

Macro Forum insights and perspectives

February 2017

Welcome

In this latest issue of the Actis Macro Forum Insights and Perspectives, we reflect on some of the immediate challenges facing Mexico, arguably the growth market most affected by the recent US election and the number of Executive Orders emerging from the Trump White House. We also reflect on the relationship between African electoral cycles and economic growth, particularly relevant as we go into a year with elections across many of Africa's most populous economies. Finally, we look at the impact of India's recent demonetisation, a dramatic policy initiative implemented on the same day as the US election took place and which succeeded, somewhat incredibly, in relegating President Trump to page two in the local media.



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The Peso and the Perception

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The poor old Mexican Peso has taken a battering, not only in recent months, but over the last few years, losing 58% of its value and declining from 13 to 21 to the US\$ between January 2014 and January 2017. The downward direction of travel has been common to many growth market currencies, but the reasons may be different, as whilst the Peso has not matched the Turkish Lira (64%) or the Russian Ruble (86%) to say nothing of the Egyptian Pound (161%), its fall has out-paced that of the South African Rand (31%) and the Brazilian Real (38%), both markets where the fundamentals have undoubtedly been materially more challenging over the same period.

So why this race to the bottom and why is there a clear difference between the factors affecting the Peso and those impacting our other currencies? In most emerging market currencies, the strength of the US\$ has been exacerbated by the declining price of commodities and endogenous political developments. Mexico is distinctive in that the commodity

impact is muted and the political issues it faces have been imported rather than home grown. Unusually, the fault here 'does' lie in the Stars (and Stripes) rather than within Mexico.

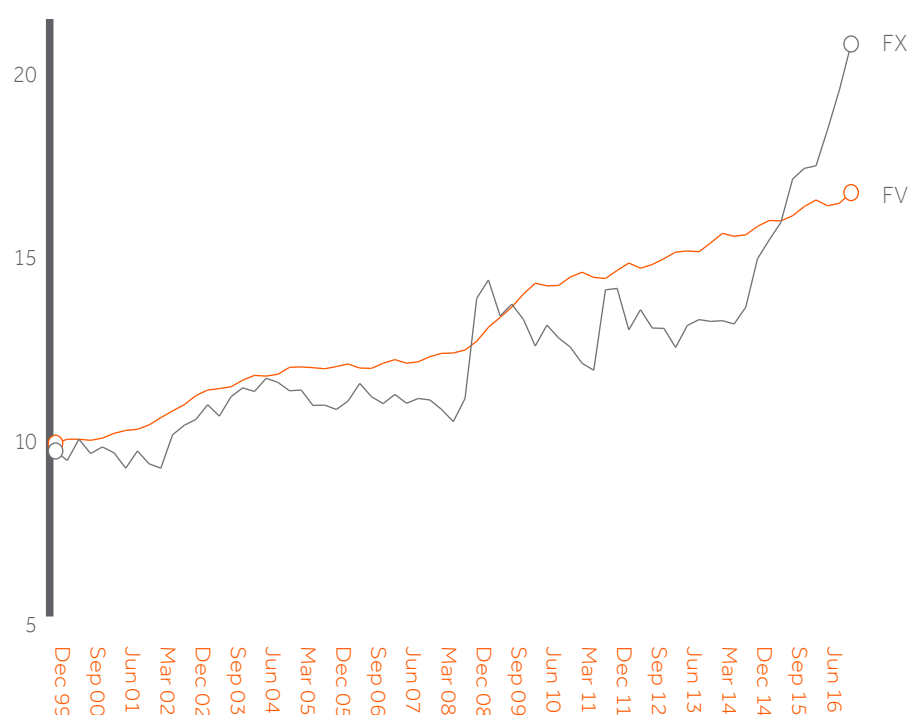
Not since the Tequila crisis in 1994 has the Peso experienced such a marked sell off. Relative currency stability has characterized the two decades since. However, history is not exactly repeating itself – in 1994, the Central Bank devalued the Peso, whereas today the market sets the FX rate. As managers of patient long-term capital, the question we have to ask is whether there is a basis for this devaluation? Is the market revising its view on fundamental value or reacting to policy statements released via Twitter?

