MIRAE ASSET
Global Investments

2018 Emerging Markets Mid-Year Outlook

A Multi-Year Recovery

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At-A-Glance

Why EM Should Outperform DM

- Structural growth opportunity
- Higher oil prices on balance (commodity-producing countries)
- Attractive valuations and positioning

Recent Volatility Creates Opportunity

- Disconnected from fundamentals
- A less vulnerable asset class
- A stable macroeconomic backdrop

China Strength and Continuity

- Transition to balanced growth
- Corporate debt has stabilized
- Consumption remains robust
- Focus on innovation and higher value goods & services

U.S. and Europe

- Central bank actions
- "America First" not as bad as expected

Latin America

- Political reform
- Fiscal reform

Eastern Europe, Middle East & Africa

- Valuation and growth stories
- Structural turnarounds

Emerging Asia

- Export momentum remains supported by healthy external conditions
- Geopolitical situation in Korea peninsula has improved
- ASEAN in stronger external position

Executive Summary

We believe that emerging market (EM) equities are in the midst of a multi-year recovery and that the recent volatility is an opportunity to increase our positions in high conviction ideas. EMs still benefit from a much larger structural growth opportunity than their developed market (DM) peers. For the remainder of 2018, we will be paying close attention to 1) political continuity and economic stability in China, 2) sensitivity to the US dollar (USD) and interest rates, and 3) attractive positioning and valuations for EM equities.

In Asia there appears to be some investor skepticism as to whether the positive trend enjoyed in 2017 can continue in light of recent external developments such as US-China trade relations. Despite the cyclical recovery maturing, we believe there is still room for growth as we see limited signs of overheating and fundamentals remain robust. Importantly, domestic conditions in key markets, including China and India, remain healthy.

In EMs ex-Asia, we are optimistic about the effects of higher oil prices, dovish central bank policies, and key elections across the region. Both Latin America and EMEA are coming from low earnings bases, which creates an opportunity for strong year-over-year growth rates.

Key Events & Trends

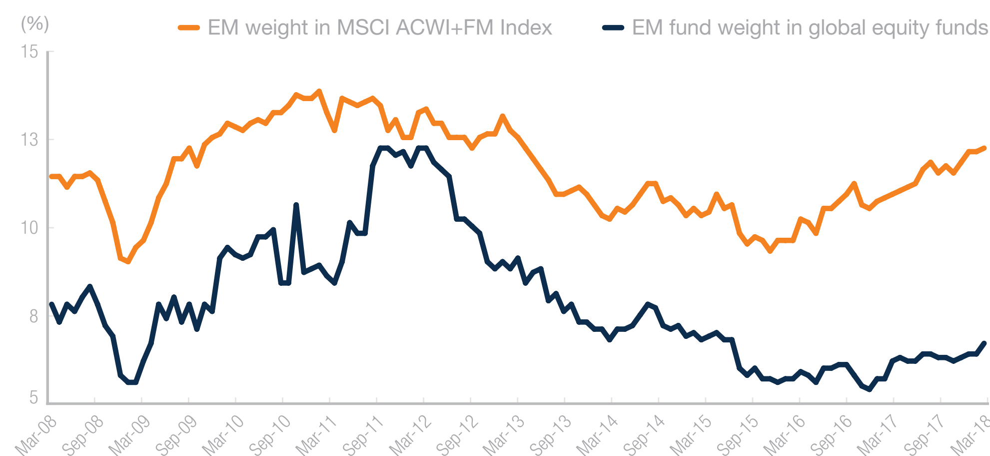
▶ Why EMs should outperform DMs

Emerging markets have been on a bull run for nearly two and a half years, but we think there is more to come. Our research shows that since the mid-1970s, EMs have enjoyed six bull cycles, which averaged 42 months in length and delivered 228% returns in USD.[1] As the current EM run started less than 30 months ago and delivered only a 47% USD return,[2] we gain comfort with our thesis that EM equities still have a significant re-rating period ahead of them.

The IMF expects GDP in EM economies to accelerate every year through 2021 and for DM economies to decelerate beginning in 2018. Yet the discount of EM multiples to DM counterparts is at one of its deepest levels in 10 years. Emerging market equities have not recovered even three quarters of the value lost in the last down cycles and institutional global equity investors are still approximately 6% underweight on the asset class. We believe that this rare combination of positioning, superior growth, and discounted valuation present a unique opportunity for EM equity outperformance.

