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Global Investments

2016 Emerging Markets Mid-Year Update

Two-Speed Growth in Asia and Emerging Markets

July 2016

2016 Emerging Markets Mid-Year Update
At-A-Glance

Emerging Market Currencies
- Painful but necessary adjustments over the past five years via foreign exchange (FX) debt, trade balance deficits, and reliance on commodity exports
- Majority of currency adjustments have occurred for a possibly more stable US dollar

Chinese Growth and Commodity Prices
- Incrementally cautious on slower pace of Chinese economic growth and supply-side reforms
- Key issues are inventory cycle, over-capacity, and capital allocation

Political Events and Central Banks
- Important central bank decisions likely to transpire in the second half of the year
- Changing political landscape in developed markets may potentially spillover to emerging markets

U.S. and Europe
- Uncertainty over timing and magnitude of U.S. Fed rate hiking cycle and political election cycle
- Brexit-related sentiment and populist Balkanization frictions

Latin America
- Economic and political inflection points
- Improved competitiveness and positive potential for structural reform, fiscal discipline, and accommodative monetary policy

Eastern Europe, Middle East & Africa
- Political deterioration and regional risks from geopolitics and instability with selectively sound fundamentals
- Benefactor of higher oil price-linked developments

Emerging Asia
- Challenging mid-term outlook for China
- Long-term attractive growth story intact throughout the region due to good demographics, lower debt, and better governance

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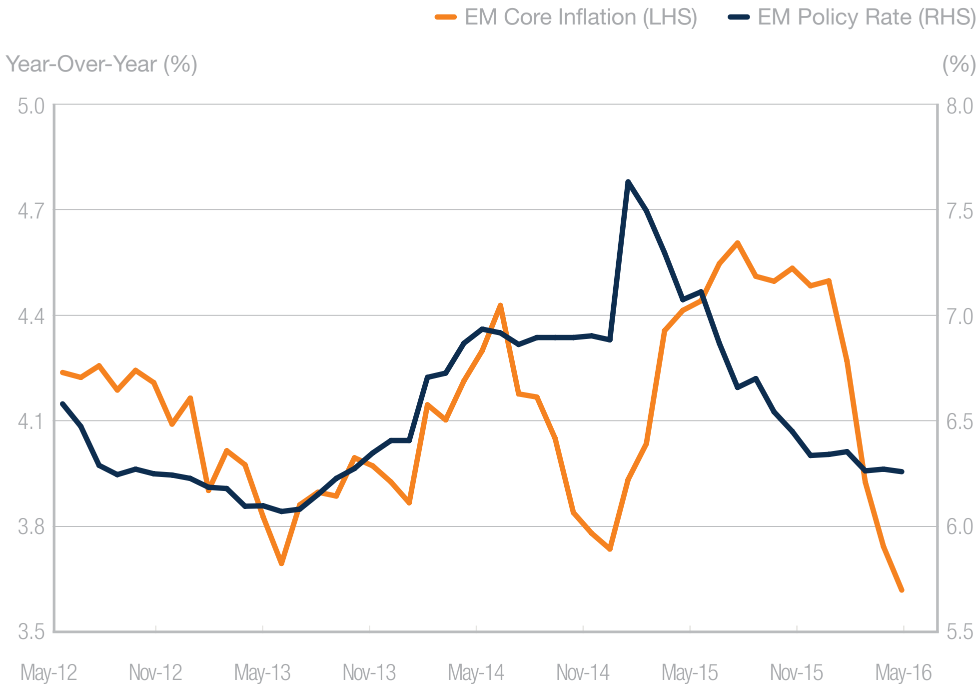
Executive Summary

Emerging Market (EM) equities hit a low in January but since then have been driven higher by U.S. Federal Reserve Bank (Fed) communication, US dollar (USD) weakness, and economic data, particularly from China. Communications from the Fed have become increasingly dovish, leading to a weaker USD against many currencies, which caused commodities to rally and cyclical industries to outperform. The rally in commodities and cyclical sectors was also supported by economic data out of China. Market participants remain skeptical on the sustainability of this environment and the second half of the year will prove pivotal. The purchasing managers' index (PMI) in most EM countries remains around the 50 mark, indicating that growth is still sluggish. We believe that for the outperformance of the asset class to continue, the growth differential between emerging and developed markets needs to widen again. For this to be sustainable, Chinese growth needs to contribute more to global trade. One bright point is that even though leading indicators are not yet suggesting strong growth, earnings revisions appear to have bottomed out. The strong negative correlation between the USD and EM assets continues. Structural current account deficits and the fact that many EM countries are commodity exporters and also large USD debtors keeps this relationship alive. We believe that the USD strength against many EM currencies has helped them fix their trade balances and increased competitiveness.

