, such as toothpaste).

Meanwhile, there is a boom in real estate development on the outskirts of Cairo. This is certainly warranted given overcrowding in the city. Some city dwellers are even living in the Necropolis, where tombs of the dead have been equipped with running water and electricity⁷.

In the absence of bank finance, developers provide six to seven year financing at 20-25%, and they use the first four years of payments to fund the construction of the shells of units which are then delivered to buyers who must pay their own contractors to finish them. The development is paced, with large projects offered in phases of several hundred units.

⁵ The Great Reflation, Beltone Financial, January 2017

⁶ <http://data.worldbank.org/indicator/NV.IND.MANF.ZS>

⁷ [https://en.wikipedia.org/wiki/City_of_the_Dead_\(Cairo\)](https://en.wikipedia.org/wiki/City_of_the_Dead_(Cairo))

We looked at three bedroom units in TAJ City, which are priced at \$75,000 for 1,500 square feet (plus \$40,000 for finishing). They are nice but remote. Some of these developments are more than an hour from Cairo through notoriously heavy traffic, but they will be closer to New Capital City, which is a mega project to move government offices half way between Cairo and the Suez Canal. So far, most buyers of the TAJ City “B-class” units plan to use them, and an unusual feature of the demand base is that the fathers of grooms are expected to buy homes for the newly-weds. This translates into some fathers even buying units when their sons are just born. There is evidence that at the high end, in “A-class” developments, as much as a quarter are going to Egyptians abroad for “investment”, so the risk of a bubble there will need to be monitored.



Another positive possibility for Egypt would be the return of **Evening Prayer**, MNHD TAJ City development
Photo by Larry Speidell
tourists. The country hosted nearly 15 million tourists in 2011, but now it is lucky to see a third of that. Lately, the Russians have been doing weekly security inspections at Egyptian airports and are reportedly becoming more satisfied with the security. Perhaps the flow of Russian tourists could resume.

It is difficult to guess at the timing of Egypt’s progress, but failure is not an option. The country’s role in regional security is critical. Aid to Egypt is likely to continue, because it has ensured that Egypt maintains peace with Israel and fights ISIS. It is perhaps a positive sign that President Trump has met with al-Sisi and pronounced him “a fantastic guy”.

Overall, we were impressed with the quality of company managements and their ability to adapt to challenge and opportunity. Hopefully, the environment in which they operate will be improving.



Romania

After my unease over security in Egypt, I was surprised to arrive at night in Bucharest and find police blocking the road from the airport to Piazza Victoria. It was the second night of protests, and a local resident sharing my cab said it was “only 90,000 tonight compared with 150,000 people yesterday”. Considering that it was minus 5 degrees Celsius, I was impressed.

In December, the center-left populist Social Democratic Party (PSD), won a parliamentary election in which turnout was dismal, at 40%. Their leader, Liviu Dragnea, is barred from office because he was convicted of election fraud and accused of bribery in another trial.

Dragnea then proposed amnesty for himself and pardons of other convicted PSD members, along with the decriminalization of bribery when the amount is less than 50,000 euros(!) Hence protestors took to the streets. After my day of meetings, I saw eight large blue riot police vans waiting for the third night of protests.



Corruption has been a big problem in Eastern Europe and remains especially acute in Bulgaria. In Romania, on the other hand, the National Anticorruption Directorate under brave Laura Codruta Kovesi prosecutes 1,000 cases per year and achieves convictions in 90%. The PSA and the Liberal Democratic Alliance have attacked the anti-corruption agency and demanded Ms. Kovesi's resignation.

The populist election victory in Romania echoes political developments in other parts of the world. The PSA won on a platform of increasing pension benefits and the minimum wage, both of greatest concern to older less educated voters. Meanwhile, the OECD has found a persistent bias toward low voter turnout among young people⁸. One Romanian said that the young people now protesting in the cold probably wish they had voted and changed the election outcome – but it's too late.

Another factor in the election may even be the increased popularity of convicted politicians. A study in India found that candidates convicted or facing charges had an 18% chance of winning versus only 6% for “clean” rivals,⁹ As the Economist observed, “Who better to represent a needy constituency than someone who ‘knows how to get things done’? If the system doesn't work for you, a thuggish MP can be a powerful ally.”



Arcul de Triumf, 1936, Bucharest

Photo by Larry Speidell



Le Bistro Français – (tres bien)

Photo by Larry Speidell

Fortunately, things are much brighter on the economic front in Romania, with GDP growth at 3.5-4% and inflation at 1%. The banks are still coping with the aftermath of a foreign currency mortgage binge, but a new “walk-away” law has been interpreted quite strictly by the courts, so provisioning is ample (and there could even be some write-backs).

Another problem for the banks is overly zealous regulators. The head of BRD fulminated over next year's IFRS 9 standard: “an amazing thing created by this technocratic elite which never did commerce, but thinks they know how to regulate finance.” (This sounds a bit like recent groaning by US banks)

In the energy sector, Romania has lots of interesting things going on with new oil and gas discoveries onshore and in the Black Sea plus pipeline expansion to enable exports to Europe through Hungary by 2020.

Overall, Romania stands out as a bright spot in the cold and wintry landscape of Europe. Bucharest even boasts beautifully restored old buildings and some fine restaurants.

⁸ Not Turning Out, The Economist, February 4, 2017

⁹ When Crime Pays: Money and Muscle in Indian Politics, Milan Vaishnav, The Economist, February 4, 2017

Conclusion

Wading through puddles from melting snow in Bucharest was nothing compared to crossing the Nile, but both Egypt and Romania are trying to stay afloat as they balance rising populism with hard economic reality. Both countries present investment opportunity, although it is much more straightforward in Romania. In Egypt, we will need to see which way the wind is blowing in the coming months to ensure a profitable journey.

*“ignoranti quem portum petat nullus suus ventus est”
If you know not what harbor you seek, no wind is favorable”
–Letter LXXI, On the Supreme Good, Seneca, 4 BC – 65 AD¹⁰*



The “Prince Mostafa” Felucca on the Nile

Photo by Larry Speidell

*ⁱ The water is wide, I cannot get over
Neither have I wings to fly
Give me a boat that can carry two
And both shall row, my love and I
– Cecil Sharp 1906*

¹⁰ https://en.wikiquote.org/wiki/Seneca_the_Younger

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