Global Funds Remain Underweight EMs

Source: EPFR Global, Thomson Reuters Datastream, HSBC calculations



[1] Bank of America Merrill Lynch, September 2017

[2] Bloomberg, 11/30/2015 – 5/31/2018

▶ Recent Volatility Creates Opportunity

After an energetic start to 2018, EM equities have sold off for a number of reasons, and we see the pull-back as an opportunity to increase our high conviction positions. A number of factors have driven the recent volatility in EMs, including profit taking after very strong performance in 2017, technical trading around the symbolic 3% threshold for 10 year Treasury yields, slower than expected growth figures out of Western Europe, speculation on further trade disputes with China, increasing sanction risks in Russia and Iran, and the US corporate repatriation program. As such, it is no surprise that countries with large external financing needs (e.g. Turkey) have experienced weakness.

We view the recent sell-off as a disconnect between the asset class' price movements and fundamentals. Emerging markets are significantly less vulnerable to DM rates and currencies than in the past. Only three of the 21 countries in the EM index have a current account deficit above 3% of GDP compared to the ten countries in this position before the events of 2013. We are also seeing strong political and economic reform stories across the region, which de-risk the asset class and drive confidence and investment. In addition, valuations remain compelling and the asset class is coming from a low base of growth. Broadly, we still see a very strong backdrop for EMs, as represented through high commodity prices, a relatively weak USD, and a steady DM environment with a slow and transparent US Fed.

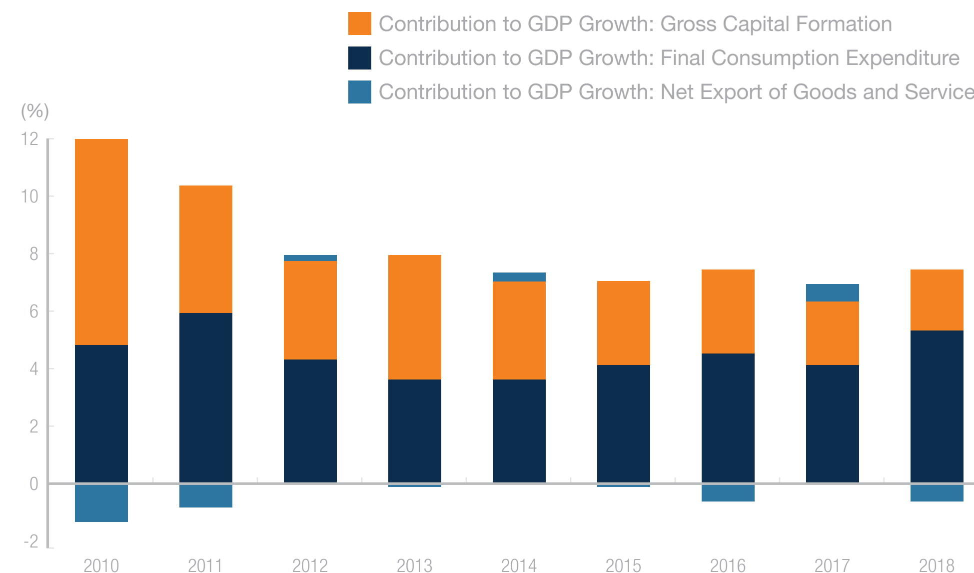
▶ Chinese Strength and Continuity

There has been growing evidence over the past year that China's transition towards a higher income economy is progressing well. Following the 19th Chinese Communist Party Congress, the Chinese government reiterated its commitment to balanced growth and a more consumption-led economy, with a greater focus on innovation and the environment.

The economy posted a 6.9% real GDP growth rate for 2017 and 6.8% for the first quarter of 2018. Consumption, supported by a resilient job market and rising wages, remains the key growth driver, contributing 78% of GDP growth for in the first quarter of this year. Consumer lifestyle upgrades across numerous categories remain a key theme. Furthermore, the government's efforts to rein in corporate debt appears to have been successful. Regulators have implemented a range of tightening polices including those aimed at eliminating the implicit guarantee on wealth management products. We believe these tightening and deleveraging measures will be carried out in a calibrated manner and should allow growth to continue at a healthy, albeit, slower pace. The ongoing supply-side policies and slower investment growth have lifted the industrial capacity utilization ratio. We expect the ratio to pick up further this year, which will support corporate pricing power and profitability.

Consumption is the Key Contributor to GDP Growth in China

Source: CEIC, March 2018



Headwinds and Tailwinds

Headwinds

- Deterioration in trade negotiations between the US and China
- Sharp or unexpected movements in the USD or Fed Funds Rate
- Country-specific political uncertainty
- Significant rise in oil prices (namely for Asia)
- Strengthening USD

Tailwinds

- Developed market growth
- Strong and stable commodity prices (notably for non-Asia)
- Country-specific political and economic reforms
- Strong domestic stories in key markets including China and India

Asia ex-Japan

Despite higher market volatility, we believe that robust fundamentals should support an overall positive year for Asia ex-Japan equities. The correction we have witnessed since February is a mid-cycle correction and we remain broadly constructive in our outlook. We believe that the global economy has moved from a gradual recovery phase in 2017 to a productive growth phase, characterized by an uptick in capital expenditures and improvements in productivity.