The second half of the year will bring numerous risks that could lead to increased uncertainty and volatility. Volatility creates opportunity for stock pickers and we see attractive prospects in emerging markets. These risk events include increased uncertainty around the Fed hiking cycle and the data that underlies the Fed communications, the outcome of the Brexit situation, U.S. elections, Greece debt settlements, the Catalan independence movement in Spain and Brazil's Presidential impeachment. Political events globally and domestically will drive risk sentiment in the second half of 2016. Our base case for the remainder of the year is for stable but unspectacular growth driven by healthy consumer demand as consumers gain more confidence. Low, and in increasingly more places negative, interest rates should, in theory, support consumption while inflation and oil prices also remain conducive to favorable tailwinds from disposable income. Lastly, the price of commodities and especially oil will have a big impact on inflation expectations and drive trade balances and domestic monetary policy, which have been important factors for EM sentiment and its growth outlook.

Low Inflation Conducive to Monetary Policy Stimulus

Source: Thomson Reuters Datastream, Bloomberg, HSBC (June 2016)



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Key Events & Trends

▶ Emerging Market Currencies

For the past five years, USD strength has been a key driver of not only EM asset returns, but also of EM economic conditions. Exporting countries have experienced a painful but necessary adjustment in their foreign currency denominated external debt, trade balance deficits, and reliance on commodity exports. The first half of 2016 brought a meaningful reversal of this trend for the first time in years. The ripple effects from stronger commodity prices helped propel the asset class higher. Now, the key question facing investors is whether this is a stabilization of the USD after the market has priced in a Fed rate hiking cycle, or just a pause before we see more EM currency weakness. We believe most of the currency adjustments have taken place and that even if we experience renewed USD strength, the pace would be slower and focused on those countries that have not fully adjusted. We therefore favor countries where we see a material improvement in the trade balance and where there is a lower reliance on near-term external debt financing. We think the direction of the exporting currencies is a very important factor that will determine much of the underlying fundamentals in EM growth for the remainder of the year.

▶ Chinese Growth and Commodity Prices

The uncertainty concerning the pace of growth in the Chinese economy has repercussions all over the world. Not only does it impact global trade but it also has a large impact on commodity prices. Recently, the acceleration of construction in China and its effects throughout the inventory cycle led to a significant rebound in cyclical sectors. There is still healthy skepticism that this was a seasonal phenomenon, but if supply adjustment has caught up with stronger demand then there could be a new cycle for the exporting world in EM.

▶ Political Events and Central Banks

Not only will there be a heavy election schedule in the second half of 2016, but there may also be important decisions regarding the actions of the world's key central banks. The external effects of these decisions will combine with potentially structurally changing domestic political developments in countries like Brazil and South Africa. These events could change the landscape and act as catalysts to EM equities ahead of growth inflection points. At the very least, we believe that the events that influence the political landscape in the developed world may also have spillover effects into EM and the second half will be a crucial timeline.

Regional Overview

▶ Asia

China macro concerns were dominant in the first half of the year, which was characterized by mood swings and volatility. Asia's attractive growth stories continue to stand out in a world seeking demand centers of economic growth. Without clear catalysts for sustainable cyclical recovery, earnings divergence should favor companies and sectors benefiting from structural drivers. These firms are in sectors profiting from the rise of the Asian consumer, such as internet and e-commerce, healthcare, insurance, consumer sectors, and selective retail banks. Despite being more cautious on China, we do not believe a hard-landing is likely. Our preference to invest in business models in "New China" (service-related segments) versus "Old China" (capital-intensive, resources, state-owned enterprises) remains intact. While Northeast Asia faces top-down difficulties, there are bottom-up opportunities. India is a bright spot in the region and in the world, while the Philippines is appealing due to its younger population and robust income growth that is less sensitive to headline uncertainty.

