MIRAE ASSET
Global Investments

The Time for Bearishness About China May Be Ending

Strategist Report Focusing on China

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The time for bearishness about China may be ending

The global equity market has experienced substantial volatility, wherein the MSCI ACWI Index fell by more than 10% from the start of January through mid-February but quickly recovered and eventually moved into the green, up approximately 1% for the year.[1] We share investors' concerns that central banks may be losing their credibility, and that there is potentially a profit recession, amid an interest rate regime that seems best described as "lower for longer". Nevertheless, turbulent as it may seem, we see ample investment opportunities in emerging market (EM) equities, which outperformed their developed market (DM) counterparts in both US dollar terms and local currency terms. From its low in January, the MSCI Emerging Markets Index has rebounded nearly 20% through April. While we remain cautious about the possibility of a continued EM market rally, there are several long-term investment opportunities in EM Asia. We believe that investors should revisit their asset allocation strategies, and where appropriate, consider expanding their holdings in EM Asia, especially in China.

[1] As of April 29, 2016.

Confronting Bearish Sentiment

We believe that investors should consider analyzing the Chinese market's potential for robust secular growth before making an asset allocation decision.

Understandably, there are many reasons why global investors remain cautious about EM exposure. With EM underperforming DM for the past five years, only 29% of investors are overweight EM according to an April 2016 survey of fund managers.[2] Specifically for China, many investors expect a bumpy road ahead as the nation transitions from an export-driven economy to a consumption- and service-centered economy. The scale and duration of the Chinese government's largely unprecedented stimulus policies lead some to question the Chinese government's ability to bear the burden of its fiscal and monetary measures. With China's debt-to-GDP ratio exceeding 200%, China is increasingly challenged in its ability to sustain its GDP growth rate. In addition, indications of elevated pressure on the Chinese credit market and shadow banking system have appeared, raising particular concerns for industries already experiencing overcapacity as well as the property market. While we share investors' concerns about the headwinds faced by EM companies, we believe that investors should consider analyzing the Chinese market's potential for robust secular growth before making an asset allocation decision, especially in light of favorable historical evidence.

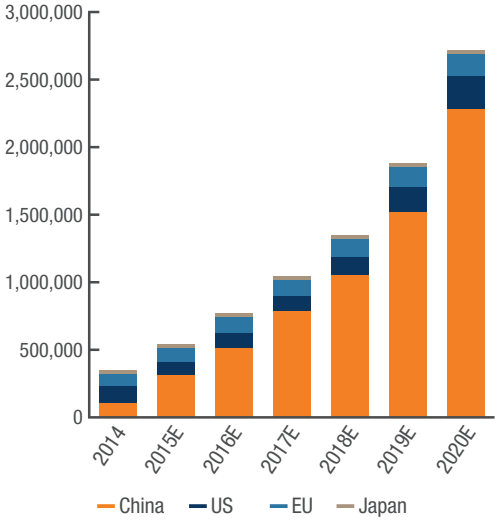
Don't Ignore China's Longer-term Growth Drivers

Plenty of financial market observers have raised concerns over a slowing Chinese economy but we take a relatively contrarian view, studying China's secular growth drivers. The emergence of "New China" points to a profound and durable restructuring, as Chinese manufacturing becomes more sophisticated and services take on a more prominent role in the Chinese economy.

Electric Vehicles

Beijing considers the development of China's electric vehicle (EV) market to be a key strategic goal. The Chinese government specified the development of the "new-energy vehicle" market in recent statements on policy and initiatives. New-energy vehicles are highlighted among technological development objectives in the government action plans "Seven Strategic Emerging Industries" and "Made in China 2025." As sales volume for global electric vehicles reached 549,000 units in 2015, an increase by 72.8% year-on-year, China contributed to 60.3% of the units sold (331,100 vehicles).[3] With a year-on-year surge of 343%, China became the world's leading EV market in 2015. Forecasts for China's EV sales reach above 2 million units by 2020, and China's goal is even more ambitious, aiming for sales of 3 million units. Regardless of the magnitude of growth in this industry, we see huge potential not only in sales for the EV industry itself, but also throughout the value chain associated with EVs.