Following stellar performance in Asia ex-Japan equity markets in 2017, earnings growth is moderating off a high base, but still growing. Meanwhile, expectations have been checked compared to late last year, when it was more of a one-sided positive view.

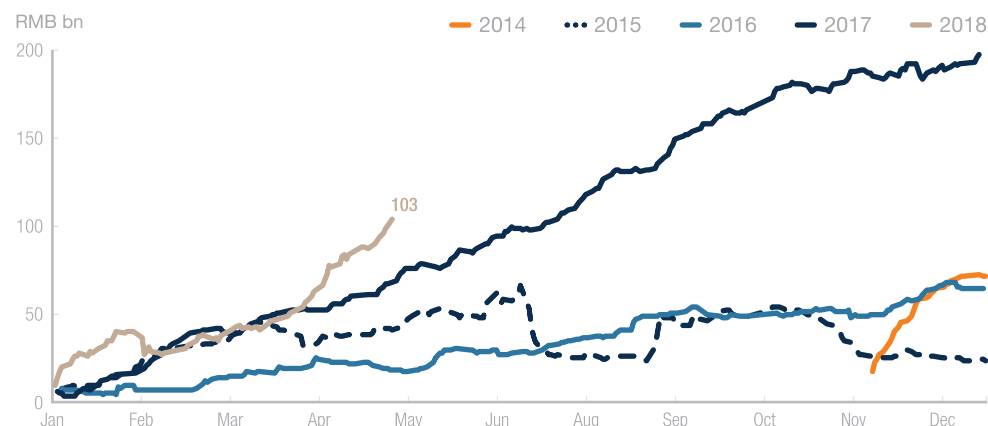
Despite the strong political rhetoric coming from US-China trade negotiations, the fundamental impact of the tariffs has so far has been limited.

China

We remain fairly positive on our outlook for China for the remainder of the year as the global macro backdrop remains favorable, domestic demand appears resilient and we expect to see a milder pace of incremental policy tightening, as indicated by the 100 basis point reserve requirement ratio cut in April. Recent earnings results show corporates are in a strong position and the upcoming A-share inclusion into the MSCI EM and ACWI indices is another indication of greater foreign participation going forward. The pace of northbound inflows through the Stock Connect has accelerated in recent weeks, suggesting growing investor interest ahead of the A-share inclusion.

YTD Northbound net inflow to A-share (2014-2018)

Source: CEIC, May 2018



The US and China trade dispute has recently dominated headlines and affected investor sentiment. Our view is that much of the discussion from the US is political rhetoric, particularly given the mid-term elections in November this year. President Trump made trade a key theme

of his election campaign in November 2016, arguing that he would reduce the US trade deficit and bring jobs back to the US. However, the US trade deficit is in large part a structural issue that cannot be solved easily or quickly by trade protectionist measures. We expect the market to remain volatile in the near term as trade friction persists and negotiations continue. The US has just announced it will proceed to implement the tariffs on US $34bn of Chinese products effective July 6th and a further US $16bn is still be under review. The impact of this tariff should have limited impact to China’s GDP, however; if further tariffs targeting $200bn+ of Chinese goods are imposed, this will likely create an overhang for markets in the near term. We have taken opportunities to shift our portfolio exposure to strong domestic demand plays where we believe the businesses will be more resilient should trade tensions escalate further.