Brexit delays the elusive global recovery as businesses revisit their investment plans for Europe. The direct impact on Asia remains limited, but the energy and bandwidth of the region's multinational companies may be focused on getting their European strategy right. The silver lining, in our opinion, would be benign U.S. monetary policy providing respite for the Chinese authorities managing the transition to a consumption-based economy. Uncertainty in Europe may limit capital flight out of China and offer portfolio diversification opportunities away from Europe. We would not be surprised if the uncertainty and anemic growth kickstarts central bank funded infrastructure stimulus measures in Japan and the U.S. over the next two years, a move towards boosting productivity and a positive trigger for global growth and equity markets.

▶ Latin America

Brazil, Latin America's (LatAm) largest economy, is going through economic and political inflection points. The economic cycle is showing early signs of bottoming out and we expect economic indicators to follow. The adjustment of the trade balance after the sharp depreciation of the currency has improved economic competitiveness. Weak domestic demand and slower imports have caused a softening of inflation expectations, which should lead to a decline in interest rates. While the growth outlook remains muted, we think that the change in political leadership could lead to much needed structural reform. The outlook for Brazil for the rest of 2016 remains one of potential economic inflection with the possibility of positive political change. We will be optimistic if interest rates start to decline while the new government provides adequate fiscal discipline through fiscal reform.

Mexico has been LatAm's standout market for several years. The market is starting to price in positive announcements on structural reforms that promise a new era of improved economic growth, and there is little room for disappointment. The rest of the year will bring more news surrounding energy reform, which will form the foundation for the remainder of the reform agenda. We should also see political noise with the declining popularity of the ruling government. In Peru, we are confident that the next few months will bring renewed optimism and growth as election uncertainty has passed and commodity prices have rebounded. Index publisher MSCI's decision to keep Peru classified as EM should have the added benefit of maintaining a captive investor base to the attractive fundamental story.

▶ Eastern Europe, Middle East and Africa

South Africa and Turkey are the two countries in Eastern Europe, Middle East and Africa (EEMEA) where we see political deterioration. In Turkey, the move towards less market-friendly actions along with regional instability will keep investors wary. Still, the growth outlook and the fundamental investment case for Turkey are hard to ignore. With a marked improvement in its current account balance, healthy consumer demand and the election cycle behind it, the country provides interesting opportunities. Turkey's biggest challenge in the near-term is dealing with domestic acts of terror, which are a stark reminder of the challenges in a country so close to the terrorism hubs of the Middle East. In South Africa, we would be encouraged by political change, with the electorate becoming increasingly disenfranchised with the ruling party. The country is struggling to generate growth and we expect that a rating downgrade will have an effect on both risk premium in the asset markets and sentiment internally.

Russia and the Middle East continue to benefit from higher oil prices. The improvement of the fiscal situation in both areas provides room for public spending that ultimately finds its way to the consumer. The sanctions that are affecting the ability of capital raising in Russia will no doubt have a longer term impact on potential growth for the economy and the quicker these are removed, the less permanent damage will be done. We expect interest rates to continue their downward trend this year and provide stimulus for growth and consumption. With oil prices remaining at current levels, as we expect they will, we are optimistic on both markets.


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"Volatility creates opportunity for
stock pickers and
we see attractive prospects
in emerging markets"

Headwinds and Tailwinds

Headwinds
- Struggling global growth and trade
- The uncertainty of the Fed
- Global politics

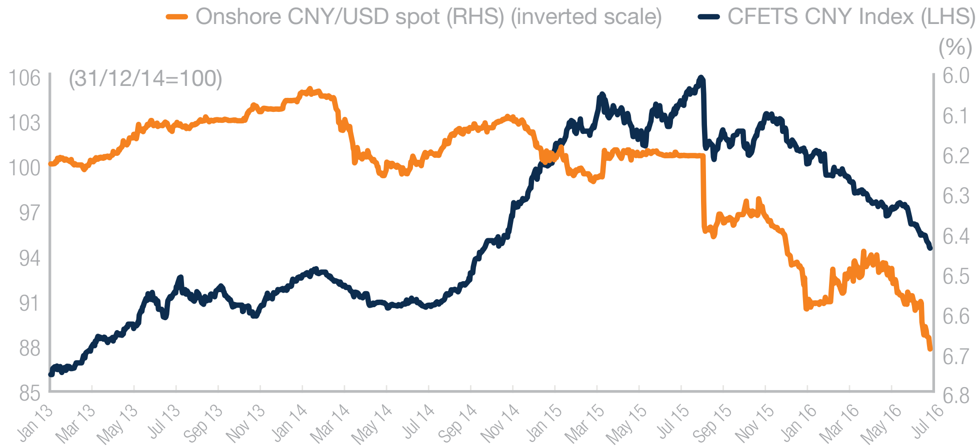
Tailwinds
- Earnings cycle
- EM political change
- Strong consumer demand

