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Global Investments

2017 Emerging Markets Mid-Year Update

Synchronous Recovery

2017 Emerging Markets Mid-Year Update

At-A-Glance

U.S. and Europe

- The normalization of monetary policies
- International trade agreements
- Return to growth

Key Events & Trends

- **Politics & Central Banks:** global political changes, monetary policy normalization, and rate cycles
- **China's Soft Landing:** balance between growth and tightening
- **The EM vs. DM Differential:** growth, valuations, and returns

Latin America

- Political and economic reforms
- Monetary easing
- The beginning of an investment cycle

Eastern Europe, Middle East & Africa

- Boosted by Western Europe's rebound
- Beneficiary of higher oil prices
- Potential for political change

Emerging Asia

- Export upswing supported by global cyclical recovery
- Improving demand conditions
- Private corporate capex

Executive Summary

Emerging market (EM) equities delivered strong returns in the first half of 2017, outperforming key developed market (DM) equity indices such as the S&P 500. Strong performance has come on the back of a rally in commodity prices, inflationary measures in the US, and market-friendly elections in Europe. Looking forward to the second half of the year, we are paying close attention to political events, central banks across the globe, Chinese tightening, and the valuation and growth differentials between emerging and developed markets.

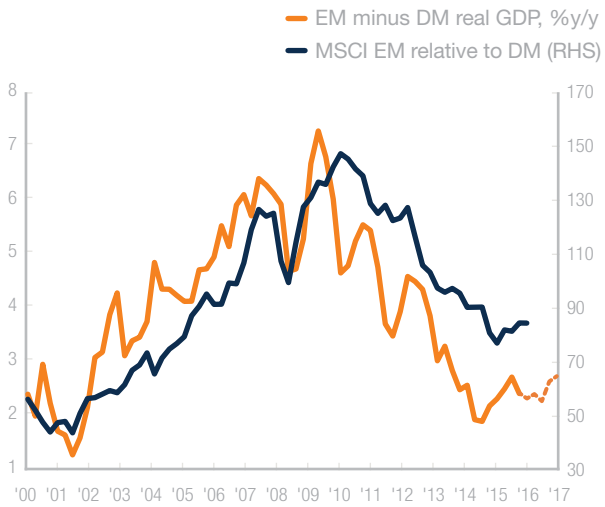
In Asia ex-Japan, markets have performed well with fundamentals improving as a result of a synchronous global cyclical recovery. Our outlook is broadly positive, particularly for China, South Korea and India, which are more export-oriented than other economies in the region. With improving external demand conditions, we should see a further pickup in private capital expenditures, which will likely drive the next leg of the recovery.

In EM ex-Asia, we are optimistic about central bank rate cutting cycles in Russia and Brazil, US and European growth spillover into Mexico and CE4 (Czech Republic, Hungary, Poland and Romania), and potential political catalysts in Brazil, South Africa, Argentina, Chile, Peru, Greece, and Mexico. These markets are growing from low earnings bases, which create the opportunity for strong year-over-year growth rates.

After a multi-year period of underperformance, the International Monetary Fund (IMF) now projects annual gross domestic product (GDP) in EM countries to accelerate every year until 2021 while DMs are expected to decelerate from 2018. This positive change in growth trajectory for EM countries, in combination with the significant underweight from global investors and positive company and country specific momentum stories, should translate into a re-rating for the asset class as we step into this next investment cycle. Overall, we expect EMs to continue outpacing DM equities on account of positive momentum, higher growth rates, and attractive valuations, creating a strong opportunity for the second half of 2017 and beyond.