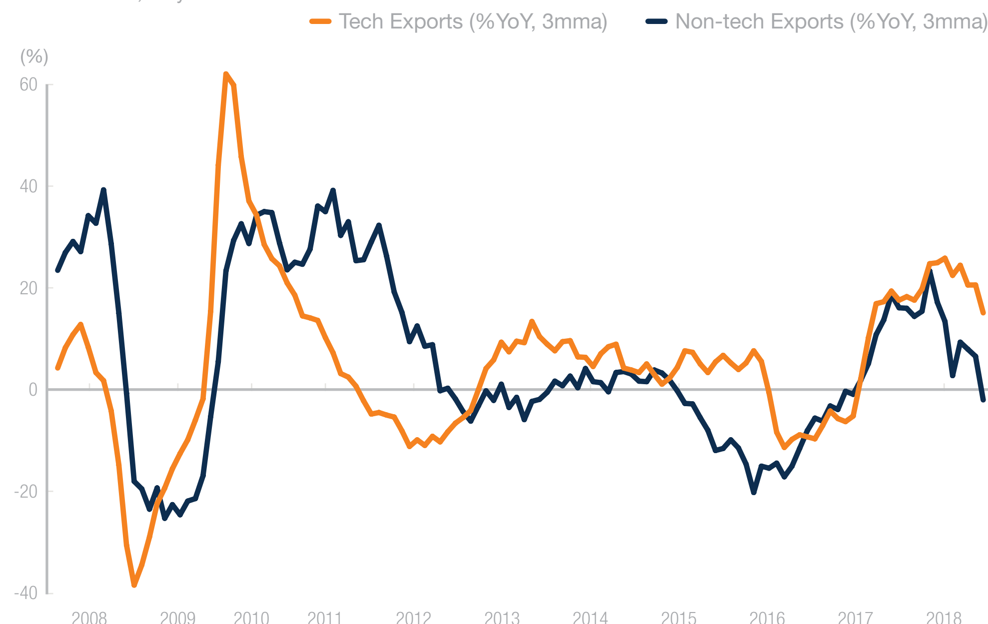
Northeast Asia

Thus far this year, export momentum in South Korea has been healthy, though April data suggests some moderation. We expect a sustained global growth cycle to remain supportive for South Korea's export volume growth. In the beginning of the year, there was concern that the semiconductor cycle would weaken amid a rapid increase in supply. However, demand for server and mobile products has been increasing steadily and as such, prices of DRAMs and NAND flash remain relatively firm.

The geopolitical tensions in the Korean peninsula went through a pattern of escalation and de-escalation throughout most of last year. However, the situation has seen marked improvements this year with North Korean leader Kim Jong-Un expressing his willingness to have diplomatic discussions with South Korea and the US. THAAD related tensions between China and South Korea have also improved as China lifted its retaliatory measures against South Korea. South Korea’s inbound tourist traffic growth turned positive in March 2018 for the first time since China’s travel ban was implemented a year ago. Cosmetic, duty free and auto companies previously impacted by the travel ban should see volume normalization and a gradual earnings recovery.

South Korea Tech & Non-Tech Exports

Source: CEIC, May 2018



Note: tech exports include wireless communication devices, semiconductor, flat panel displays, home appliances, and computers.

In Taiwan, there are signs that the export recovery has begun to filter through to consumers as spending and consumer confidence has picked up. Industrial production data indicate that manufacturing activity continues to be strong.

India

Although the implementation of India's goods and services tax (GST) last July caused some transitory disruptions to the economy, there has been a steady recovery in subsequent months. Key macro indicators, including imports and auto sales figures, point to robust underlying demand. Private consumption expenditure has also remained robust. More recently, we have begun to see incipient signs of a revival in investment activity. If end demand remains strong a recovery in private capex is likely for later this year. Capacity utilization ratios have already begun to pick up, rising to 74.1% in the fourth quarter of 2017 from 71.8% previously. Market sentiment on the rural demand recovery is also rising as the government is expected to put greater focus on rural development and social spending leading up to the general elections in 2019.

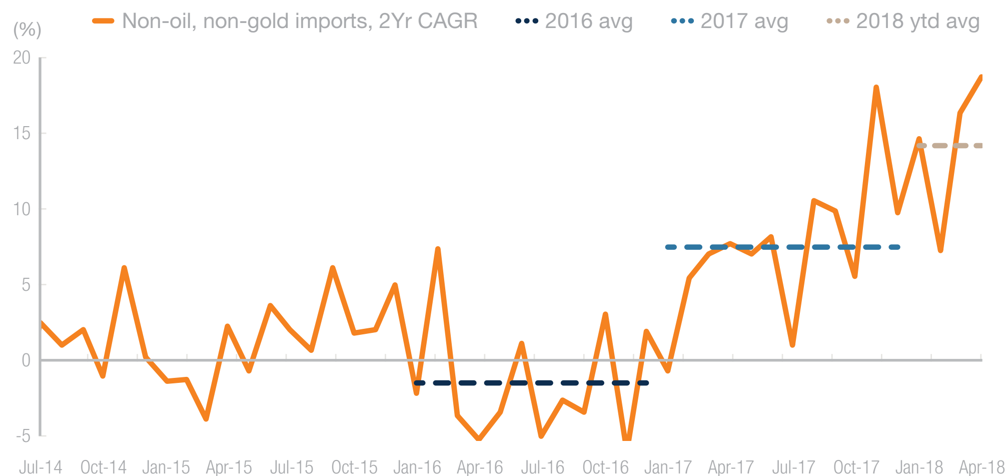
The rupee's depreciation in recent months is a function of USD strength versus EM currencies. Though the rising price of oil is an issue for inflation and the current account deficit (CAD), what matters most is the economic buoyancy and the subsequent tax revenue pick up in the coming quarters. A CAD of approximately 1.5% is likely to be mitigated by higher foreign direct investment (FDI) flows in light of the country's improved economic outlook. We expect annual rupee depreciation to be around 3% to 4%, which is in-line with the inflation differential between India and US.