Asia

The first half of 2016 was a very difficult period characterized by huge mood swings. The year began weakly on concerns over the Chinese renminbi (CNY), followed by euphoria as commodity prices rallied, and then investors returned to a risk-averse mode on Chinese macro concerns. The mood swings were accompanied by a sharp shift in style from quality and growth into cyclical value.

CFETS RMB Index and RMB/USD (inverted scale)

Source: CLSA, CFETS, Mirae Asset Global Investments (July 2016)



Note: CFETS denotes China Foreign Exchange Trade System's trade-weighted index based on a basket of 13 currencies against the Chinese renminbi.

Throughout the volatile first six months, we maintained our view that demand growth continued to be challenged globally, which made Asia's attractive structural growth stories stand out. A dovish US interest rate outlook and a weaker USD are macro tailwinds for the region. In addition, oil prices at the $50 per barrel level provide a boost to the region. On the other hand, concerns over China's growth, ballooning debt, the fragile CNY as well as other global geopolitical events will continue to drive market uncertainty and investor sentiment. Under this uncertain macro backdrop, we believe it is more important than ever to focus on companies that benefit from structural growth with sustainable competitive business models and higher earnings visibility.

We do not believe the style shift into cyclical value seen in the first half of the year is sustainable given global demand growth and weak corporate earnings. Without a clear catalyst for a sustainable cyclical recovery, earnings should continue to diverge, favoring companies and sectors with sustainable structural growth drivers. These companies can often be found in sectors benefiting from the rise of the Asian consumer, such as internet and e-commerce, healthcare, insurance, consumer sectors, and selective retail banks.

Globally, we continue to face issues such as worsening demographics in certain economies, high indebtedness and the adoption of automation that negatively impacts wage growth. The unprecedented amount of quantitative easing since the Global Financial Crisis has proven to be inadequate. Going forward, we believe policy makers will need to introduce plans such as large scale infrastructure projects from the US or Japan, especially in response to events such as Brexit, in order to make us more positive on the macroeconomic support for equities.

China

China has been one of the primary sources of volatility in the past year and will likely remain a source of uncertainty for the rest of 2016. While we have always maintained that China is slowing, we are surprised that the impact credit expansion had on growth in the first quarter is already waning. The pace of supply-side reform is also slower than what we had hoped to see. The consumer-driven New China is still relatively resilient compared with the rest of the economy, even though it too is witnessing a deceleration in growth.

Despite an incrementally more cautious tone, we maintain our view that China can manage its economic transition without material risk of a hard-landing scenario, given its strong trade surplus, FX reserves, domestically-held debt and a manageable fiscal deficit. The medium-term outlook and company business model for New China remain intact, and earnings delivery remains resilient relative to Old China. As such, we maintain our preference for selective companies within New China, while being mindful of macro-driven downside risks to our base-case scenario for the remainder of the year.

We expect the next 12 to 18 months to be challenging for China. The government will need to address tough issues such as over-capacity and capital allocation, and avoid policy mishaps such as state-owned enterprise cross-holding and currency mismanagement.

Northeast Asia

South Korea and Taiwan continue to face challenges in their domestic economies due to their relatively unattractive demographics and high household debt levels. Many of their traditional industries such as consumer electronics and shipbuilding have been hurt by Chinese competition and weak global demand. While these markets may not look attractive from a top-down perspective, we are able to find attractive bottom-up opportunities. For example, a number of South Korean cosmetics and consumer staples companies are not only doing well in the Chinese market but are increasingly gaining share across other EM countries. On the technology side, while the smartphones are rapidly being commoditized, there are component makers with a technological edge that gives them relatively better visibility and pricing power.

