CIO LETTER

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Emerging Markets: Setting Up for a Better Future

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There is a legitimate question as to whether the time is ripe for a positive reassessment of the EM investment case, or, conversely, if we are undergoing a new cycle of high volatility and frustrating returns for the asset class, such as that experienced in the 90s.

"The voyage of discovery is not in seeking new landscapes but in having new eyes."
Marcel Proust

The last decade may well be remembered as the golden era for Emerging Markets (EM). These economies emerged from the crisis of the 90s and experienced a success story of restructuring and strong growth early in the millennium. Cheap labor markets and massive capital inflows, along with extraordinarily loose monetary policies put in place globally to fight recession, were behind the EM renaissance. During this period, to be long EM, and EM-related asset classes such as commodities, was the correct positioning. Global investors poured money into the asset class, which became mainstream not only for institutional but also for retail investors.

The announcement in late 2013 of a "tapering" of monetary stimulus in the US provided an abrupt wake-up call for investors. The prospective end of the abundant flows of central bank liquidity into financial markets, which helped fuel EM investing after the 2008 crisis, focused investors on a different reality. Specifically, some growth models were unbalanced, with excessive dependency on exports and misallocation of resources in low-productivity sectors, while complacent governments had largely avoided implementing the necessary structural and institutional reforms to sustain growth. Beginning in 2011, EM equities have lagged the broader global market. EM fixed income help up relatively well until 2013, when a "blind" search for yield was replaced by a more cautious assessment of EM economic and institutional weaknesses.[1]

At this point, there is a legitimate question as to whether the time is ripe for a positive reassessment of the EM investment case, or, conversely, if we are undergoing a new cycle of high volatility and frustrating returns for the asset class, such as that experienced in the 90s. If we look at our expected long-term returns for all the major asset classes, based on current valuations and the forces of mean reversion[2], to us, EM equities appear to offer the biggest opportunity on a five- to seven-year horizon. On the other hand, if we believe that EM are entering a new phase of high volatility prompted by structural economic weakness and renewed geopolitical tensions, this valuation gap may be entirely justified and take a considerable period to be closed.

Let's start our analysis by saying that we hardly see the conditions for a 90s-like crisis: most of these economies and their financial markets have progressed materially since that inflammable period.
Looking at the **recent flows to EM and their debt structure**, we see more encouraging signs relative to those observed during the Latin American and Asian crisis of the 90s.

[1] Source: Bloomberg. Underperformance since March 31, 2011 to March 31, 2014 calculated with the MSCI Emerging Market Equity Index and the MSCI World Equity Index, in USD, total return.
[2] Mean reversion hypothesis are based on asset classes prices reversion to their long-term average prices.

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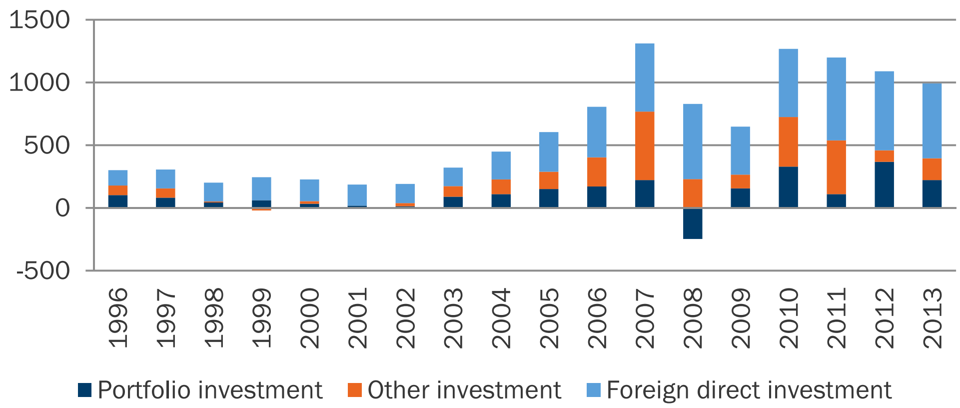
Back then, most of the funding to EM was coming from a few financial institutions, mostly US and European banks, with leveraged balance sheets.

Instead, recent investments have been coming from a much more diversified investor base, including corporations for FDI (Foreign Direct Investments) and non – leveraged retail and institutional funds. It is worth noting FDI component has remained relatively stable over the past decade, while the share of global portfolio flows has been much more volatile and rose after the global financial crisis.

This has two main implications in our view. On one hand, the predominance of non-leveraged investors signals a lower vulnerability of these markets to forced selling in the event of a sudden crisis, such as in the 90s. However, it doesn't completely insulate EM from changes of investor sentiment as it typically happens in risk on/risk off blips.