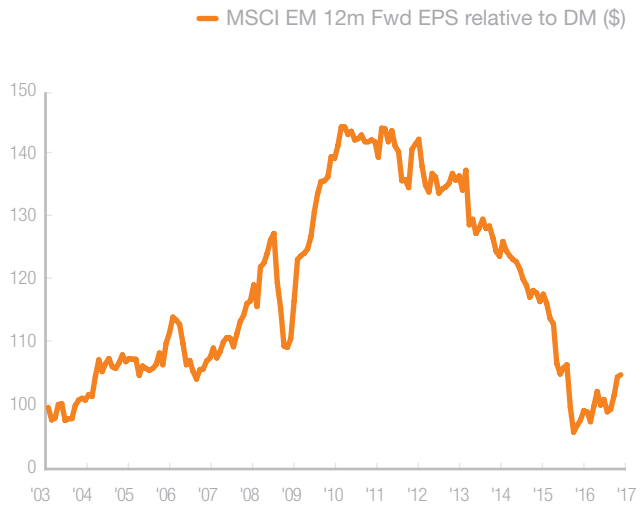
Higher EM Growth vs. DM

Source: Datastream, J.P. Morgan (March 2017)



EM Earnings to Outpace DM

Source: Datastream, IBES (March 2017)



Equity Market Valuations

Source: Bloomberg Research Affiliates (March 2017)

Key Events & Trends

Political Events & Central Banks

The second half of 2017 will likely be influenced by US and European political agendas and actions from the world's key central banks. While the US continues to raise rates, signaling a healthy US economy, the market is now focusing on European economic numbers to see when the group of sovereigns will follow. On the opposite end of the spectrum, both Russia and Brazil are in the midst of rate cutting cycles, which could deliver stronger prospects for growth.

In Latin America, all eyes are on Brazil's ability to push through reforms in the midst of the second presidential corruption scandal in as many years. NAFTA negotiations between Mexico and the US will also be influential. In South Africa, the market is paying close attention to fourth quarter ANC elections and near-term actions from sovereign rating agencies. Terrorism, regional stability, and political reactions in the US, Russia, Europe, and Middle East will also be important stories to follow for the remainder of the year.

China's Soft Landing

The delicate balance between China's sound economic figures and the government's tightening policies will likely have global repercussions. Not only does this impact global trade, but it also has a large effect on commodity prices. There is skepticism around the sustainability of the government programs and whether the strong economic figures can continue. However, a real supply-side adjustment in tandem with stronger Chinese demand could start a new cycle for export-focused EM countries. We believe that Chinese growth will moderate softly, as China increases tightening to address financial stability risk. More importantly, we believe that the tightening moves are coming in a slow and steady manner and would not disrupt the global economy.

The EM vs. DM Differential

After half a decade of missed expectations, we take a constructive view on the EM equity asset class due to a rare combination of cheaper valuations, higher growth, and positive momentum.

EM equity valuations are coming from an extremely low base and global investors are still approximately 6% underweight the asset class. This has led to a 30% discount in valuation vs. DM counterparts.[1] We believe this is counterintuitive given the growth outlook for EM countries relative to DM counterparts.

After years of decline, the IMF now expects annual GDP in EM countries to accelerate in the years ahead while DMs decelerate from 2018, leading to a higher EM-DM growth differential. The change in expected growth rates has turned positive for emerging markets for the first time since 2010. As such, these vibrant dynamics are supportive for investors who can identify secular trends and those sector-leading companies that can disrupt categories as sustainably competitive players.

Headwinds & Tailwinds

Headwinds

- Regional instability in the Middle East and heightened North Korea tensions with the US and its neighbors (China and South Korea)
- Political volatility in South Africa and Brazil
- Rising interest rates in the US

Tailwinds

- Potential political reform stories in South Africa, Brazil, Argentina, Chile, and Peru; monetary easing policies in Brazil and Russia
- Spillover from strong economic growth in the US & Europe and robust capex pickup
- China's cyclical strength greater than expected

[1] Bloomberg, Mirae Asset Global Investments (June 2017)