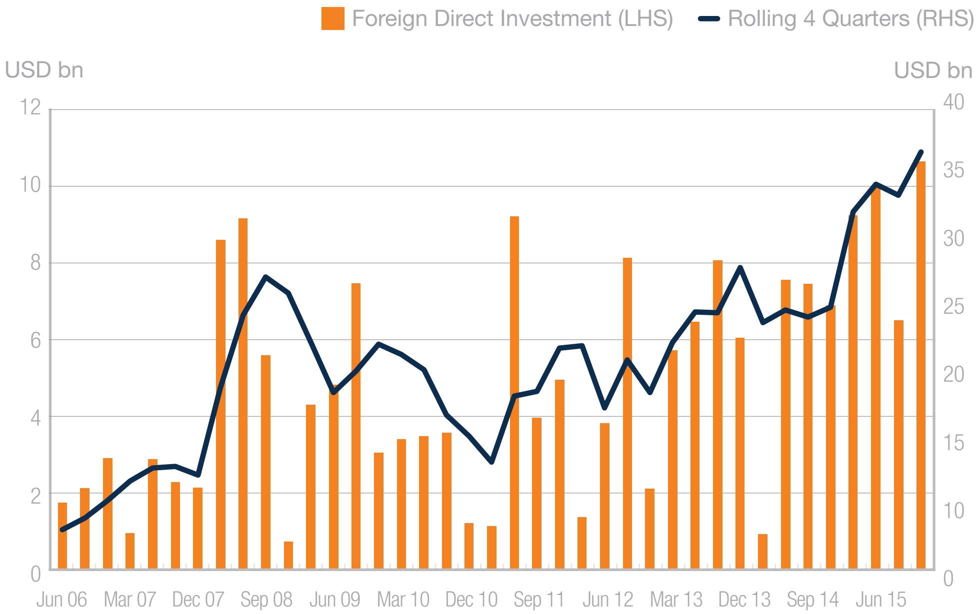
India

India continues to stand out in a world where structural demand growth is difficult to find. While the attractive demand-side story is well known, India's Achilles heel has always been supply-side bottlenecks. What has made us more positive towards India in the past two years has been how Prime Minister Narendra Modi's government has addressed many of the issues that had held the country back. We are witnessing significant improvements, such as infrastructure rollout, financial inclusion, state electricity board reforms and a new bankruptcy code – all low-hanging fruit to improve productivity and realize India's potential.

The recent announcement of Reserve Bank of India Governor Raghuram Rajan's departure was a negative surprise for the market since he has been credited for achieving the macro stability that gave foreign investors confidence to invest in the country. It remains to be seen if his successor will continue in the same policy direction. Short of any drastic policy U-turn, we expect the market to return to the country's improving fundamentals. A key catalyst for the market will be the current monsoon season. Good rainfall could provide a boost to rural income after two very dry years. The listing of government-owned insurance companies on the stock exchanges will also help drive flows into the country.

India Total Foreign Direct Investment

Source: Reserve Bank of India, Credit Suisse, Mirae Asset Global Investments (June 2016)



Our preference within India is for high quality domestic cyclicals such as retail banks, consumer discretionary and selective consumer staples in under-penetrated segments. While the long-term thesis remains intact for the pharmaceutical sector, we see near-term regulatory headwinds. Hospitals, on the other hand, offer higher visibility within the healthcare sector. Though the recovery in India is slower than expected, the steps taken by the government towards boosting infrastructure spending on roads, railways, rural electrification, financial inclusion through unique identification and cleaning up government banks should go a long way to enhance productivity.

The Association of Southeast Asian Nations (ASEAN)

ASEAN markets performed well in the first half of 2016 relative to the rest of the region, largely driven by the benign U.S. interest rate outlook and a weak USD. Within the region, we prefer the Philippines, where a young population and robust income growth offer superior structural growth that is less sensitive to many of today's macro uncertainties. The incoming administration of President Rodrigo Duterte is showing signs that it is business-friendly with an economic agenda that focuses on growth, attracting foreign investors, improving government efficiencies and taking care of the marginalized.