Global Sales: Electric Vehicles & Plug-In Hybrid Electric Vehicles



Source: Macquarie, Mirae Asset Global Investments

[2] Source: Bank of America Merrill Lynch Fund Manager Survey, April 2016.
[3] Source: "Global and China Electric Vehicle Industry Report 2016-2020," Research in China, Reportsnreports.com.

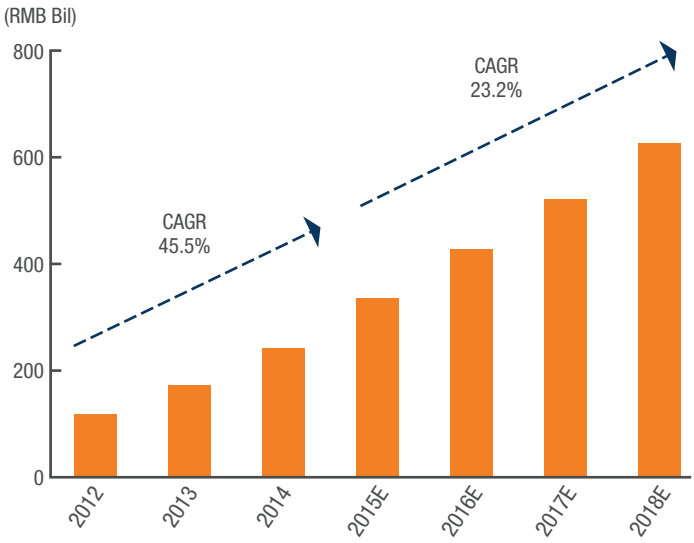
Online-to-Offline (O2O) Global Leader

China has established itself as the global leader in the online-to-offline or "O2O" segment of the retail industry. The goal of O2O is to entice online users to visit brick-and-mortar stores for purchases, a capability at which Chinese retailers excel. China announced a new economic model, "Internet Plus," which requires the integration of internet technology with traditional industries. China's O2O objective is focused not only on revamping traditional e-commerce, but encompasses larger goals of using analysis of "big data" to enhance all facets of consumption, including education, healthcare and social media.

Robotics & Automation

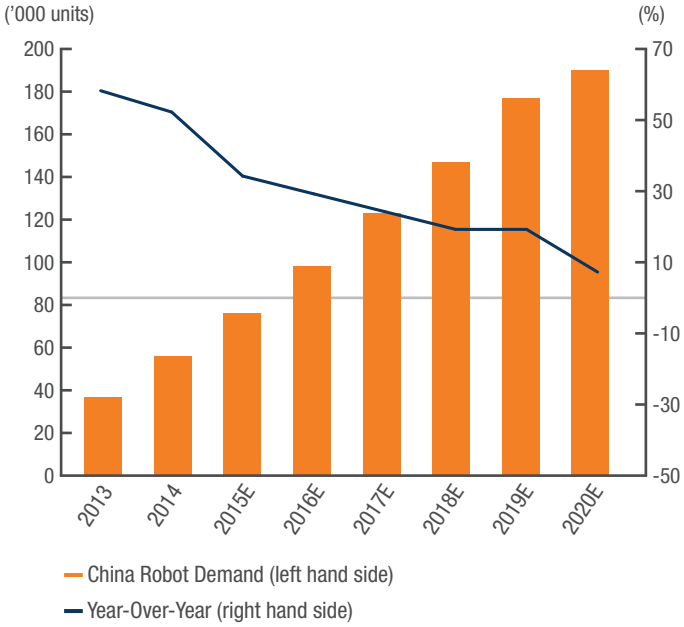
Rapid progress in the development of robotics is another trend that we observe emerging in China. As labor-intensive industries in China are rapidly losing competiveness because of rising labor costs, China has turned to robotic automation. Robotics is a key component of the "Made in China 2025" action plan, publishing supportive policies to stimulate research and development and manufacturing of robotics. By 2018, China will likely account for more than a third of industrial robot sales globally, positioning the nation as the world's largest market.