In the April 2016 edition of Actis Insights and Perspectives, we introduced readers to the way we look at currencies, focusing on Fundamental Value (FV) rather than the near-term oscillations of the Foreign Exchange (FX) rate. Our analysis is based on a belief, supported by compelling academic evidence, that in the long run currencies move in line with differential inflation rates adjusted for productivity differences between countries. While a multitude of other variables influence foreign exchange rates in the short run,

in the long run our thesis is that they tend to gravitate to these fundamentals. In that article we profiled the Rand and Real, and concluded that these exchange rates were 15%-30% under-valued relative to Fundamental Value (FV). The Rand has since appreciated from ZAR16 to ZAR13.5 to the US\$ and the Real from R\$4 to R\$3.2 to the US\$.

Utilizing the same methodology to look at the Mexican Peso tells an interesting story (see below). The Peso has been tracking in line with FV since 2000, it is only in the last couple of years it has seriously diverged. What is more, the Peso is now amongst the most undervalued of the currencies we track. The FV analysis again suggests the Peso is between 20-30% under-valued relative to the US\$. Whether it will strengthen in the short term and see our forecast substantiated in the same way as for the Rand and the Real is another matter, as the current political climate in the US most definitively leaves Mexico "between a wall and a hard place". Our model would suggest, however, that it is perceptions and not fundamentals that have led to the current exchange rate situation, and while perceptions can persist for a long time, we continue to believe that in the long run, currencies will revert to fundamentals.

Mexico FX vs FV



Source: Bloomberg, Oxford Economics



Beyond the wall

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As a growth market investor, we are accustomed to heightened volatility in our markets, whether resulting from presidential elections, political instability, shifts in fiscal or monetary policies or periods of civil unrest. Our multi-decade investment legacy in these markets has taught us three important lessons – (i) the world is not linear (and ambiguity is an ever-present); (ii) it is dangerous to presume that common sense always prevails, at least in the short term; and (positively) (iii) never under-estimate the power of a country to adapt to new circumstances.

Having said all that, even for experienced investors it has been challenging to remain sanguine in the period of heightened uncertainty that has followed President Trump's election in November 2016. In the November edition of Actis Insights and Perspectives, we discussed the possible impact of the election on growth markets (see "Pollsters Trumped Again!"), and now that we are a month post-inauguration, we thought we should re-visit Mexico, to analyse the aftermath of the US presidential election on Mexico, probably the market most impacted by the protectionist rhetoric during the US election campaign.

"NAFTA la vista"

In contrast to the historical role played by the US as the architect of global free trade, the Trump campaign was anchored by a significant shift in US trade policy, whereby rising protectionism would underpin the thesis of "making America great again".

Trump made clear his intention to review multiple trade agreements, including NAFTA, and this has in fact played out in the series of recent executive orders emerging from the Trump White House.

NAFTA has strengthened trade relations between Mexico and the US, with ca. 80% of Mexico's exports now going to the US, and with the manufacturing sector accounting for ca. 20% of GDP growth since 2008. That explains why a challenge to NAFTA from north of the border has seen the Mexican Peso weaken sharply, the Mexican stock exchange drop ca. 15% (in USD) and the country risk premium rise 60bps after President Trump was elected.

From an economic standpoint, the Central Bank of Mexico (Banxico) reacted quickly increasing the benchmark interest rate twice by a cumulative 100bps to 6.25%, against a market expectation of a 25bps increase. This move was in response to likely devaluation associated with the US election, which itself impacted inflation, the recent liberalization of gasoline prices, and the review of minimum wages: together these could boost inflation expectations. In order to try and curb excessive volatility in the Peso, the Central Bank has USD176bn in foreign reserves at its disposal as well as access to the Flexible Credit Line (FCL) with the IMF. In the political arena, rising risk of US protectionism, if realised, could catalyse populist movements in Mexico, during a period when leftist parties have been gaining ground in advance of Mexican Presidential elections in 2018.

So the reaction to the uncertainty has been rapid, and to date has done something to re-inject a degree of confidence into the economy. In the Mexican energy sector, where Actis' renewable energy platform Zuma Energia operates, a scaling back of economic integration in the region could certainly impact on Mexico's plan to increase the importance of natural gas in its power generation matrix, as that does depend on continued imports of US shale gas.

