



## 2018 Emerging Markets Outlook

Next Leg of the Recovery

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### A Sustainable EM Rally

- Attractive positioning and valuations
- Higher growth rates

### Chinese Continuity

- Political and economic stability
- Key growth driver in Asia and globally

### The Return of Capex

- Positive cycle of capex growth
- Margin expansion

### U.S. and Europe

- Central bank actions
- From uncertainty to growth
- International trade

### Latin America

- Shift to fiscal responsibility
- Reforms driving growth

### Eastern Europe, Middle East, Africa

- Valuation and growth stories
- Turnaround situations
- Structural peripheral growth stories

### Asia ex Japan

- Exports to provide positive spillovers
- Commodities pick-up
- Fiscal support

## Executive Summary

We believe that emerging market (EM) equities are in the early stages of a multi-year recovery and are optimistic about continued EM outperformance vs. developed markets (DM) in 2018 and beyond. Looking to 2018, we are paying close attention to political continuity and economic stability in China, the start of a new global capital expenditure (capex) cycle, and attractive positioning and valuations for the EM equity asset class.

In Asia ex Japan, the global synchronous recovery has supported exports and growth has turned stronger in most economies. The global recovery remains on track and we believe that the next leg of the recovery will be supported by an uptick in private corporate capex. The capex recovery will likely boost productivity growth which should sustain the expansion for longer and ensure a better quality of growth.

In EM ex-Asia, we are optimistic about central bank easing cycles in Brazil and Russia, US and European growth spillover into Central America and the CE4 (Poland, Czech Republic, Romania, and Hungary), and potential inclusions for both Argentina and Saudi Arabia into the MSCI EM index. Latin America and EEMEA are coming from low earnings bases, which should create an opportunity for strong YoY growth rates.

## Key Events & Trends

### ► A Sustainable Rally in EM

We believe that EM equities are in the early stages of a multi-year run. Looking back to the mid-1970s, we have seen six EM bull cycles. On average, those cycles have lasted 42 months and delivered 228% returns in USD.<sup>1</sup> As the current EM run has started less than 24 months ago and delivered only roughly a 45% USD return,<sup>2</sup> we gain comfort with our thesis that EM equities still have a significant re-rating period ahead of them. After a half decade of decline, the International Monetary Fund (IMF) now expects GDP in EM economies to accelerate every year through 2021

and for DM economies to decelerate beginning in 2018. This divergence in expected growth rates has turned positive for emerging markets for the first time since 2010. At the same time, the discount between EM multiples to their developed market counterparts are at one of their widest points in 10 years. In addition, the EM equity asset class has not clawed back even half of the assets lost in the last down cycle and institutional global equity investors are still approximately 5% underweight EM equities. We believe that this rare combination of positioning, higher growth rates, and valuation discounts present a unique opportunity for EM equity outperformance.

Interest rate hikes by the US Federal Reserve may cause short term volatility, but we have seen that an early cycle tightening does not derail EM equity performance. EM countries are also less vulnerable to higher US interest rates than they have been in the past as many of these countries have come out of the last negative cycle with healthier current account balances and less USD reliant debt profiles.

## Emerging markets trading at an attractive discount relative to developed markets

Source: Bloomberg. 1-year forward P/E. As of December, 31, 2017

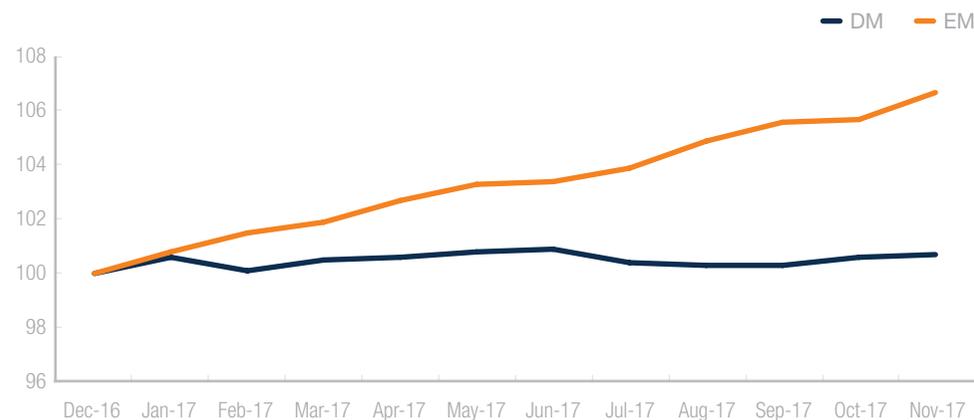


<sup>1</sup> Bank of America Merrill Lynch, September 2017

<sup>2</sup> Bloomberg, 11/30/2015-10/31/17

## Emerging markets earnings revisions trend upwards for 2018

Source: Factset, CLSA. Based on 2018 forecasted earnings revisions. Rebased to 100.