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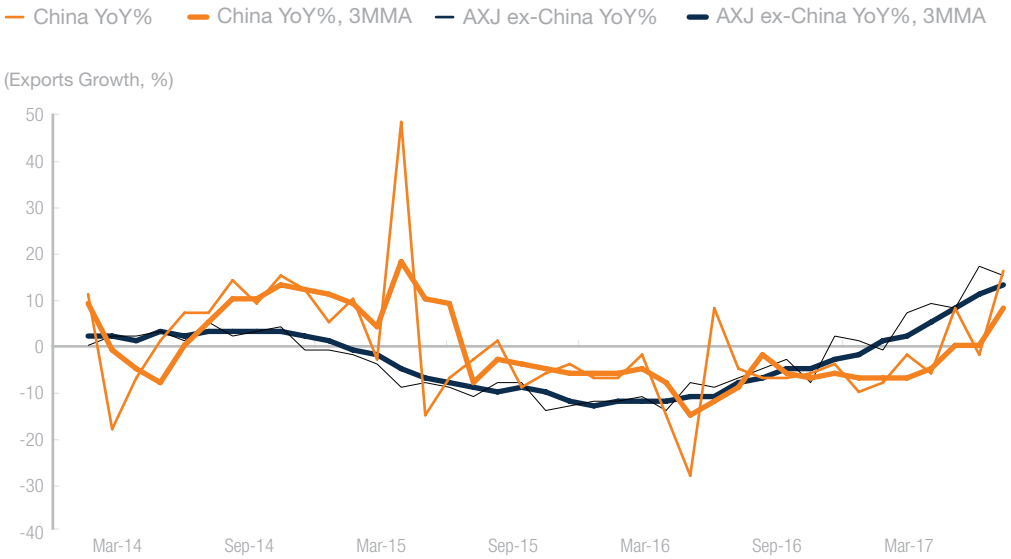
Asia ex-Japan

Asia ex-Japan will continue to benefit from a synchronous global recovery. The upswing in the global trade cycle should support economic growth, reduce disinflationary pressures, and help policy makers better manage the deleveraging process.

We expect growth in export-oriented economies such as China, Hong Kong, and South Korea to be stronger than in more domestic-oriented economies such as the Philippines and Indonesia. In our view, the overall environment will remain supportive of an upturn in nominal GDP growth, which will, in turn, give companies an incentive to invest. This shift towards private corporate capex should help ensure better quality of growth.

Improving Global Growth Ensures Export Recovery

Source: CEIC (March 2017)



China

China started the year with a strong first quarter as real GDP growth accelerated 0.1% to 6.9% year-over-year (YoY), beating expectations. Corporate earnings results were also impressive as a whole. Consumer sentiment and retail spending remain strong, as retail sales grew 10.7% YoY, compared to 10% YoY in May 2016.[2]

In light of recent calibrated tightening measures by Chinese policymakers, we expect growth to soften slightly and the pace of increase in the debt-to-GDP ratio to slow. As China is looking to open its financial services and capital markets to foreign participation, calibrating credit growth in the economy is becoming more imperative from a macroeconomic stability perspective. Given that the growth momentum in the first quarter of 2017 was strong and the external backdrop remains healthy, this should be enough to absorb the impact of China's policy shift.

MSCI has announced it will include China A-shares in the MSCI EM and MSCI ACWI market indices. Following three prior unsuccessful proposals, this 'yes' decision marks an important milestone in the integration of A-shares with global equity markets. While the initial inclusion factor is low at 5%, we believe this is an endorsement of the country's developing equity market and a positive catalyst for overall sentiment.

