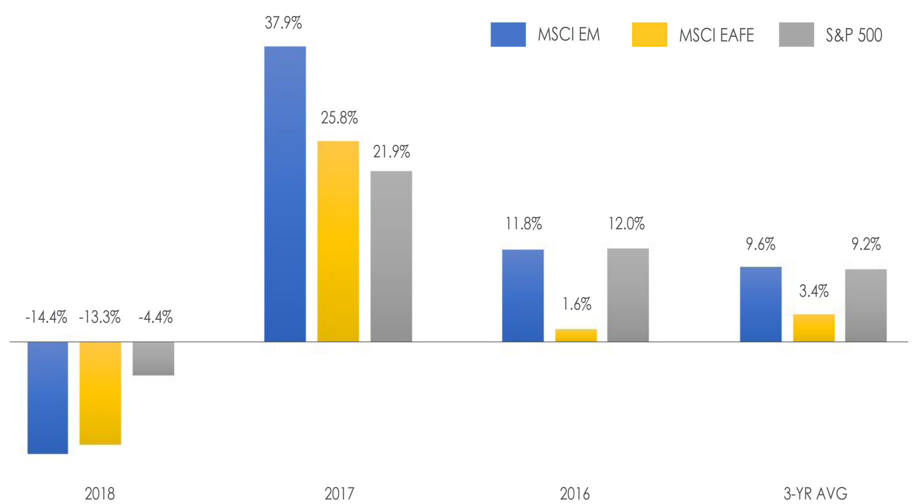
WHY IT MAY BE TIME FOR EM EQUITIES TO SHINE AGAIN

Emerging market equities disappointed most investors in 2018 and it is hardly surprising that there remains much skepticism about their prospects in 2019. The ongoing trade war could get uglier, the Chinese economy could weaken further, political risks could resurface in Russia, Turkey or elsewhere. There is enough negative noise surrounding the asset class to distract even seasoned investors.

EM EQUITIES HAVE OUTPERFORMED OVER THE LAST THREE YEARS



Total returns in USD

Data source: Bloomberg

Not many seem to remember that EM equity returns were ahead of developed market equities, including the U.S., in 2017 and also over the trailing 3-year period as shown in the chart above. Even fewer may recall that EM equities outperformed DM equities in 9 out of the last 15 calendar years.

MOST ATTRACTIVE EM VALUATIONS IN RECENT YEARS

If we ignore the clouds of pessimism, it is evident that EM equities appear better positioned to outperform in the coming years. To start with, we believe that EM valuations are the most attractive in

KEY TAKEAWAYS

Emerging market equities disappointed most investors in 2018 and it is hardly surprising that there remains much skepticism about their prospects in 2019. However, not many seem to remember that EM equity returns were ahead of developed market equities including the U.S. in 2017, and also over the trailing 3-year period.

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recent years. By most widely accepted measures, EM equity valuations are well below the developed markets. At below 11.5 times, the trailing Price/Earnings (P/E) multiple for the MSCI EM Index is near its lowest level in five years. That appears inexpensive considering the growth in operating margins, return on equity and dividend yields over the same time period.

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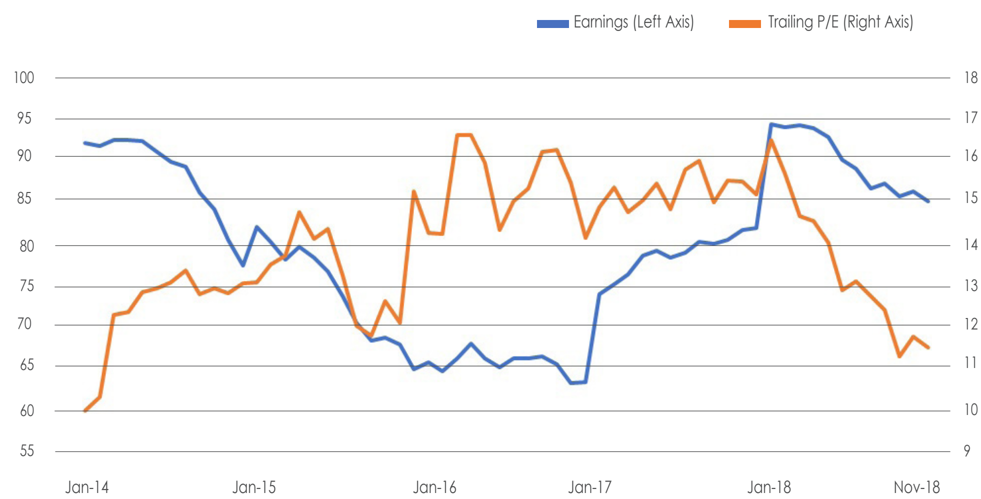
EM OPERATING MARGINS AND ROE HAVE IMPROVED

Operating Margin and Return on Common Equity in percentage

Data source: Bloomberg

P/E NEAR 5-YR LOW, DESPITE HEALTHY EARNINGS



Earnings are per share

Data source: Bloomberg

At the country level, trailing P/E multiples in China, Korea and Russia are nearing the levels seen during the 2008 global crisis. While economic and political risks remain elevated in these countries, we believe the low equity valuations already reflect most of these fears. Marginal improvements in corporate earnings or continued political stability should reduce investor pessimism and lift equity valuations.

WHAT INTRIGUES US ABOUT EMERGING MARKETS AND WHY?