However, to date we have seen no slowing down in the pace of investment in the sector and the importance of self-sufficiency in power generation is likely, if anything, to be increasingly recognised in future capacity auctions in the Mexican market. Good news for some perhaps, but for now and for the foreseeable future, these investments are likely to see higher funding costs and potentially reduced appetite from US investors.

What comes next? Political campaigns are usually marked by promises and polemic speeches, which are either amended or forgotten by a candidate when elected and the focus switches to how best to govern. As George Washington stated: "To form a new government requires infinite care and unbounded attention; for if the foundation is badly laid, the superstructure must be bad."

In consequence, we expect that a number of President Trump's campaign promises may be watered down, and even if the border wall is finally built, the NAFTA issue might not be as simple as the President believes it to be. Two main factors drive this view - the US-Mexico trading partnership has up until now resulted in extensive supply-chain integration, with 60% of the exports in the US classified as intermediate goods, acting as an important engine for the US production ecosystem. Hence, a potential US withdrawal from NAFTA would harm both sides. Secondly, regardless of the ability of a US President to issue executive orders, it seems clear from the reaction to the recent travel ban, that the US President unilaterally withdrawing from NAFTA would face a challenge, whether from the US Senate or the courts.

As we highlighted in our prior edition, if the US is to continue to build an export base, it will need to recognise that 80% of the growth in world's middle class is going to come from growth markets, and Mexico, given its strategic location, will be an important piece of this puzzle.



'They tried to bury us.
They didn't know
we were seeds'

Mexican proverb



Demonetization: Flawed execution could threaten a well intentioned reform

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India's current Prime Minister Narendra Modi was elected on the poll promise of fighting corruption and cleaning up the "black" economy (undeclared transactions outside the tax net), which by some estimates is worth over 20% of the official GDP. After a series of measures over the last couple of years, which have had varying degrees of success, the Government introduced its most drastic reform to date on November 8th 2016 by withdrawing the two highest denomination banknotes (500 Rupee and 1,000 Rupee) from circulation. The policy move created ripples throughout the country and caused large scale disruptions to businesses in the near term. For those of us in India at the time, the magnitude of Modi's move was demonstrated by the fact that Donald Trump's victory in the US Presidential Election on the same day became "second page news"!

"A Policy Shock"

India has a large unorganised sector and cash is used for 98% of all consumer transactions by volume. The two bank notes removed from circulation comprised 86% of all currency in circulation in India and their sudden withdrawal had a profound impact on the incomes of the poorest and on business activity across categories. The rural economy, particularly the agrarian part, which includes payments made by the government to farmers for acquiring produce, wholesale trading and transport of agricultural produce and purchase of farming inputs, is almost entirely cash driven. The biggest impact was seen across discretionary categories such as consumer durables in which demand declined by 50% in the days following demonetization. Unorganised labour in the country, which is largely paid in cash, saw a large drop in incomes and significant layoffs. The initial popularity of the plan was based on the belief that

the greedy and corrupt, who had stored their black money in bank notes, had been caught off guard and would face heavy fines and tax scrutiny if they exchanged the old notes for new currency. In reality, however, many of these people had the flexibility to find alternative uses for their unused currency and most probably were not holding the bulk of their undeclared wealth in cash but instead in a combination of property and gold.

The Government has remained steadfast in its view that it was worthwhile to go through some short term pain for the longer term benefits of higher transparency and flushing out black money from the system. However, in its quest to maintain absolute secrecy around the timing of the move, the Government seemingly failed to plan the implementation phase properly and the ill-conceived operation to replace old currency notes with new ones created an immediate liquidity crunch and led to an almost daily ritual of short term policy flip flops. Public support for the move, which was overwhelmingly positive in the early days, also receded somewhat due to the inconvenience caused to a large section of the population.

The Government also suffered a setback as demonetization was expected to ensure that a part of black money stored in cash would not get exchanged, being unaccounted wealth (or black money). These unreturned monies would result in reduction of currency liabilities for the Central Bank and create some fiscal headroom for the Government in the form of additional spending power. Estimates for the amount of unreturned black money varied from 15-25% of the total demonetized currency of US\$220bn, which would have provided US\$35-45bn of additional spending power to the Government. However, the entire stock of demonetized currency was exchanged over the last two months, partially diluting one of the core target outcomes of the policy.