The Scale of China's O2O Industry



Source: iResearch, Samsung Securities. CAGR = Compounded Annual Growth Rate.*

Industrial Robot Sales in China at CAGR 23% in 2014-2020E



Source: CLSA. CAGR = Compounded Annual Growth Rate.

*This figure does not reflect a measure of performance for any mutual fund.

Estimates are only projections and not guarantees.

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Technical reasons to evaluate EM stocks in Asia

If more favorable markets move these indexes closer to their long-term average levels, then the arithmetic points to an opportunity in EM stocks that is greater than in DM stocks.

Reversion to historical mean performance

In addition to the longer-term growth drivers, there are reasons for investors to consider the current market as a potential entry point to increase an allocation to EM stocks and to Asian stocks in particular. The past five years, during which DM has persistently outpaced EM, are somewhat anomalous by historical standards. For the ten years ended March 31, 2016 the average annualized return in US dollars for the MSCI Emerging Markets Index is 0.61% while the comparable figure for the MSCI World Index is 2.13%. Over the trailing year, each index is underperforming its long-term average, but by dramatically different degrees. The EM index is 1,475 basis points behind its 10-year average while the DM index is only 745 basis points below its 10-year average. Moreover, the MSCI EM Asia index is a whopping 1,735 basis points behind its 10-year average. Such a significant departure from the long-term average could be an indicator worth considering. If more favorable markets move these indexes closer to their long-term average levels, then the arithmetic points to an opportunity in EM stocks that is greater than in DM stocks as the indexes revert to their historical mean performance levels.

Significant Deviation from Historic Average Index Levels

Source: Bloomberg

Attractive current valuation levels

In addition to deviations from the historical average index levels, valuations for EM stocks have become relatively attractive when compared with DM stocks, especially on a price-to-book (P/B) basis. The average P/B ratio for EM versus DM has reached a level not seen since 2002. We believe that Asian companies are generally priced below fair value and measurements of relative P/B ratio suggest that the gap between market price and fair value has grown in recent years, especially since the market has likely priced in a number of negative factors for many EM companies. Historically, such extreme positions have been followed by periods of outperformance by EM stocks as equity markets recover.

Underinvestment in EM companies

In terms of relative capital flows, EM has suffered from continued capital outflows since 2013, resulting in the widened gap between EM and DM. Yet, given the change in market conditions, we anticipate that mean-reversion could drive capital into EM equities in the medium term. In our analysis, the decreased allocation to EM equities we witnessed among many institutional investors in recent years can be considered a tactical re-positioning that has remained in place for longer than typical for such allocation moves. Now, however, global market movements have led a number of investors to reexamine their tactical weightings or even to reevaluate their asset allocation strategy. As investors restore their EM equity allocations to equal-weight with their targets or reduce net short positions, capital may flow back into EM.

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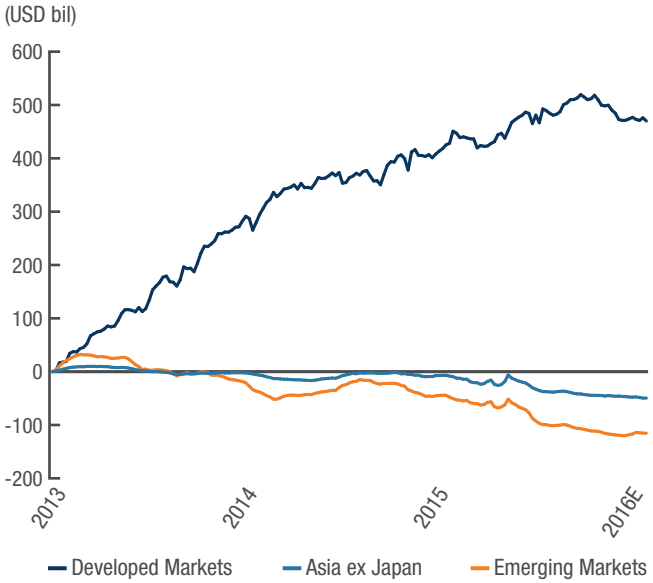
EM's Relative Valuation Returns to 2002 Levels

Source: Bloomberg

Estimates are only projections and not guarantees.