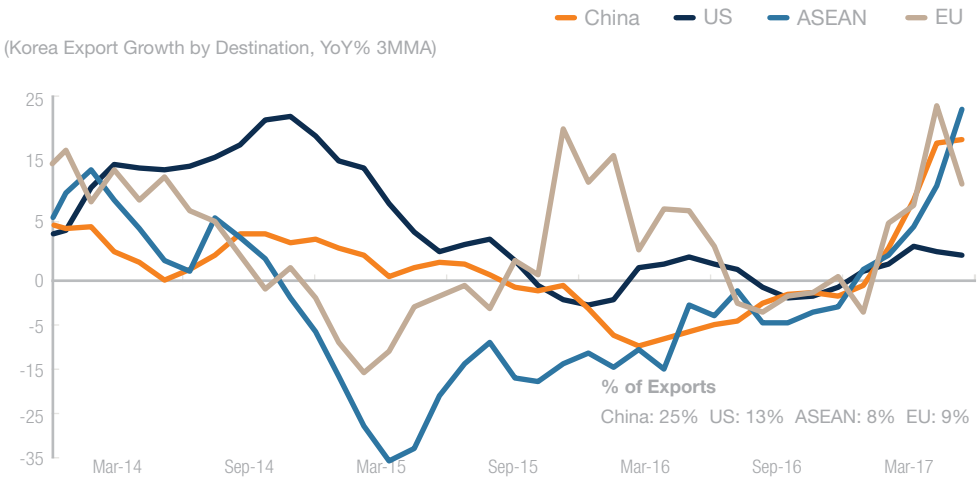
Northeast Asia

South Korea has performed well this year. Exports have picked up and the political issues which plagued the nation now seem largely resolved following the election of the new president, Moon Jae-in. Our view is that the South Korean economy will continue to be a key beneficiary of the global recovery, supported by export growth. The income recovery will likely help slow down the increase in debt-to-GDP ratio and possibly enable the private sector to deleverage its balance sheet.

[2] Mirae Asset Global Investments (2017)

South Korea Exports Broad-based Recovery

Source: CEIC (March 2017)



We expect the South Korean consumer names impacted by the THAAD conflict to pick up in the second half of 2017 as the political situation with China improves. Mr. Moon's chaebol (family-run conglomerates) reform agenda should also be positive in the long-term and lead to improved corporate governance and corporate cash outlay.

Taiwan's central bank maintained its policy interest rate at 1.375% for the fourth consecutive quarter. Taiwan's export growth moderated in recent months on softening exports of electronic components. Economic growth is expected to slow slightly in the second half of the year and inflation is likely to remain benign.

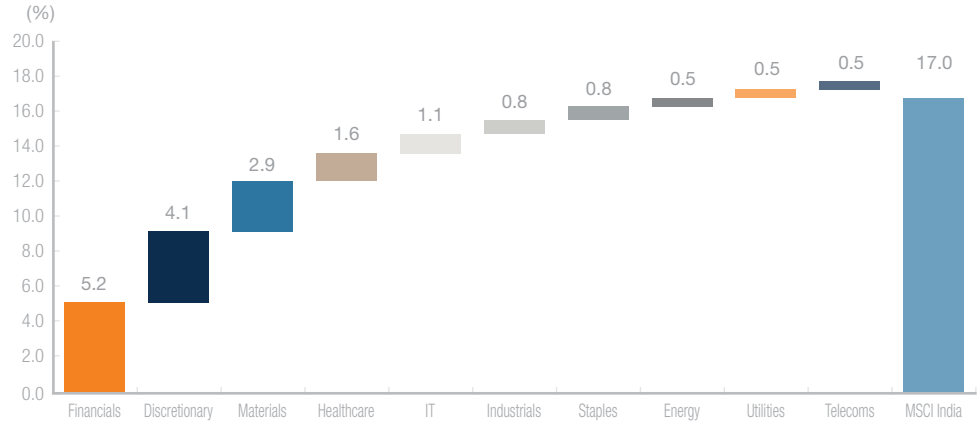
India

The Modi government continues to implement reforms aimed at improving the country's infrastructure and institutional framework. GDP growth decelerated in the first quarter as a result of idiosyncratic issues such as the impact of demonetization. Fast moving consumer goods, pharmaceuticals and liquor companies are expecting a de-stocking by wholesalers and retailers ahead of the Goods and Services Tax (GST) implementation. Some GST-related disruption is expected in the third quarter, but the GST should bring productivity improvement in the medium-term.

Indian equity markets have rallied strongly since the beginning of the year and we think valuations are now relatively expensive. However, an earnings recovery later in the year should support the market.

India's Sectoral Growth Composition

Source: MSCI, IBES, Datastream (March 2017)



The Association of Southeast Asian Nations (ASEAN)

The cyclical outlook for ASEAN has improved due to a pickup in the global economy. In the Philippines, domestic demand has ameliorated and increased infrastructure spending has led to twin deficits. The key near-term issues are the appointment of the next governor of the central bank, and pending legislation on tax reform. Standard & Poor's upgraded Indonesia's credit rating to investment grade and this led to the immediate rerating by the market. Given the reversal of the commodity rally, some structural rebalancing is needed to lift medium-term growth prospects.

Latin America & Eastern Europe, Middle East and Africa (EEMEA)

Latin America and EEMEA are coming from low bases of growth, which creates the opportunity for strong year-over-year improvements in the second half of the year. The largest economies in both regions, Brazil and Russia, are in periods of meaningful monetary easing.