"Limping back to normality"

The Government had predicted that the liquidity situation would take about 60 days to normalize as the old banknotes were being replaced with new ones of 2,000 Rupee and 500 Rupee denomination. Those calculations proved overly optimistic with cash outages at Bank ATMs being the norm over the last two months. As of December 2016, new currency equivalent to 40% of the value of cancelled notes has been printed and distributed, and this is expected to increase to 60% by mid-February.

However, post an initial period of uncertainty and extreme forecasts about the negative impact on the economy, recent data from corporate earnings seems to suggest that the negative impact on certain sectors of the economy may have been over-estimated. Sectors that were expected to have the highest negative impact included Autos, especially two wheelers, Construction and Real Estate, Building Materials, Financial Services, Consumer Durables and Apparel. Payments businesses were expected to receive a boost due to increase in electronic payments.

Data from corporate earnings suggests that two wheeler manufactures have indeed seen sales declines of 20-30%, while property sales have also declined by up to 20%, leading to a correction in property prices and decline in prices of cement and other building materials. However the impact on Financial Services businesses has been mixed, with some Banks and Specialty Finance companies seeing an uptick in collections as old notes were used to repay outstanding loans resulting in an improvement in asset quality. Loan growth was expected to slow down for most Banks, but the impact has been lower than expected so far and will be more pronounced in the January – March quarter. Our portfolio companies have reported similar on-the-ground impact with consumption being impacted by 15-20%, while our ATM outsourcing business, AGS, which was expected to see an increase in transaction volumes, actually saw a decline due to a severe shortage of the new banknotes, which led to almost half of ATMs being idle in the first few days post demonetization.

“What happens next?”

As events have stabilized over the course of the last few weeks, debate has shifted from the often shrill commentary about poor execution to whether the policy objectives have been met or not. Even though it is difficult to argue unequivocally that the government succeeded in achieving what it set out to do, there has certainly been a benefit from accelerating the role of digital payments in the economy; electronic payments have grown by >30% in the weeks following the demonetization. The Government has also announced a series of subsequent measures and incentives to promote the digital economy including lowering transaction charges on low value transactions. Overall, in the medium term, various steps to increase digital payments will structurally reduce currency in circulation, and lead to higher growth in financial savings/higher digital transactions.

Despite the short term impact of a slowdown in GDP growth, if demonetization achieves the longer term benefits of greater transparency, higher tax collections, and higher financial inclusion, the adage of short term pain for long term gain may hold true and India will have turned a new chapter in its economic history.



Africa's democratisation dividend?

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If there is one thing that Brexit and Trump demonstrated in 2016, it is that political risk is not and has never been the sole preserve of the emerging markets. Investors in Europe and the US need only look back a few years to the disputed result of the Gore-Bush election and the hanging chads of Florida, the repeated scandals of the Berlusconi and Sarkozy years in Italy and France or the period in 2010-11 when Belgium went 589 days post-election without being able to form a government.

This risk is reflected in the performance of the capital markets. Since 1928, the S&P 500 has fallen an average of 2.8% in US presidential election years that don't feature an incumbent seeking re-election. In fact, of the eight years included in a two-term presidential cycle, the final year of the second term — when the incumbent is constitutionally prevented from running — is the only one that has seen average negative market returns. By contrast, in years when the sitting president is up for re-election, the S&P 500 has averaged positive returns of 12.6%. So whilst politicians seeking office will typically run on a promise that change will be positive, it would appear that markets tend to disagree.

So as we move into 2017, an important year in Africa's electoral cycle, how will markets and indeed the economies of these countries react to the prospect of a number of leaders stepping down or losing their mandate? Democracy is "new" to Africa, and in fact is new in many markets. For roughly the first 2,400 years since the idea of democracy first developed, "government by the people" was considered a chaotic, impractical idea. In fact it took until 1900 for universal suffrage to be introduced anywhere on the planet. By 1973, only about 30% of sub-Saharan countries were defined by Freedom House as "free" or "partly free". In its latest report the share stands at 59%.