Equity Fund Flow Has Favored DM



Source: EPFR

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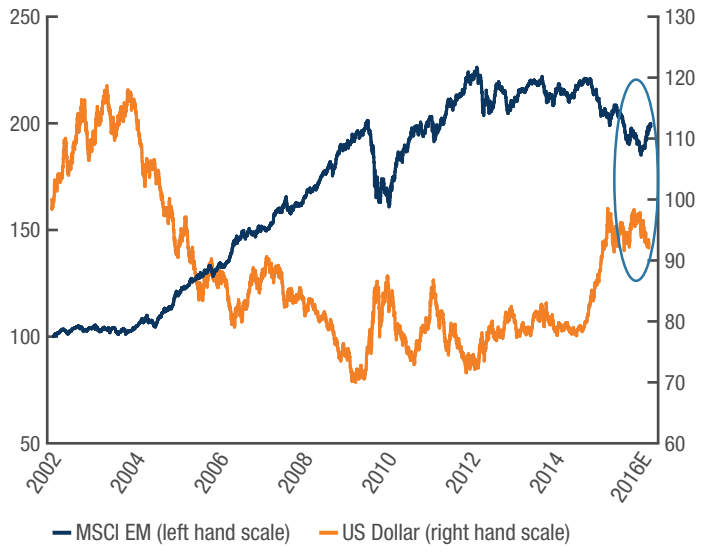
The weakening of the dollar was driven by the US Federal Reserve's decision to hike interest rates at a pace slower than the market had originally anticipated.

US Dollar Stabilization

In terms of the foreign exchange or FX markets, EM currencies historically have shown negative correlation with the US dollar, with EM currencies growing stronger as the US dollar weakens. Since the beginning of 2016, the US dollar has slid by 4.2% against a basket of currencies as measured by the US Dollar Index. We agree with the widely held assessment that this weakening of the dollar was driven by the US Federal Reserve's decision to raise interest rates at a pace slower than the market had originally anticipated. The weaker US dollar has, in turn, led to a rebound in EM currencies by 4.6% YTD.[4] Since a stronger US dollar hurts many US companies' earnings and further rate hikes may cause a rout in the global markets. We believe the Fed will remain more cautious about the pace of interest rate hikes. We also believe that a further appreciation of the US dollar is likely to be limited, and, as a result, EM currencies are likely to stabilize in the current interest rate environment.

USD Weakens as EM Currencies Strengthen



Source: Bloomberg

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[4] Measures the MSCI Emerging Markets Currency Index through April 30, 2016.

Bright Corporate Profitability from "New China"

In terms of profitability, our outlook for earnings in the Chinese equity market is mixed as we observe MSCI China's earnings have been revised down by 2% in 2016. Energy, Telecommunications, and Materials are suffering the most from MSCI's downgraded earnings outlook. On the other hand, positive earnings momentum is anticipated to continue for the consumption-driven New China sectors and industries including Health Care, Consumer Discretionary and Internet. Similarly, while most of the industries in China have experienced a gradual decline in return on equity (ROE) over the past five years, New China industries (e.g., information technology) have delivered the highest growth in ROE. We expect these discrepancies among different sectors will be widened by the continuing support of New China from the Chinese government.

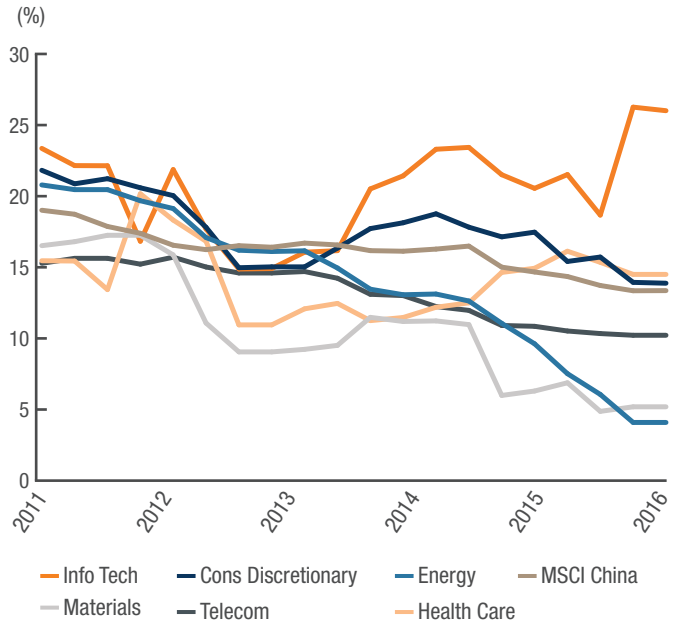
Earnings Revision by Sector (MSCI China)