Other factors for growth in these regions include politics and commodity prices. Many countries in Latin America, including Brazil, Argentina, Peru, and Chile, have new or forthcoming elected officials that are considered more market-friendly and fiscally responsible than their predecessors. Regarding commodities, Russia, Brazil, Mexico, and Middle Eastern nations should all benefit from OPEC's production targets leading to higher oil prices. Brazil, the Andean countries, and South Africa should benefit from attractive supply and demand dynamics for metals.

Overall, we believe that the combination of a low base for earnings, attractive valuations, and high growth rates create strong prospects for the second half of 2017 for Latin America and EEMEA.

Latin America

After a long period of populist rhetoric and left-leaning wealth redistribution, Latin American governments seem to be shifting back to prudent and fiscally responsible policies. In turn, we are seeing reforms that lead to greater consumer confidence, stronger currencies, lower inflation, and increased prospects for growth. Brazil is in the midst of its second presidential scandal in as many years, yet we remain optimistic that the country can maintain its positive momentum through the 2018 election cycle. Mexico stands to benefit from the strong US economy, continued reforms, and potentially a more friendly-than-expected NAFTA renegotiation. Chilean President Michelle Bachelet's left-leaning policies have made her unpopular, and the market is anticipating market-friendly candidates in the fall election. We are already seeing positive impacts from the market-friendly policies of President Macri in Argentina and Kuczynski in Peru. Colombia's government should benefit from higher oil prices, which will allow the country to move forward with its much-anticipated 4G infrastructure program. Lastly, Argentina has moved forward with centrist reforms and could enter the MSCI EM index next year.

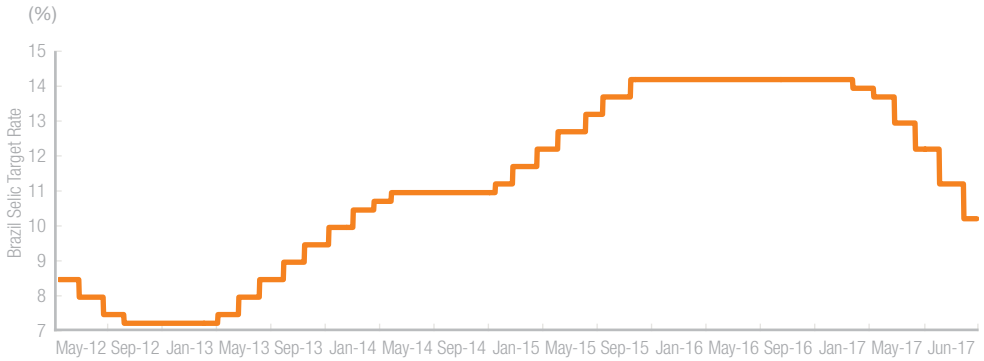
Brazil

We remain optimistic on Brazil despite recent political uncertainty. After several years of economic challenges and a soaring fiscal deficit, the judiciary system has attacked corruption, the central bank has brought inflation back within its targets, and government reforms are bringing confidence back to the private sector. On the negative side, President Temer, who had acted as a champion for necessary fiscal reforms, is in the midst of corruption charges and could face impeachment or requests for resignation. This brings a sense of uncertainty to the reform agenda, which translates into near-term price volatility.

That said, this volatility also presents an opportunity to build positions at attractive valuations in a country with a positive longer-term outlook. The combination of Brazil's improved fundamentals, a seemingly independent central bank, a powerful judiciary system, and a bright outlook for 2018 elections should provide a backdrop for asset price appreciation.

Brazil's Central Bank Interest Rate

Source: Bloomberg, Mirae Asset Global Investments (June 2017)



Mexico

The Mexican equity market has rebounded strongly since the US election, but uncertainty still looms around the 2018 Mexican election and NAFTA trade renegotiations. The initial uncertainty on the outlook for Mexico was based on fears of a protectionist US government and higher domestic inflation. That said, Mexican equities should continue to outperform on the back of growth and market-positive politics. Mexico's GDP continues to see upwards revisions based on strong exports, private investments, and as a leveraged play on the strong US economy. The US has eased off of its aggressive NAFTA renegotiation rhetoric and seems open to a mutually beneficial agreement. We are beginning to see strong 2018 election candidates emerge from the PRI and PAN parties, which should ease fears concerning the rise of the Moreno party.