The Association of Southeast Asian Nations (ASEAN)

Higher US yields and USD have caused concern over the macro stability and growth outlook for the ASEAN region. The 2013 "taper tantrums" led to macro stability risks and external funding pressures amid debt buildup, weak current accounts, higher inflation, and lower foreign reserves. However, this time, macro fundamentals have improved considerably for most countries compared to 2013. We expect Indonesia and the Philippines to begin a tightening cycle. The advanced economic cycle in the Philippines makes a case for higher rates; while Indonesia also faces pressure to increase rates to maintain exchange rate stability.

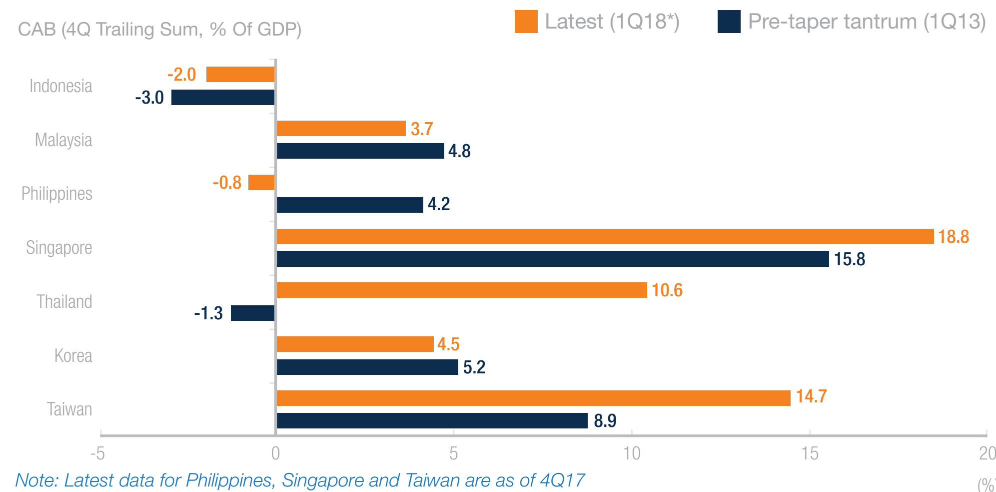
India Imports (non-oil & non gold)

Source: CEIC, CME, Morgan Stanley, May 2018



Current Account Balance (4Q trailing sum, % of GDP)

Source: CEIC, Morgan Stanley, May 2018



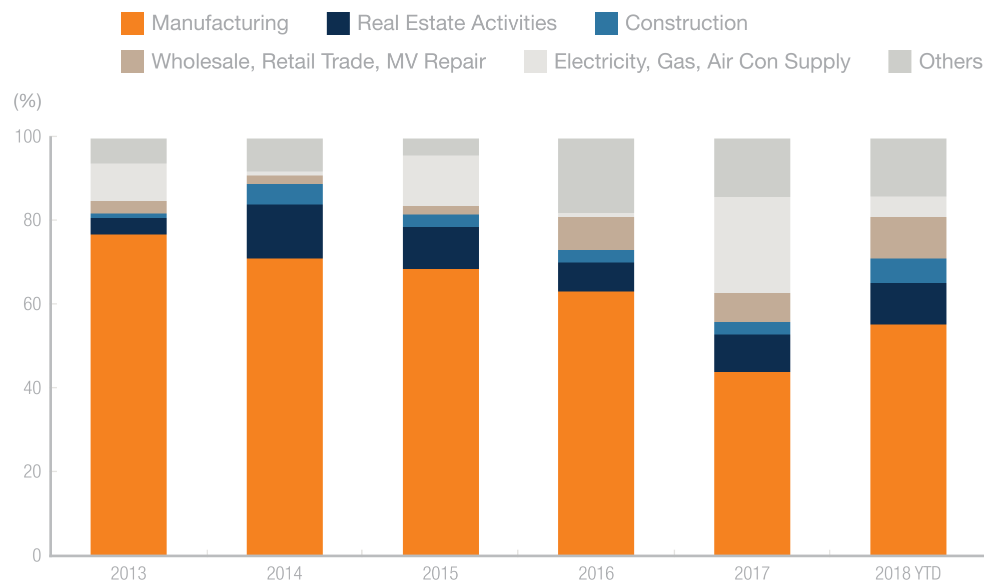
Note: Latest data for Philippines, Singapore and Taiwan are as of 4Q17

Launching the Belt and Road Initiative (BRI) has elevated China's role in filling ASEAN's infrastructure gap. ASEAN now accounts for one-third of China's investment commitments and construction contracts in the BRI regions. China's increasing investments also provide a cushion to the region's external balances.

Though Vietnam is classified by MSCI as a frontier market, we believe the country shows some of the same promise of its EM neighbors. Strong growth has been underpinned by robust reforms, macroeconomic stability and FDI. Furthermore, FDIs in Vietnam are diversifying from manufacturing to other domestic consumption-oriented sectors such as real estate and retail.