SECTOR	1 MONTH	3 MONTH	YTD	5 YEAR
MSCI China	-0.5	-5.2	-2.0	-6.0
Energy	-18.4	-50.7	-56.7	-85.8
Material	-7.8	-13.6	-3.7	-62.3
Industrial	-2.5	-4.9	1.9	-15.7
Consumer Discretionary	-0.4	-6.0	7.2	-27.5
Consumer Staples	0.2	-7.2	-0.6	-44.3
Health Care	-2.5	-1.7	16.0	30.8
Finance	-1.1	-3.1	-2.4	33.1
Information Technology	13.4	6.6	26.0	110.8
Telecom Services	-2.1	-7.1	-3.9	-6.5
Utilities	0.6	-1.6	-2.3	112.1

Downgrade Upgrade

Source: Bloomberg

"New China" Sectors Lead the Index by ROE



Source: Bloomberg

Conclusion

Despite the recent strength in the equity market, many investors are still reluctant to invest in EM because of its underperformance over the last several years. As described above, EM Asia, especially with China at the forefront, may present an attractive opportunity on a risk-return level to build or expand an allocation. Long-term secular trends in Asia and improving margins in select companies can serve as an investment opportunity, and with investors' positioning skewed heavily towards underweight in EM, EM Asia could serve as a source of positive relative performance for global investors going forward.

DEFINITIONS AND IMPORTANT INFORMATION

Gross Domestic Product (GDP) is the monetary value of all the finished goods and services produced within a country's borders in a specific time period.

MSCI ACWI captures large and mid cap representation across 23 Developed Markets and 23 Emerging Markets countries.

MSCI China Index captures large and mid cap representation across China H shares, B shares, Red chips and P chips.

MSCI Emerging Markets (EM) Asia Index captures large and mid cap representation across 8 Emerging Markets countries. With 550 constituents, the index covers approximately 85% of the free float-adjusted market capitalization in each country.

MSCI Emerging Markets Index is a free float –adjusted market capitalization index that is designed to measure equity market performance in the global emerging markets.

MSCI World Index captures large and mid cap representation across 24 Developed Markets countries.

Price-to-Book Ratio (P/B) is the ratio of the share price of a publicly-traded company to its book value per share, which is the company's total asset value less the value of its liabilities.

Return on equity (ROE) is the amount of net income returned as a percentage of shareholders equity. Return on equity measures a corporation's profitability by revealing how much profit a company generates with the money shareholders have invested.

US Dollar Index (DXY) is an index (or measure) of the value of the United States dollar relative to a basket of foreign currencies, often referred to as a basket of US trade partners' currencies.

About Mirae Asset Global Investments

Mirae Asset Global Investments manages investment strategies for clients across the globe. With over $82 billion in total assets under management (as of March 2016), and over 600 employees, including 138 dedicated investment professionals, Mirae Asset offers a breadth of emerging markets expertise. Mirae Asset's offices are located in Australia, Brazil, Canada, China, Colombia, Hong Kong, India, Korea, Taiwan, the U.K., the United States and Vietnam.

We focus on actively managed emerging market-focused portfolios through a bottom-up investment process rooted in on-the-ground research. Mirae Asset Global Investments is recognized as one of the world's largest emerging market equity investment managers* and has one of the largest teams of investment professionals dedicated to emerging markets. Our worldwide team of portfolio managers, analysts and strategists maintains proximity to the investment opportunities that we research, allowing a deep understanding of companies and the cultures in which they operate.

www.miraeasset.com

*Source: *Investments & Pensions Europe,* November 2015.

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