Andean Region (Colombia, Peru, Chile, Argentina)

The Andean region has a diverse outlook, with the brightest storyline coming from Argentina.

Argentina maintains a bright outlook despite not entering the MSCI EM index in the June review. The MSCI determined that although Argentina had presented the necessary requirements for inclusion into the index, its positive track record was limited and that it should remain on watch for another year. This created a setback for flows, but also an attractive entry point into the market, as the country should move into the index next year and could see more positive reforms after this year's mid-term elections. President Macri has shown a commitment to step away from Peronism and Kirchnerism with market-friendly policies that cut spending, raise revenues, and allow the country to tap capital markets and begin reinvesting in infrastructure. In addition, the central bank is working to bring inflation below 10%.

Peru is structurally the strongest market in the Andes. Pedro Pablo Kuczynski has proven himself as a centered, market-friendly president who is committed to investing in the country's infrastructure. Peru experienced setbacks due to floods, which have hampered its 2017 growth outlook, but we see this as an opportunity to invest at attractive valuations and we maintain an optimistic view on the country.

Though Chile is in an election year, we see the market presenting a lukewarm investment environment. Equities should welcome the exit of President Bachelet and the entrance of any of the leading candidates, but the current government has created structural challenges (bicameral voting systems) that will make it more difficult for a new leader to pass necessary reforms. Chile's market is also correlated with copper prices, which have had a strong first half of 2017 but may face headwinds given China's outlook for tightening, which would reduce demand.

Colombia's growth prospects depend on rising oil prices, which would allow the country to move forward with its entire 4G infrastructure program and avoid draconian taxes.

EEMEA

We believe that countries in Eastern Europe have the strongest earnings prospects for the second half of 2017. Russia is well positioned to benefit from rising oil prices and lower domestic interest rates and CE4 countries are benefitting from economic growth returning to Western Europe. South Africa faces structural challenges, but they may be overcome with political reform. Turkey faces dual headwinds from its large fiscal deficit and newfound political system of an executive presidency.

Russia

Russia is poised to return to growth this year following a two year recession. The country is a huge beneficiary of rising oil prices (we are encouraged by the combination of the current low base and OPEC's commitment to production targets through the rest of the year), which trickles down to stronger consumer demand, improved sentiment, and a stronger currency. The improvement of the fiscal balance removes pressure on taxes and provides room for increased public spending, which creates jobs and boosts consumption. It is also worth noting that inflation has come down faster than expected, and allowed the central bank to reignite a powerful monetary easing cycle.

On the other hand, sanctions remain a question mark as President Trump finds himself in the midst of accusations for colluding with the Kremlin throughout his campaign. We do not believe that the removal of sanctions is priced into the equity market (as valuations are trading ~50% below EM), but remains a long-term positive catalyst, which we do not incorporate into our analysis. .

Equity Market Valuations: Russia vs. Emerging Markets

Source: Bloomberg, Mirae Asset Global Investments (June 2017)