Vietnam's annual FDI to various sectors

Source: CEIC, HSBC, May 2018



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LatAm & EEMEA

Latin American and EEMEA equity markets are positioned to perform well through a volatile second half of 2018. While some headwinds remain, we believe that the combination of a low base for earnings, attractive valuations, and high growth rates create strong prospects for both Latin America and EEMEA for the remainder of the year.

Brazil, South Africa, Russia, and Mexico are the biggest countries by market cap in the region. Not only do these countries benefit from higher oil prices (Russia and Brazil more directly than the others), but they each have their own unique momentum drivers as well.

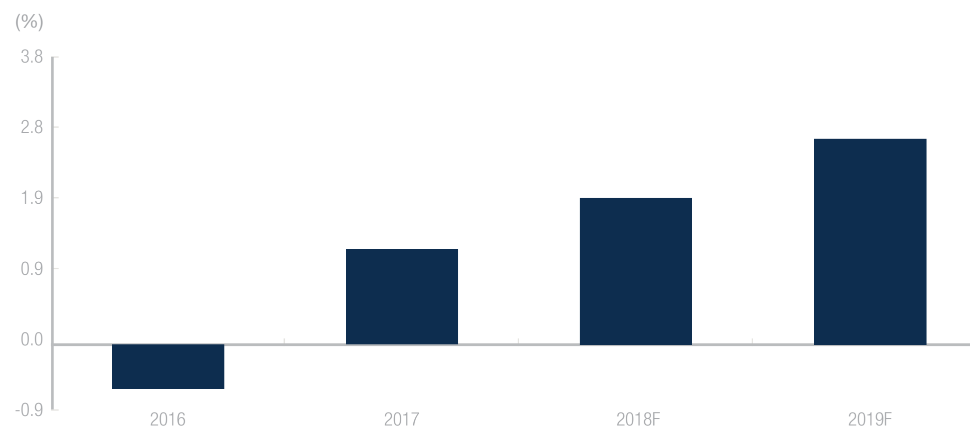
Latin America and EEMEA also present favorable technical and structural opportunities. On the structural side, countries like Peru, Hungary, Poland, and the Czech Republic should continue to deliver robust year-over-year GDP growth. On the technical side, Argentina and Saudi Arabia will be added to the MSCI EM Index in 2019, which could lead to significant inflows to their local stock markets.

Latin America

Latin American countries are benefitting from higher commodity prices and more market-friendly leadership. Governments appear to be shifting back towards prudent and fiscally responsible policies after a long period characterized by populist rhetoric and left-leaning wealth distribution policies. Consequently, we are beginning to see reforms that lead to growing consumer confidence, stronger currencies, lower inflation, and monetary easing cycles. On the other hand, we are also seeing significant hurdles and potential obstacles in the form of Brazilian and Mexican elections, Argentinian inflation, and NAFTA renegotiations.

Latin America GDP Growth

Source: IMF, World Economic Outlook (April 2018)



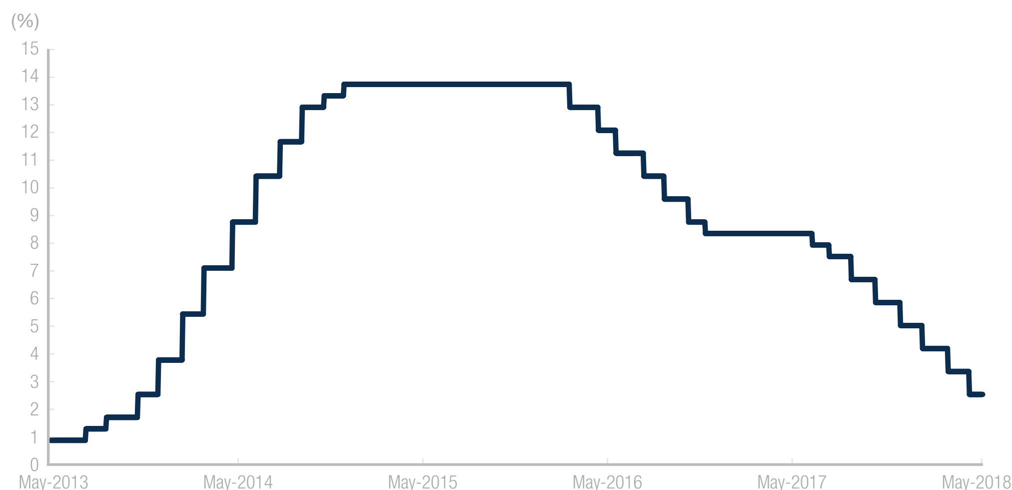
Though we have seen recent strength in the USD, it is important to note that this has not had a negative impact on commodity prices and we believe that the commodity tailwind could offset any perceived headwinds from further adverse USD movements.