### ► Chinese Continuity

We maintain the view that China is not heading into a hard landing scenario and will continue to be a key growth driver for Asia and globally. China's drive to deleverage will likely continue and should have a limited negative impact on growth. We expect the process to be gradual and policymakers will adjust accordingly if growth slows too much or if market conditions change.

Meanwhile, consumption growth continues to outpace investment growth and the economy is shifting more towards higher value-added economic activity in sectors such as technology, energy, healthcare and more, with a rising share in global higher value-added exports. China has increasingly adopted the use of automation and artificial intelligence which provides a means for the economy to maintain or upgrade their competitiveness.

Chinese equities have had very strong performance in 2017 year, up more than 53%, and outperformed its emerging market and global peers.<sup>3</sup> Looking ahead to 2018, China's equity returns will likely moderate; however, we believe longer term structural drivers will remain as the

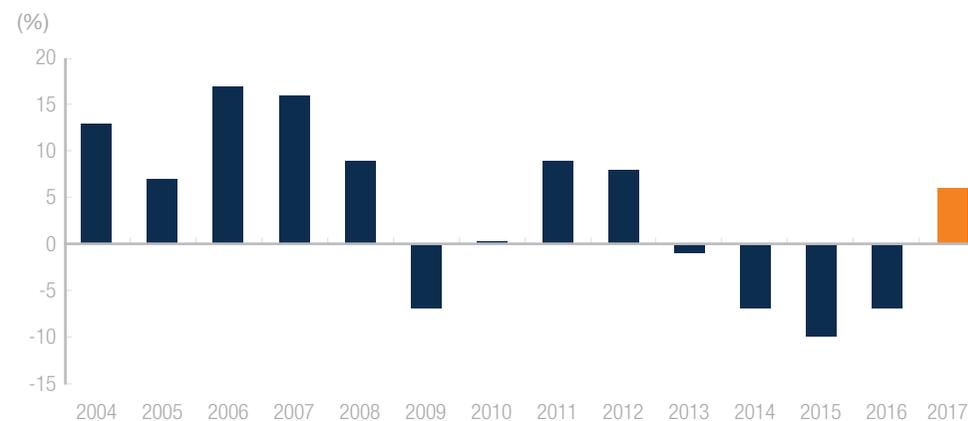
economy moves towards one that is more consumption driven. In addition, global investors' allocation to China has rebounded from a record low underweight and we see scope for further narrowing of the underweight to support Chinese equities in the year ahead.

### ► The Return of Capex

After almost half a decade of declining global corporate capex growth translating into negative demand for EM exporters, capex growth has pivoted back to a positive cycle. 2017 should finish with approximately 6% capex growth after four years of decline. Additionally, leading indicators point to a continued recovery in capex, which should help support top-line growth and margin expansion after a 23% decline in global capex over the past four years. This change should help drive sustainable growth in 2018 and beyond as capex-led GDP growth tends to correlate with foreign inflows and a re-rating of asset prices. It is important to note that early data points to a capex cycle that is less reliant on commodities, which supported the 2004-2008 EM cycle, and signals a more sustainable rally. This return of investment signals an important shift in EM corporate sector confidence as capex-driven growth tends to boost nominal GDP more than wage-driven growth, which allows revenues to outpace costs.

### Capex rebounds in 2017

Source: S&P Global Ratings: Global Corporate Capital Expenditures Survey 2017.



<sup>3</sup> MSCI, as of December 31, 2017. China = MSCI China Index, Emerging Markets = MSCI EM Index, Global = MSCI World Index.