Elections are when democracy and economic growth interact most directly, and the elections that have taken place across Africa over the last 20 years and particularly over the last two years are in many ways significant developmental milestones. In 2015, Nigeria achieved its

first peaceful transition between civilian governments since independence. In 2016, Ghana elected Nana Akufo-Addo as its new president following an extremely tight contest. Most recently, the election in The Gambia was considered a bellwether for African democracy as a whole, and although the defeated incumbent was initially reluctant to surrender his office, it now appears as though a peaceful transition has been secured. This was an important achievement, as a failure of the electoral process even in a country of 2 million people where the GDP is less than a third of the amount spent by 2016's US presidential candidates, could have done meaningful damage to the reputation of the wider continent.

At first glance Sub-Saharan Africa's recent economic evolution suggests a positive relationship in the region between democracy and economic growth. In parallel with the introduction of regular multi-party competitive elections to 40 countries in Africa over the past decade, we have seen a period of relatively consistent economic growth and a departure from the stagnation and recession of the "hopeless continent" of the past. Growth in GNP rose from an average of 1.7% in the late 1980s to over 5% in the run up to 2010-2012, and it was this combination of growth and a new hope for political stability that were behind the emergence of the "Africa Rising" narrative.

So whilst from a continental perspective, the emergence of democracy seems to have had a beneficial economic impact, at

a country level, the impact has not always been so positive. For instance, Ghana's growth dropped from 15% in 2011 to 7.9% in 2012, the election year. In Zimbabwe, the drop was 4.3% ahead of the 2013 presidential election. We would expect to see this phenomenon recur again this year in countries where elections are happening, as electoral cycles impact on economic policy decisions. Examples of this are extensive. Following the election in Ghana in 2008, the National Democratic Congress reassessed many existing contracts, in some cases withholding payment for up to two years. Non-performing loans in Ghana's banking sector soon more than doubled to 18 percent. In Zambia, the new government reversed the privatization of Zamtel, and introduced additional capital requirements for the banking sector. And in all markets, developed and emerging, ministries and government departments can descend into pre-election paralysis, delaying or deferring critical investment decisions pending clarity on the new administration's policy changes.

Africa's quest for democracy has also famously delivered some of the most prominent political shocks of the last decade, as the quest for fair and universal suffrage has resulted in civil unrest. The Arab Spring—triggered by the protest of unemployed youth in Tunisia in late 2010—unleashed a wave of upheaval and conflict that soon spread to Libya and Egypt. These three countries' economies did not grow at all between 2010 and 2015,