South Africa

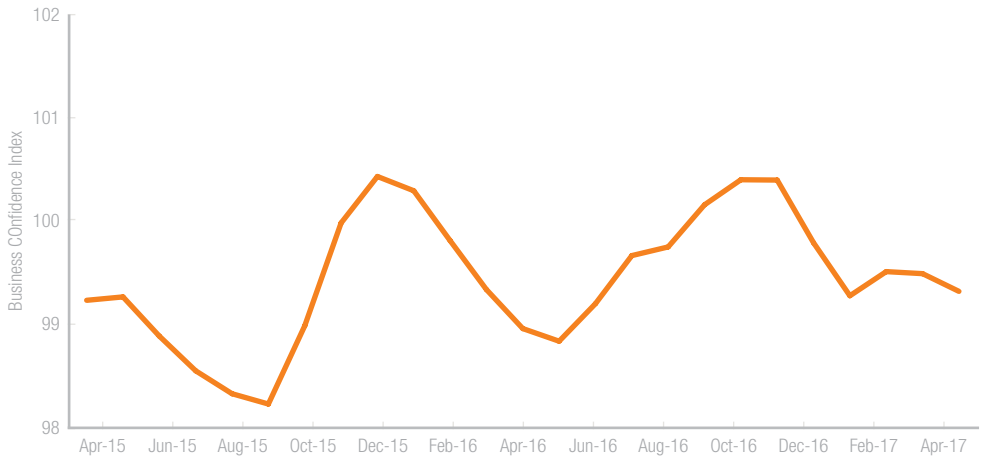
South Africa is approaching a fork in the road. The country is on watch for a credit downgrade to sub-investment grade from rating agencies. This risk was present at the beginning of the year and has now been heightened with President Zuma's removal of Finance Minister Gordhan. This uncertainty leads to a negative effect on risk premiums and sentiment. On the positive side, we are encouraged by rising commodity prices along with the momentum of the disenfranchised population as it speaks out against the ruling party and lays the foundations for eventual political change. The rating decisions and the December 2017 election of a new head of the ANC party (who will be the candidate for the 2018 presidential election) should dominate headlines for the remainder of the year. Though the economy continues to suffer from weak growth and political instability, a new ANC leader could lead to dramatic necessary reforms, which would significantly boost the South African equity market.

Turkey

Turkey remains a concern. The referendum was successful for the AKP party, and President Erdogan now operates with the absolute power of an executive presidency. Though this allows him to drive short-term growth via subsidies, we do not see this as a sustainable situation for Turkey. We are concerned about the country's growing current account deficit, regional instability, and independence of the central bank. That said, valuations are attractive and the market could rebound with global macroeconomic movements.

Business Confidence in Turkey Declines

Source: OECD, Mirae Asset Global Investments (4Q 2016)



Other EEMEA Countries

Middle East markets will continue to be driven by oil prices, regional stability, and the eventual opening of Saudi Arabia to foreign investors. Macroeconomic dynamics appear stable on the back of the rebound in oil prices.

In Greece, all eyes are focused on the country's ability to pass the second 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 reduce risk premiums and allow investors to focus on fundamentals.

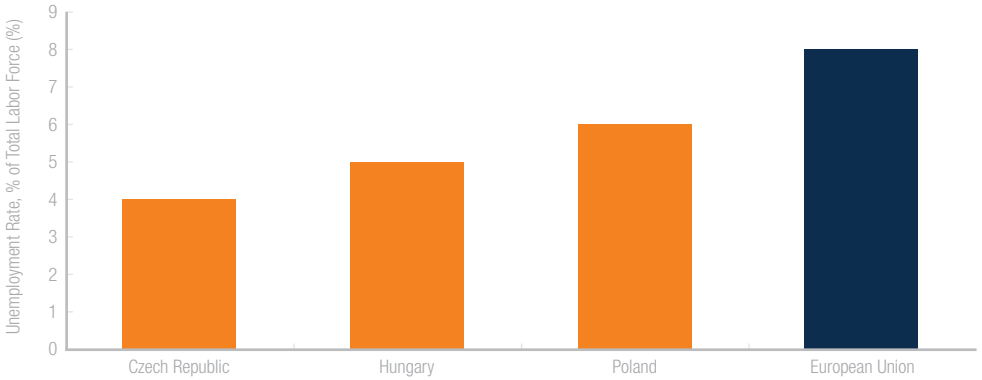
Though Poland had a strong first half of the year, we remain concerned about the PiS party's goal to redistribute wealth via tax increases and subsidies. That said, most of Poland's market is made up of banks who benefit from the global outlook for higher interest rates.

In Hungary, Prime Minister Orban, seems to have moved beyond his populist rhetoric and is gaining popularity through market-friendly moves that have boosted the economy. Orban will face elections in 2018 and has implemented policies such as cutting the corporate tax rate from 19% to 9% and increasing the minimum wage by 15%.

Lastly, we are optimistic about Romania's prospects as it has the best GDP growth in the region and will soon receive EU funds set to boost infrastructure.

Unemployment Rates of CE3 vs. Europe

Source: OECD, Mirae Asset Global Investments (4Q 2016)



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