LatAm & EEMEA

Emerging markets in LatAm and EEMEA have various different political dynamics and stories associated within each region and country. From a big picture perspective, though, we remain optimistic about the potential of inflection of growth points and an improving consumer that may allow for more sustainable growth to return.

Latin America

Unlike much of the rest of the world, Latin America is showing trends towards market-friendly reforms. We believe that Brazil's impeachment of President Dilma Rousseff could be a strong catalyst for positive change. We are already seeing impacts from the market-friendly policies of President Mauricio Macri in Argentina. In Chile, President Michelle Bachelet's left-leaning policies have been met with great resistance. The Peruvian election was dominated by three market-friendly candidates, and Mexico is slowly but surely pushing through its reform plan.

Brazil

Brazilian market volatility has followed the direction of political developments more than any other EM country. With President Dilma Rousseff impeached and a caretaker government in place, the pressure is on to tackle much needed but hard-to-implement fiscal reform. The jury is still out on whether the new leadership has the support to carry out the required reforms or if it will simply be a placeholder for early elections for the next phase of Brazilian politics. Importantly, fundamental economic data shows that after almost two years of economic hardship, the economy is showing some signs of improvement and a slight decline in inflation expectations. The new head of the Central Bank has communicated the need for looser monetary policy, which should support growth and investment. We caution that Brazil still has a lot of work ahead of it and there will be disappointment and volatility in the near-term.

Mexico

The Mexican consumer has been a highlight for the region. The strong and stable economic environment finally gave way to better sentiment and consumer spending. Energy reform is ongoing and higher oil prices could provide strong support to the reform agenda and the country's fiscal position. The impact of the US elections and the declining popularity of the current government should not be underestimated. The market might be fully valued and increased risk perception will be quickly priced into the equity market. We expect the rate hiking cycle to have a minimal effect for the rest of 2016, but the U.S. economy, politics, and currency will be strongly related to developments in Mexico.

Andean Trio (Colombia, Peru, Chile)

Peru is structurally the strongest market in the Andes. With the elections out of the way and a market-friendly candidate in place, we are optimistic that Peru can have a strong second half of the year. The rebound of commodity prices and the decision by MSCI to keep the country in the EM index should also keep sentiment strong. Chile suffered from natural disasters, weak sentiment, and unpopular politicians. We expect the sentiment and low popularity of the ruling government to continue. In Colombia the rebound of oil prices improves the government's ability to carry out much needed infrastructure spending and should help many sectors in the economy.

EEMEA

We believe that Russia is well positioned to benefit from rising oil prices and lower domestic interest rates. South Africa faces structural challenges that could be overcome by political reform. We think that Turkey will provide a strong investment case if it can move past regional instability and political headlines.

Russia

We believe Russia is positioned for a comeback after years of turmoil. The country is a huge beneficiary of rising oil prices, which trickles down into stronger consumer demand and improved sentiment. On top of that, the country has seen declining inflation expectations, and begun what we believe will be a significant cycle of rate cuts. This should drive growth and improve sentiment. In terms of headwinds, the market is still heavily dependent on the price of oil and the country's actions in Ukraine and Syria, on top of their outstanding sanctions, may give foreign investors pause.

South Africa

South Africa is on watch for a credit downgrade from ratings agencies, which will have a negative effect on risk premiums and sentiment. On the positive side, we are encouraged by the momentum of the disenfranchised population as it speaks out against the current ruling party and lays foundations for eventual political change.

Turkey

Turkey offers healthy consumer demand, attractive demographics, and reasonable valuations. That said, we are wary of regional political turmoil and terrorism along with the ruling party's push for absolute power and changes to the constitution.

Other EEMEA Countries

We are cautiously optimistic on Greece and negative on Poland, but we see opportunity in the consumer story in the Central and Eastern European Three (CE3) countries of Poland, The Czech Republic and Hungary. Greece's agreement with creditors and recent elections should allow investors to focus on fundamentals again. The rise of Poland's ruling Law and Justice (PiS) party appears worrisome, as forthcoming tax increases in the financial sector could hurt earning and investor sentiment. In the Middle East, markets will be driven by weak earnings and investor sentiment as well as oil prices, regional stability, and the eventual opening up of Saudi Arabia.

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