Capital Flows to EM – US Dollar Billion



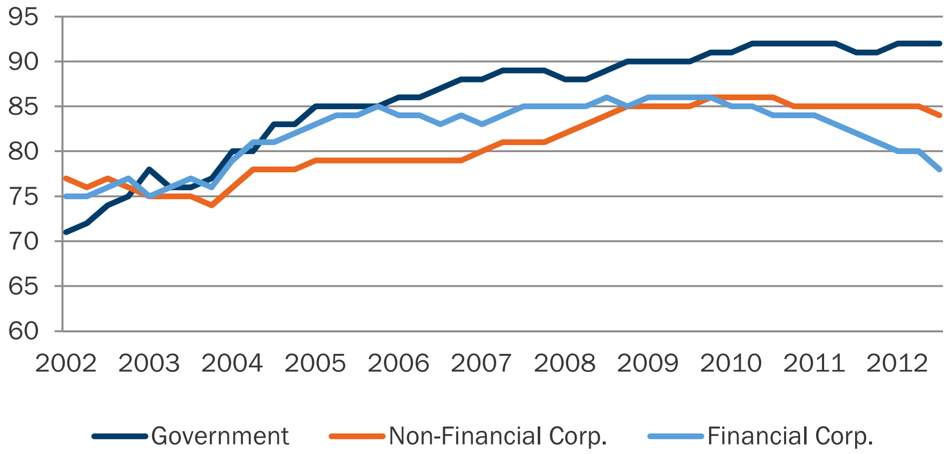
Source: IMF, Financial Stability Forum, April 2014. Other investment covers short- and long-term trade credits; loans (including use of Fund credit, loans from the Fund, and loans associated with financial leases); currency and deposits (transferable and other—such as savings and term deposits, savings and loan shares, shares in credit unions, etc.); and other accounts receivable and payable. Transactions covered under direct investment are excluded.

Another relevant difference versus the 90s is related to the **EM debt structure**. In the mid-90s, a significant part of sovereign Emerging Market Debt outstanding was denominated in dollars. This proved a significant cause of instability, as mismatches between revenues in local currencies and liabilities in dollars became unsustainable in times of crisis, amid currency depreciation and outflows. Now, the situation appears materially different, as local-currency sovereign debt accounts for about 80% of total sovereign debt[3]. In addition, the currency composition of external debt instruments is much more local.

Domestic markets also dominate new issues, both in the government and in the private sector, even though in very recent years, the wide interest rate differentials between EM and DM has stimulated a partial return to strong currency emissions from the corporate sector.

[3] Source: JPM Local Market Guide, September 2013.

Share of Emerging Market Debt Issued in Domestic Markets over Total Emerging Market Debt



Source: IMF, Financial Stability Forum April 2014.

We believe that the evolution with respect to the size and depth of EM financial markets, as well as the improved fundamentals (especially in terms of foreign-currency reserves) has put EM on a more solid foundation than in the 90s.

Clearly, we are not saying that EM are completely immune from crises. The increasing role of global portfolios and the proliferation of a broad spectrum of investment vehicles ensure that EM are closely intertwined with global financial conditions.
In particular, EM are today sensitive to the effects of a normalization in monetary policies, especially in the US. The effects of an unwinding of current monetary conditions may be material and unpredictable, as these policies were implemented through "unconventional" tools (mainly quantitative easing), rather than through the usual lever of interest rates.

Nonetheless, we believe that the evolution with respect to the size and depth of EM financial markets, as well as the improved fundamentals (especially in terms of foreign-currency reserves) has put EM on a more solid foundation than in the 90s. The ability of policy makers to reinforce the financial system and develop a broad base of domestic investors should make them even more resilient. On top of this, it is worth noting that EM central banks are now better equipped to take decisive action to curb dangerous situations, a case in point being the steps taken by Turkey and India in the recent crisis. The number of currency boards, crawling pegs or fixed exchange rates that played a wide role in past crises has greatly diminished. Moreover, many EM have introduced inflation targeting as a way of conducting monetary policy, thereby strongly enhancing transparency of the economic policy actions.

So, if we do not view as likely a repetition of a 90s-style crisis, the relevant question becomes whether a compelling EM investment case is taking shape, after three years of material underperformance. As we have mentioned, based on estimates for long-term real expected returns calculated by our internal research teams[4], Emerging Markets look much more attractive than Developed Markets. This statement holds true for both equity and fixed income. However, a valuation case, in our opinion, should never be the only consideration in making strategic changes in our asset allocation. A number of other factors are to be considered, including an assessment of structural economic improvements, political developments in individual countries and the presence of geopolitical tensions such as the current ones involving Russia and Ukraine.
The starting point of this analysis is, in our opinion, a thorough examination of the Chinese situation. In fact, we are convinced that **China is the cornerstone of a new EM investment case, as on its growth depends most of the economic fortunes of the EM universe**.

