Frontier Markets Are on Sale — but It Could Be a Wild Ride

Reshma Kapadia, Barron's Magazine July 18, 2019 7:30 am ET

Frontier markets are a rarity: Relatively impervious to presidential tweets and the trade tit-for-tat, rising when other markets pull back—and yet, still unloved.

The case for frontier markets typically goes like this: Countries such as Sri Lanka, Argentina, and Vietnam resemble today's emerging markets 20 years ago, with large populations moving up the economic ladder and potential for political and economic reforms that could bolster economic growth. Markets tend to be driven by local investors and are sensitive to oil and currency fluctuations, political scandals, and local headlines, making them less correlated to broader markets—and to each other. But they are susceptible to wild swings driven more by sentiment than valuations.

Last year, the MSCI Frontier Market index fell 16%, hit by a 50% drop in Argentinian stocks as the country struggled with double-digit inflation and an expanding budget deficit. This year, the index is up 15%, outpacing the 12% gain in emerging markets, helped by double-digit gains in Kuwait, which is benefiting from higher oil prices, market reforms, and investor interest amid expectations that it could soon graduate to emerging market status.

At 12.5 times next year's earnings, frontier markets are still cheaper than emerging markets. Yet frontier market stock funds suffered outflows of $2.3 billion, according to EPFR Global, in the 12 months ended June 30.

Some darlings have disappointed. "Five years ago we could have painted a bullish leadership picture in Africa, but the reality is that they have taken one step forward and a couple back," says Oliver Bell of T. Rowe Price. Sri Lanka and Pakistan failed to deliver anticipated reforms, and political turmoil there has sapped economic growth.

But upcoming elections in Argentina and Sri Lanka, as well as improvement in some other frontier economies, could improve sentiment. Also helpful: The Federal Reserve's recent dovish stance. When the U.S. raised interest rates last year, some frontier countries had to raise rates to protect their currencies, sacrificing economic growth.

"The asset class is cheap, and much of it is removed from trade frictions," says Laura Geritz, a frontier market investor. And if the U.S. cuts rates, there will be less incentive to hold dollars and more impetus to take a risk on some overseas assets."

All of these managers assume a long-term view and stress that the frontier markets story isn't a cohesive one—for instance, countries like Bangladesh and Pakistan suffer from higher oil prices, while exporters like Kuwait benefit; Bangladesh and Vietnam play a big role in global supply chains while most other countries do not.

While the market has recovered after last year's drubbing, fund managers say many well-run companies remain cheap. Banks with strong returns on capital in Sri Lanka trade at just three or four times earnings, for example, and in Pakistan, they trade at a discount to book value.

Sri Lanka had been a favoured market a few years ago as it emerged from a nearly 30-year civil war, but economic growth has been slow, hurt by high oil prices, and the government has been embroiled in scandals. The Easter bombings that killed 258 people dealt a blow to tourism, a major source of economic growth. But coming elections could break the political gridlock that has stymied needed reforms.

Elections this fall could determine Argentina's outlook for the next decade, Bell says. He puts a 20% chance on Cristina Fernández de Kirchner getting re-elected—an outcome, he says, that would raise worries about another debt default and capital controls. But if President Mauricio Macri returns to office, it could be an important watershed, allowing him to accelerate reforms and breaking Argentina's recent pattern of lurching from one crisis to the next.

Vietnam has made news as companies diversify their supply chains away from China. But fund managers say the trade war isn't a game changer, as Asian companies have been moving production to the country for years to capitalize on labor costs that can be as much as half that in China. Indeed, President Donald Trump suggested late last month Vietnam could be his next tariff target. Another concern: If the trade war pushes China to devalue its currency, exporters like Vietnam would have to follow to stay competitive.

Both could hit sentiment, but managers say they'd view a pullback as an opportunity. Vietnam's strong exports, big foreign reserves, and stream of foreign direct investment would act as a buffer if the currency is devalued. Plus, it's taking long-term steps to develop its economy, investing in infrastructure and education. "Vietnam remains fundamentally strong," says Bell, who likes its financial and consumer stocks.