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Investors cling to frontiers as emerging markets sink

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By Carolyn Cohn

LONDON (Reuters) - As emerging markets tumbled this year, the riskiest country groupings on the fringes have been a haven.

Small markets, local stories and in some cases pegged currencies backed by strong central bank reserves have shielded frontier markets from the worst of the emerging market rout.

Lebanon, Tunisia, Bulgaria, Lithuania, Qatar and Kuwait are among the world's lesser developed markets and are outperforming more mainstream emerging markets in the most recent storm.

The benchmark MSCI frontiers index .dMI7400000PUS has eked out a 1 percent rise in total returns this year, but that compares with a 7.4 percent loss in emerging markets .MSCIEF and a 5.4 percent drop in developed stocks .MIWO00000PUS.

To be sure, the performance of headline frontier indices mask the differing fortunes of an eclectic group of markets that includes Argentina, which is going through another severe currency crisis.

But far from the widespread advice to be hyper selective right now within the emerging markets universe, sticking with the broad frontiers index may have been the most reliable play over the past year.

Last year too, emerging stocks, bonds and currencies fell as investors fretted about lower growth in countries such as Brazil and China and the end of the U.S. Federal Reserve's monetary stimulus programme, which had depressed U.S. bond yields and driven volatile investor flows to high-yielding assets.

But frontier stocks and bonds rose in 2013, boosted in markets such as sub-Saharan Africa by a stronger growth outlook.

"We have picked up where we left off last year," said Slim Feriani, CEO of Advance Emerging Capital. "The key difference is currency, you do not have currency moves like we have seen in the Fragile Five."

The so-called Fragile Five currencies of the major emerging economies of Brazil, India, Indonesia, South Africa and Turkey have suffered sharp losses over the past 12 months, forcing protective interest rate rises in several cases, on a reversal of the investor inflows of the past few years.

Many frontier markets, including the Gulf countries of Kuwait, Qatar and the United Arab Emirates, have currencies pegged to the dollar.

Pegs can be a problem if central banks run out of foreign exchange reserves to prop up their currencies. But the energy-producing surplus countries of the Middle East have $30-60 billion in reserves, and can likely ride out the current volatility if push came to shove.

These three countries make up more than 50 percent of the frontiers index, helping to explain its outperformance.

Other top-performing frontier markets this year include Bulgaria and Lithuania, which have currencies linked to the still relatively buoyant euro.

NO CORRELATION

Frontier markets, so-called because of the relative difficulty of getting in and out of them, have won far less international investment than emerging markets and so have been less prone to the flight of speculative hot money.

Emerging markets have attracted index-tracking retail investors through exchange-traded funds (ETFs) and these have been among the first to take fright and leave, investors say.

Emerging stocks are a trillion-dollar market, of which $300 billion (184 billion pounds) is in ETFs, compared with less than $20 billion under management in frontier stocks, according to estimates by banks and fund tracker EPFR.

This cash has headed for the exits as the Fed started cutting its bond-buying programme, a process famously described as "tapering" last May by then-chairman Ben Bernanke.

"A lot of the money coming out of emerging markets is still due to tapering tantrums," said Antoon de Klerk, fund manager at Investec. "That liquidity would not have reached frontier markets to nearly the same extent."

Because of this lack of liquidity, there is also a lack of correlation between frontier markets and other markets, and between individual frontier markets.

Investors look more closely at local factors instead.

The top-performing frontier markets this year are Jordan and Lebanon, which investors ascribe to improving sentiment about neighbouring Syria, following a peace process which started last month.

Tunisia has also rallied, boosted by the adoption last week of a new constitution.

And just as investors cheer reform-friendly emerging markets such as Mexico, Morocco .MASI, which suffered a downgrade from the emerging market to the frontiers index last year, has shown resilience following the government's willingness to tackle energy subsidies.

Even where frontier markets have fallen this year, it is not necessarily related to the global situation, analysts say.

"The frontier currencies that are not pegged get driven by a lot of internal factors," said Angus Downie, head of economic research at African bank Ecobank.

"The global economic situation has had an impact in Africa but it's somewhat muted - Africa is not fully integrated with global economic trade."

The Ghanaian cedi, for example, has hit record lows, forcing the central bank to stabilise it. But investors say this is because new energy resources in the country encouraged high levels of government debt, rather than due to global factors.

"The fall in the cedi has wholly been of Ghana's making, it is a massively overheated economy," said de Klerk.

However, some of last year's frontier darlings are now feeling the heat of the global sell-off.

Nigerian stocks , which soared 43 percent in 2013, have fallen 2.5 percent in 2014, the naira is trading below its 150-160 per dollar band, and the central bank says hot money remains in the system.

Mauritian stocks .MDEX have fallen after rallying 20 percent last year, domestic bond yields have risen and the central bank governor said this week that rates should be raised to prevent capital flight.

And even if investors like local stories, they may have to sell the bad with the good in the event of an even larger-scale sell-off, in order to meet client redemptions from their funds.

"We are seeing continuing outflows of emerging markets, week in, week out, we have seen some panic," said Feriani.

"Frontier markets have remained uncorrelated, that won't go on forever - I am a bit cautious."

(Editing by Anna Willard)