## Headwinds & Tailwinds

### Headwinds

- Country specific political uncertainty
- A US challenge to the status quo of global trade
- Uncertainty around the Korean peninsula

### Tailwinds

- Strong global GDP growth
- Rising capacity utilizations to drive operating leverage and earnings upgrades
- Political and economic reforms

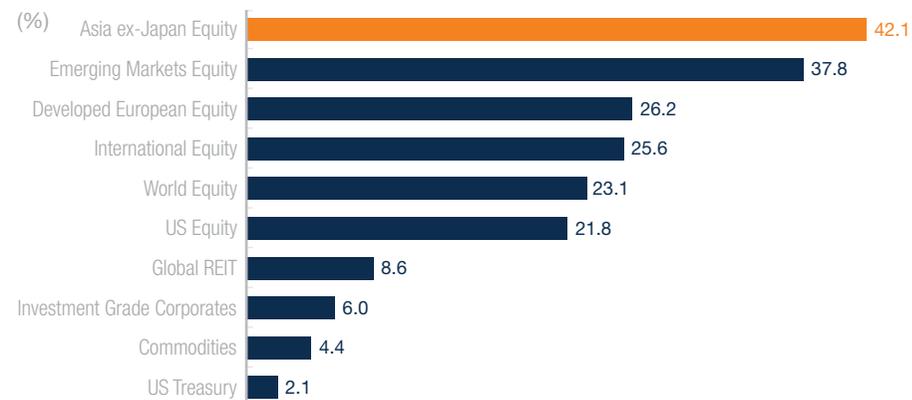
## Asia ex Japan

### ► General Overview

Asia ex-Japan equities were the top performing asset class this year, up more than 42% in 2017. Heading into 2018, the macro outlook for this region continues to look healthy and we believe growth remains sustainable, inflation may pick up modestly, and a revival in capex and productivity will likely lead to greater momentum. In addition, Asian companies are in the midst of a strong earnings recovery. After years of downgrades, earnings estimates are now in a positive upgrade cycle.

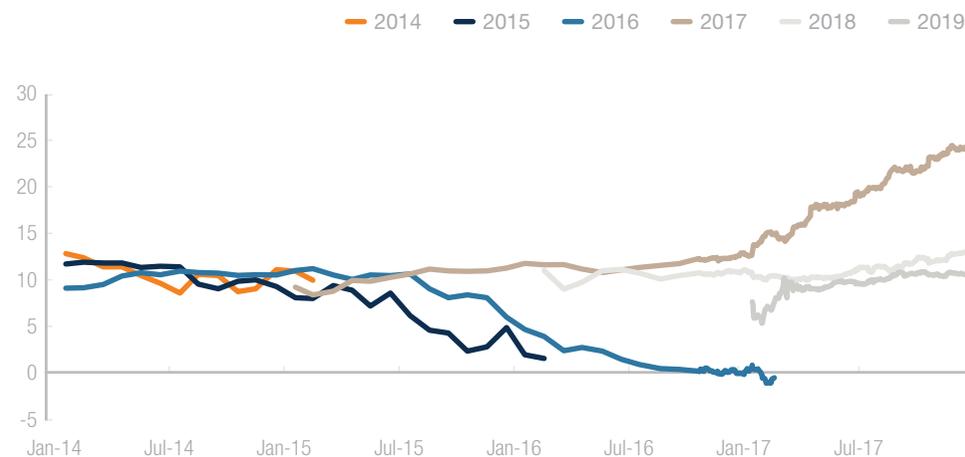
### Asia ex Japan outperforms in 2017

Source: MSCI, S&P 500. Emerging Asian Equity = MSCI AC Asia ex-Japan; EM Equity = MSCI EM; Developed European Equity = MSCI Europe; International Equity = MSCI EAFE; World Equity = MSCI World; US Equity = S&P 500; Global REIT = S&P Global REIT; Investment Grade Corporates = S&P 500 Investment Grade Corporate Bond; US Treasury = S&P US Treasury Bond; Commodities = S&P DJ Commodities. As of December 31, 2017.



### Earnings estimates for Asian ex Japan equities are in a positive upgrade cycle

Source: Factset, Mirae Asset, December 2017. Based on consensus EPS growth estimates for MSCI Asia ex-Japan.