[4] The model assumes a long-term mean reversion of the asset prices.

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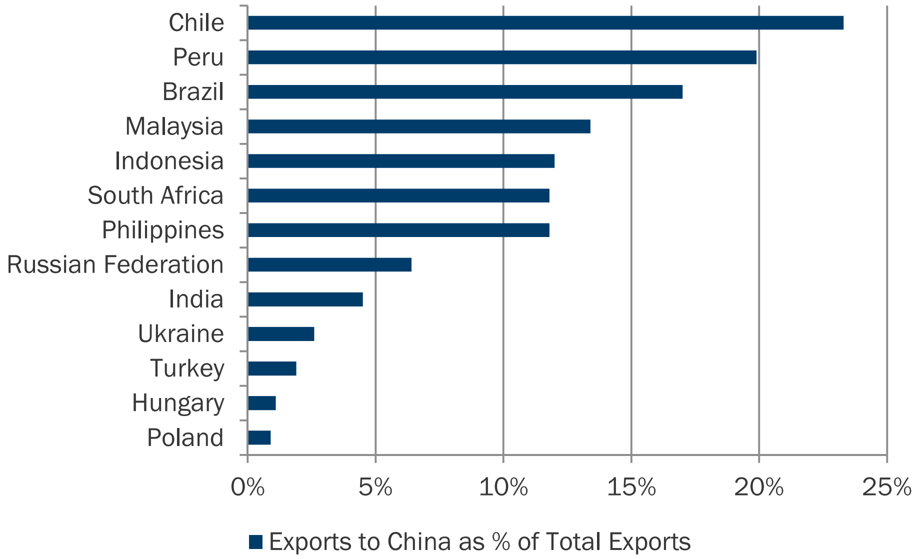
China now accounts for about 45% of the Global GDP growth. Importantly, a number of EM depend on China as their single largest export market (see graph below). Therefore, although the individual investment case for each country will depend, in our view, principally on local economic and institutional factors, the overall EM investment case cannot convincingly be made without a clear view of Chinese economic prospects. In this vein, it is critical to consider the potential effects of the new Chinese leadership's actions.

Exporters to China More Exposed to a Chinese Slowdown



Source: CEIC/Datastream, data as of December 2013.

We are encouraged by the fact that concrete actions are already in place to address the major sources of instability, such as the excessive credit growth of the last few years.

If China is able to manage a smooth transition to a less-leveraged growth model without incurring a hard landing, emerging economies will probably face the current slowdown without major shocks, having been given enough time to address their imbalances. The new Chinese leadership has a big responsibility in this process as it remains committed to a final outcome that incorporates a larger role for market forces and private entities in the Chinese economy. We are encouraged by the fact that concrete actions are already in place to address the major sources of instability, such as the excessive credit growth of the last few years.

Indeed, the main concern for investors regarding China is on debt. In China, the model of investment-led growth has generated a debt frenzy. What is worrying most of the financial community is not only the increase in total debt as a percentage of GDP (indeed, this is also a common trend for many developed economies), but also the lending structure. The strong reliance on bank loans (more than half of all credit) leaves the banking sector as a near-monopolist in handling the credit risk. In addition, the development of an unregulated "shadow" financial system raises concerns on future equilibria and has to be managed carefully by policymakers.

On the other side, putting the Chinese debt issue into perspective, we note that the deleveraging process has started and is complementary to the ambitious reform program set up by Chinese authorities with the objective of a more efficient allocation of capital. **We believe that the current debt problem in China can be managed effectively given the commitment of the current leadership, the high level of concentration of debt in State-Owned Enterprises and in local governments, and the fact that the debt is mainly denominated in local currency.** Moreover, the low level of central government debt

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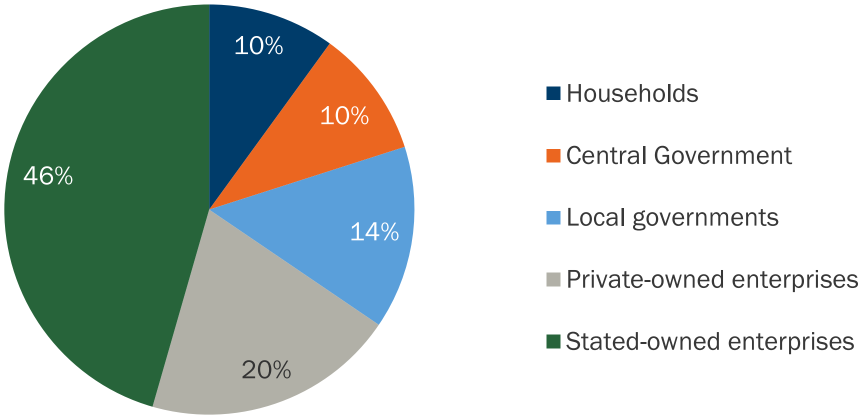
(about 30%) leaves comfortable room for fiscal policy in case of a crisis. Finally, low foreign ownership of the debt (about 4% in China, among the lowest in EM), limits the contagion risks and partially insulates China from withdrawals in case of surging risk aversion.