Brazil

Brazil started the year on solid footing as one of the best performing EM countries and we are taking advantage of the recent pullback to build larger positions in our high conviction names. The market has retreated sharply on account of a combination of recent USD strength, the trucker's strike leading to GDP downgrades, less conviction on economic reform, and mixed political polls. However, we remain optimistic on Brazil for the second half of the year on account of significantly lower interest rates translating into increased borrowing and a new capex cycle. This should drive lower unemployment, higher disposable income, as well as increased spending and consumption. With former President Lula currently in prison, we believe that there are strong prospects for a market friendly 2018 presidential election. In our opinion, the obvious need for fiscal reform and the recent movement against corruption in the highest levels of Brazil's economic and corporate sectors could prohibit candidates the market perceives as "unfriendly" from running for office and open the door for leaders focused on continuing Brazil's recent movements towards economic orthodoxy.

Brazil's selic rate reaches a five year low

Source: Bloomberg, as of May 30, 2018



Mexico

We have grown less cautious on the Mexican equity market. There has been progress on the NAFTA renegotiation front, but we do not anticipate a resolution ahead of Mexican elections this summer. Despite the recent uncertainty, we have seen rhetoric being toned down as all three sides would prefer an amicable resolution so companies can resume investing for future growth. While we believe the market would benefit from a PRI (Meade) or PAN (Anaya) party victory in the 2018 presidential election, we also acknowledge that the leading candidate, Andres Manuael Lopez Obrador is probably not as populist as the market fears. He was a pro-business leader as mayor of Mexico City and his recent comments in support of Mexico City's new international airport and backing off from the concept of nationalizations depict a more rational candidate than we originally anticipated. We also believe that Mexican inflation has peaked and that the central bank will stop hiking rates, and potentially pivot, within the coming months.

Andean Region (Colombia, Peru, Chile, and Argentina)

Colombia, also in an election year, has been one of the best performing EM's this year on the back of the roughly 16% rise in oil prices. Higher oil prices will allow Colombia to move forward with its much-anticipated 4G infrastructure program, but its dependency on such a vulnerable driver makes the long-term investment weak. In Peru, President Martín Vizcarra seems to be continuing with former President Pedro Pablo Kuczynski's market friendly policies and the country should see strong growth as it is coming from a low base. Chile should benefit from the end of Michelle Bachelet's presidential term, and an investment-driven agenda from President Sebastián Piñera, but growth opportunities remain lukewarm. Lastly, it remains to be seen if the implementation of market-friendly policies in Argentina under President Mauricio Macri will be enough to offset fears of twin deficits, high inflation, and extreme pressure on the currency.

EEMEA

EEMEA contains a wide-range of opportunities based on valuation, growth, economics, and politics. We continue to believe that Russia is both undervalued and well positioned to benefit from a combination of rising oil prices and further monetary easing. Countries in Eastern Europe, which boast some of the best GDP growth rates in the world, should continue to grow, but are vulnerable to a slowdown in Western Europe. South Africa is benefitting from new leadership and structural reforms, which should bring confidence and investment back into the country. Turkey, which historically struggled with fiscal deficits now faces the additional burdens of an executive presidency. Last, though challenged by geopolitical tension, we see opportunities for outperformance in both Egypt and Saudi Arabia in the Middle East/Northern Africa region driven by prudent economic policies and a stable backdrop in the form of energy prices.