Focus on African elections 2017

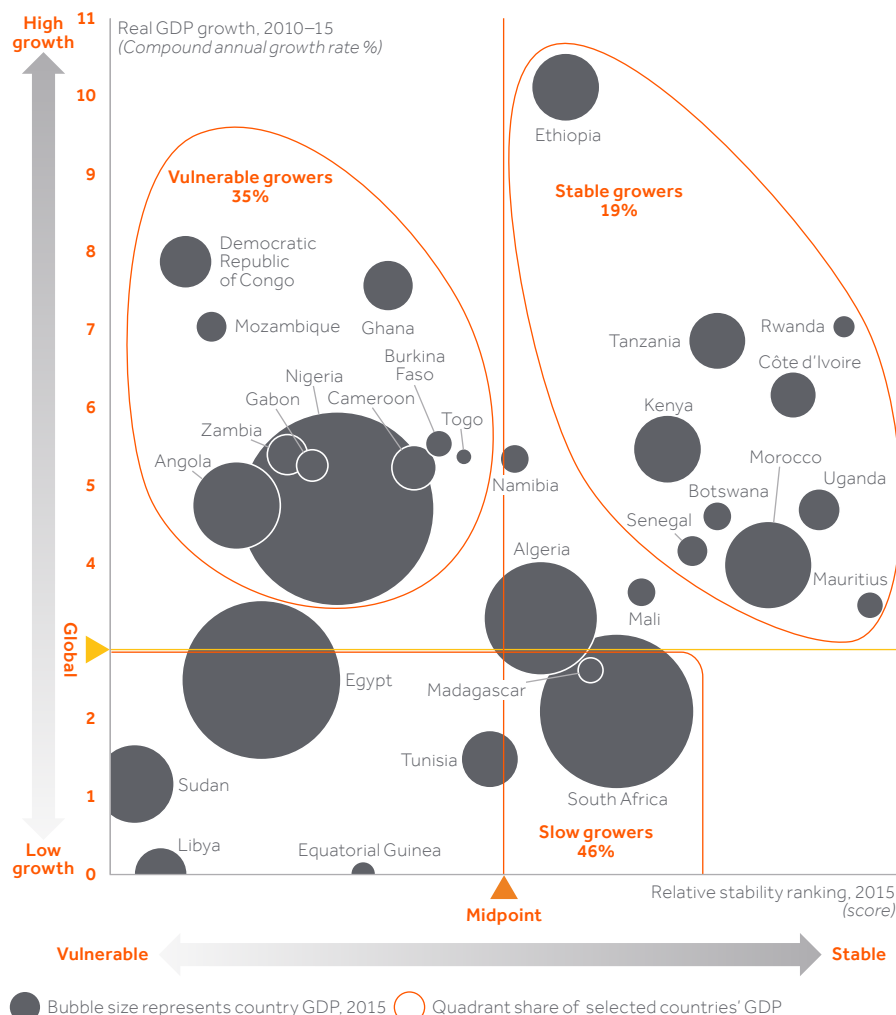
1. Rwanda: Aug. 4, 2017: President Paul Kagame seeks a third, seven-year term he won the country's second election in 2010 with 93% of the vote.
2. Kenya, Aug. 8, 2017: Kenyans will go to the polls to elect nearly 2000 officials including the president, senators, county governors, members of the national and county assemblies, and women county representatives
3. Angola: Aug. 2017: In Dec. 2016, president Jose Eduardo dos Santos announced that he will step down as president before the 2017 elections whilst remaining leader of the ruling People's Movement for the Liberation of Angola party. João Lourenco, a former defence minister, as vice president is the heir apparent.
4. Liberia: Oct. 10, 2017 After 10 years in office Africa's first female president and Nobel Peace Prize recipient, Ellen Johnson-Sirleaf of Liberia leaves office. She will be remembered for the Ebola crisis and rebuilding a country ravaged by war. Liberia's next president- will inherit an economy impaired by commodity prices and a post-Ebola decline in official inflows.
5. The Democratic Republic of Congo: TBC 2017 the government and opposition members in the DR Congo seem to have agreed a deal that would see President Joseph Kabila step down after the next election.

a sharp contrast with 2000 to 2010, when they expanded at an average annual rate of 4.8%. Events of this nature are hard if not impossible to predict, but at this stage we do not foresee any of the 2017 scheduled elections triggering this type of economic or political setback.

It is tempting to conclude that there is a virtuous relationship between democracy and economic growth and development in Africa. Yet the interplay between the two is far from clear cut partly perhaps because democracy's economic effect is cumulative, and the effects of democratic institutions take several electoral cycles to manifest. What is far more evident is how the domestic and international perception of democracy, however imperfect, impacts on a country's attractiveness for investors.

The emergence of an educated, wealthier and younger middle class and rapid urbanisation are key indicators for the macro-economic outlook, the attraction of foreign direct investment and for the rise of democracy. A richer, younger, tech-savvy generation is more inclined to reject the bribery and corruption of the old "winner takes all" order. The question then becomes whether there is an income threshold above which this assumption holds, and interestingly this conclusion is supported by empirical analysis by Oxford's Sir Paul Collier which states that "democracies become less inclined to violence and patronage-based politics as incomes rise. Once GDP per head rises above roughly \$2,700, greater democracy generally begins to make countries more stable". Currently some 12 sub-Saharan countries have reached this level and sure enough, they are the ones where democracy is performing best. An

Comparison of historical GDP growth rates to country stability rankings



Source: Exhibits from the McKinsey Global Institute, *Lions on the Move II*, 2016

interesting way perhaps for us to identify the next generation of countries that could drive the resurgence of Africa's next wave of growth and stability.

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