China: While the rest of the world seems to have become ever more anxious about a growth slowdown in China, the relatively lower Chinese equity valuations are largely ignored. Despite the still rapid economic growth and healthy earnings, Chinese equities have not received much investor interest. Economic growth has undoubtedly slowed, but on an absolute basis, China's contribution to the global economy continues to increase every year. At close to $13.5 trillion in current prices, the Chinese economy is nearly three times larger than it was a decade ago. As such, the increase in aggregate output from the current 6.2% growth in China is significantly more than when the country had double-digit growth.

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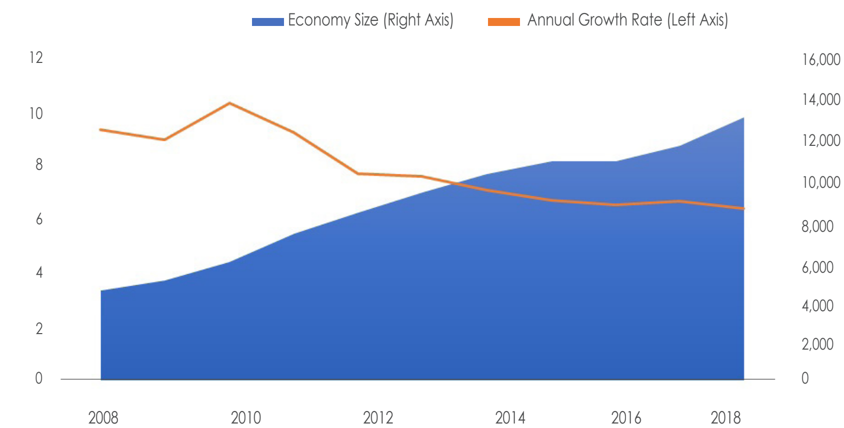
CHINESE GROWTH HAS SLOWED, BUT THE ECONOMY IS THREE TIMES LARGER THAN IN 2008



Economy size in USD billions at current prices and annual growth in percentage

Data source: IMF WEO Database Oct 2018

A trade war with the U.S. is undoubtedly negative for China, especially if it is not resolved soon enough or escalates further. However, given the significant economic risks to both sides from a prolonged stand-off, an early truce that could lead to substantive negotiations and a long-term settlement seems more likely. While we believe it is prudent to carefully consider exposure to Chinese corporations that could be hurt by weak overseas demand in the short-term, extreme pessimism about the trade war has driven down valuations of domestic Chinese stocks that are largely insulated from foreign trade issues.

Unlike in the past when massive stimulus measures were rolled out to support the economy, the current Chinese leadership appears to prefer more targeted policy measures. While this approach restricts aggregate growth in the short run, these measures are more sustainable and are unlikely to produce excessive structural imbalances.

Leveraging the large domestic market, some of the Chinese corporations have become more competitive and are likely to see more overseas success in other Asian markets that are less restrictive. Several of them, especially the leading Chinese corporations in ecommerce and other online services, have built large customer bases that should help their earnings for several years to come.

Brazil: The Brazilian economy contracted in 2016 and 2017, as the negative effects of the commodity price correction lingered. Policymaking effectiveness was made difficult by the political uncertainties created by the corruption scandal and the impeachment of the past president. Most of that appears to have settled down and Brazil's expected GDP growth of 3% in 2019 is nearly double that of the previous year.

The new Brazilian government is widely considered to be pro-business and is expected to carry out much needed structural reforms. Even after the recent gains, the country's currency is still relatively inexpensive by historical measures and makes Brazilian assets more attractive to foreign investors. Interest rates in Brazil are likely to stay at current levels and support domestic demand growth.

India: Growth in India is likely to improve this year after disruptive policy changes restricted economic activity in recent years. While the effectiveness of some policy measures such as demonetization or cancellation of higher denomination currencies remains questionable, other reform initiatives such as a nationwide value added tax are likely to benefit the Indian economy in the long run. If there are no significant internal or external shocks, the Indian economy is likely to grow 7.5% or more this year.

India is a major beneficiary of low oil prices and inflation risks are likely to remain low, allowing the central bank to hold interest rates steady. Even if there is a leadership change after the national elections in April 2019, India is unlikely to see any significant reversal in policies as there is broad political consensus on the current state of the economy.

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Indonesia: Despite all the negative headlines concerning Indonesia's external debt challenges, the country's economy continues to chug along at 5% annual growth. After its currency declined during the first half of 2018, Indonesia raised interest rates and reduced public expenditure. These helped stabilize the currency and triggered the recovery in Indonesian equities later in 2018. National elections are scheduled in 2019 and the current government is expected to be reelected.

Mexico: Though its early steps caused much investor unease, the new Mexican government is likely to be more pragmatic in its policy measures as the country's fiscal situation does not offer much room for flexibility. The recent government budget focused more on fiscal discipline than most analysts expected. After the sell off in 2018, we believe most of the political risks in Mexico are priced in the equity valuations as the country's economy should benefit from stable U.S. growth in 2019.

Russia and Turkey: Compared to recent years, the possibility of aberrant actions by Russia, Turkey or another country now appears lower. The economic sanctions against Russia have been effective so far in restricting the government, while the sharp currency and financial market volatility in Turkey during the first half of 2018 had a similar effect on its government. Valuations in both Russia and Turkey appear reasonably compelling for long-term investors.

To conclude, despite the alarming headlines about global trade wars and currency volatility, we believe emerging market equities remain one of the more attractive choices for global equity investors. Healthy fundamentals and inexpensive valuations for emerging market equities may offset the perceived market risks. As the current fears about global trade and interest rates fade, we expect the asset class to reward patient long-term investors.