Russia

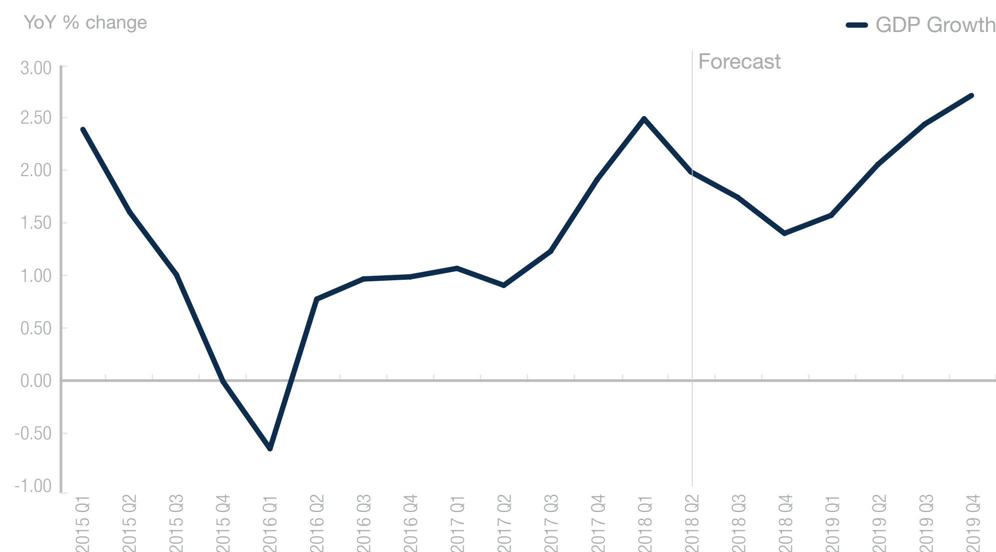
After a strong start to the year, the Russian equity market pulled back dramatically in early April following the US government's announcement of sanctions targeting seven Russian citizens and twelve associated companies, along with seventeen government officials. The greatest significance of these sanctions was that the US added names to the Specially Designated Nationals list, which restricts all business with those companies including holding debt or equity instruments. Increased tension in Syria soon followed and the market saw a dramatic sell-off in the following weeks. With that said, we remain optimistic on Russia due to the strong near and medium term outlook for oil prices, a sound economy going through an impactful easing cycle, and a Russian corporate sector that has been under sanctions since 2014 but did not have to make any dramatic adjustments to operations. The market has come back about 10% since April 9th (as of May 14th), while valuations and growth prospects are some of the best in emerging markets. President Vladimir Putin's reelection should remove any near-term political uncertainty. We do not believe that the removal of sanctions is priced into valuations, but remains a long term positive catalyst, which we do not incorporate into our analysis.

South Africa

We have grown much more positive on South Africa after Cyril Ramaphosa won the election for leadership of the African National Congress (ANC) and then, subsequently, replaced former President Jacob Zuma at the executive branch. Thus far, President Ramaphosa's highlights include 1) removing Zuma, 2) strong changes to the cabinet, including appointing market-friendly finance and mining ministers, 3) gaining majority support in the ANC National Working Committee, 4) reconstituting the board of Eskom and other state-owned enterprises, 5) replacing the allegedly corrupt head of the IRS, and 6) encouraging the National Prosecuting Authority to seize assets of those linked to state capture. These are dramatic, but necessary, reforms which boost confidence and translate into strength for the South African equity market.

S.Africa: Growth is picking up

Source: OECD Economic Outlook 103 database; and Statistics South Africa.



Turkey

Though valuations and the structural story in Turkey appears attractive, the political scenario and macroeconomic uncertainty in the country remain a concern. The index had fallen roughly 26% year-to-date ending May 31st, with about 19% of the detraction coming from currency weakness. As Turkey operates under twin deficits, its external shortfall makes the country particularly vulnerable to USD appreciation. The twin deficits are also facing additional pressure from the spike in oil prices (Turkey is an importer of oil) and the increase in regional geopolitical tension (Turkish revenues are very dependent on tourism). That said, the central bank has made an effort to stabilize the currency via a series of interest rate hikes and a simplification of its base rate model. President Erdogan now operates with the absolute power of an executive presidency. This has allowed him to drive short-term growth via subsidies, but investors see this as unsustainable and his interference with central bank policies bring additional concerns. The government has called for early elections on June 24th. This could reduce uncertainties if it is followed by an orthodox fiscal and economic policy, but, as of now, the outcome remains opaque. Turkish valuations are extremely inexpensive and the market could rally on the back of a shrinking CAD and/or a market-friendly election outcome.

Other EEMEA Countries

As a region, macroeconomic dynamics appear stable on the back of the rebound in oil prices, but geopolitical uncertainty remains prevalent. Egypt continues to perform well, as the government has committed to austerity and unpegged its currency. This has led to improvements for the country's twin deficits. After prudent actions from the central bank, inflation has begun to stabilize, and we are now witnessing the early stages of an impactful rate cutting cycle, which should translate into growth. The country's demographic story also translates into a strong long-term driver. Saudi Arabia is benefitting from recent oil strength, but is going through all of the necessary requirements to open itself up to foreign investors and obtain inclusion into the MSCI Emerging Markets Index.

In Greece, all eyes are focused on the country's ability to pass the third review of its bailout program with the IMF and the Eurozone. A successful review could allow Greece to participate in Europe's QE programs, which would bring down risk premiums and allow investors to focus on fundamentals.

Unpegging the Egyptian Pound

Source: Bloomberg, May 31, 2018.

The CE4 (Poland, Czech Republic, Romania, and Hungary) should continue to boast some of the highest GDP growth figures in the world, but recent weakness in Western Europe has taken much of the wind out of the region's sails. Many of these economies are dependent on Western European demand along with the divestment of European Union infrastructure funds. The region presents relatively educated population bases with attractive tax rates and low costs of labor, which should continue to attract investment through 2018, but investors should monitor the economic normalization process in Western Europe as a key driver as well.

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