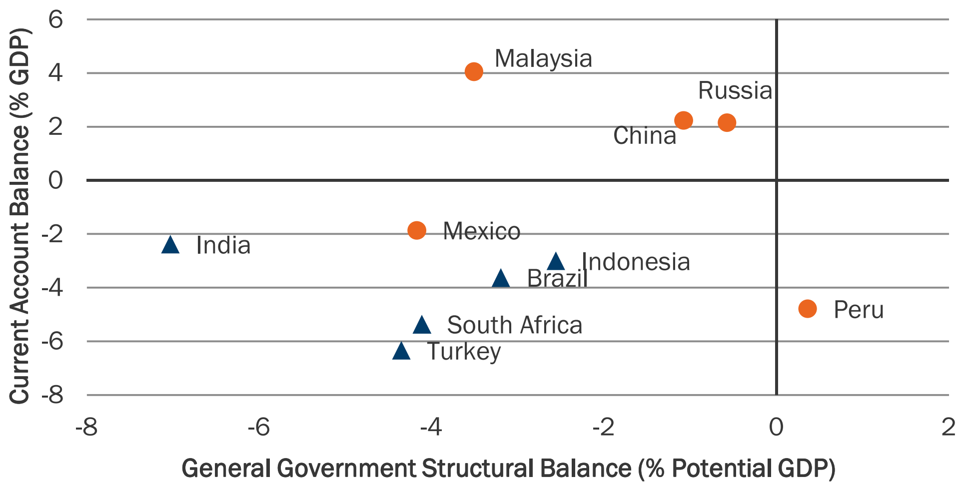
Chinese Total Debt Composition by Borrower in %



Source: PBOC, NBS, NAO, CEIC and SG cross Asset Research/Economics, data as of February 28, 2014.

If we add that valuations for the equity market are actually very interesting, the case for a positive view on China, currently our favorite country among EM, is compelling.
For other countries the picture is more varied. The so-called "fragile five" (Brazil, South Africa, Indonesia, India and Turkey) as well as Ukraine (now under the spotlight for geopolitical reasons but also with weak fundamentals) show the most evident signs of the traditional EM disease: twin deficits, low diversification of the economic model, unfriendly business environment (corruption and scarce transparency, which also applies with force to Russia) and reckless credit expansion.

Twin Deficits



Source: IMF World Economic Outlook, April 2014. Data are 2014 Estimates.

For most of these countries, equity valuations are depressed and already reflect a distressed situation. Looking at these markets in a dynamic perspective with a medium-term horizon, we see some opportunities emerging. We are carefully monitoring India, where the political process could be a catalyst for unlocking huge growth potential driven by economic and institutional reforms and building up a new investment cycle. Russia could become an interesting “valuation” case, although any investment decision is still subordinated to how the political crisis with Ukraine will play out.

The outlook for Brazil appears less positive. The country needs to diversify the production system, which is overly reliant on commodities, and build new infrastructure. However, the political commitment to necessary reforms appears to remain weak. For some other Asian countries, the outlook (which is mostly dependent on China) appears firmer, but market valuations are already discounting better economic conditions. We believe this is also the case for Mexico.

Connecting all the dots and drawing some conclusions, we believe that the recent volatility in EM may lead to selective new investment opportunities both in fixed income and in equities. This constructive view is strictly linked to our base scenario, which remains mildly positive for risky assets. However, we doubt that EM will outperform DM in case of a severe bear market.

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In equities, we continue to look to gradually increase positions on weakness and volatility, with a long-term view that EM equities may offer better opportunities than DM.

In fixed income, we favor the corporate sector which is still offering an interesting risk premium. However, we are aware that the credit risk is affected by the country risk, as demonstrated by the underperformance of the “fragile five” corporate bond index over the last 12 months versus the overall Corporate EM Bond index[5]. In addition, some segments of the corporate sector are piling up new debt. For these reasons, we continue to stress the importance of being selective and of using a research-driven process that incorporates both macroeconomic analysis and review of individual company balance sheets.

In sum: While the big EM party is likely in the past, we believe there are still important opportunities for an investors with an open mind and an active research-driven approach.

5 JPM CEMBI Broad diversified Index and JPM CEMBI Broad Diversified Fragile Fives considered.