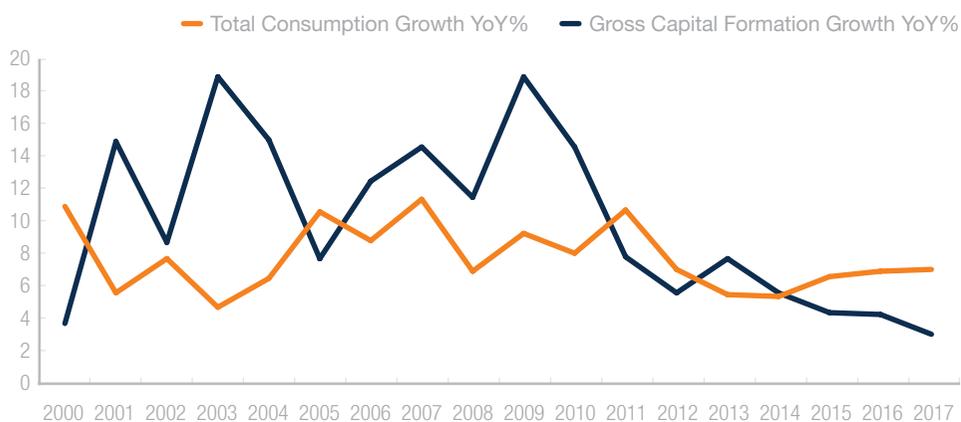
## China

At the 19th Congress of the Chinese Communist Party, the Chinese government pledged its commitment towards a more consumption-driven economy and balanced growth, rather than targeted growth. As such, we expect GDP growth to slow modestly as the government implements changes in an effort to rebalance the economy, focusing on supply side reform, financial deleveraging and the environment. We believe that these tightening measures will be carried out in a gradual and calibrated manner and should allow growth to continue at a healthy, albeit slower pace.

Domestic consumption will likely remain resilient, supported by demographic trends, rising income and technology advancement. Consumption grew 8.4% year to date through November 2017, up from a growth rate of 8.3% in 2016 and 8.0% in 2015. Moreover, with the global synchronous recovery remaining on track, the positive net trade contribution should offer some support.

### Consumption growth in China accelerates as investment growth decelerates

Source: National Bureau of Statistics, CEIC, Morgan Stanley, November 2017

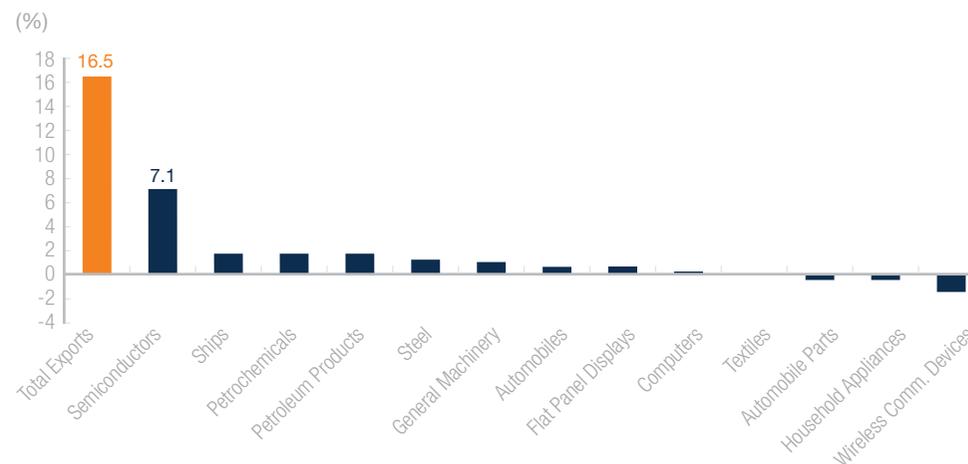


## Northeast Asia

South Korea has seen a strong rebound in exports on the back of the global recovery, particularly demand for semiconductors and memory chips. Year-to-date export growth grew 16.5% YoY, the second strongest export momentum in the Asia-ex-Japan region, after Indonesia. However, so far, exports rather than domestic demand, is still the main driver of South Korea's macro recovery.

### Exports are the main driver of South Korea's recovery

Source: CEIC, Morgan Stanley Research. Exports are for January-November 2017 combined.



With regards to the geopolitical tension in the Korean peninsula, our view is that the situation is likely to remain status quo. North Korea conducted another missile test in late November and, again, investors mostly shrugged it off. It appears markets have become somewhat desensitized to these missile launches and are more focused on positive economic data. Meanwhile, some tensions remain between South Korea and China over THAAD\*, though there were some signs relations may improve following President Moon's visit to China.

Taiwan has also benefitted from the smartphone cycle and supportive external environment and will likely continue to do so heading into 2018. Similar to South Korea, the spill-over effect of cyclical recovery to domestic demand is not that evident as of yet.

\*THAAD = Terminal High Altitude Area Defense

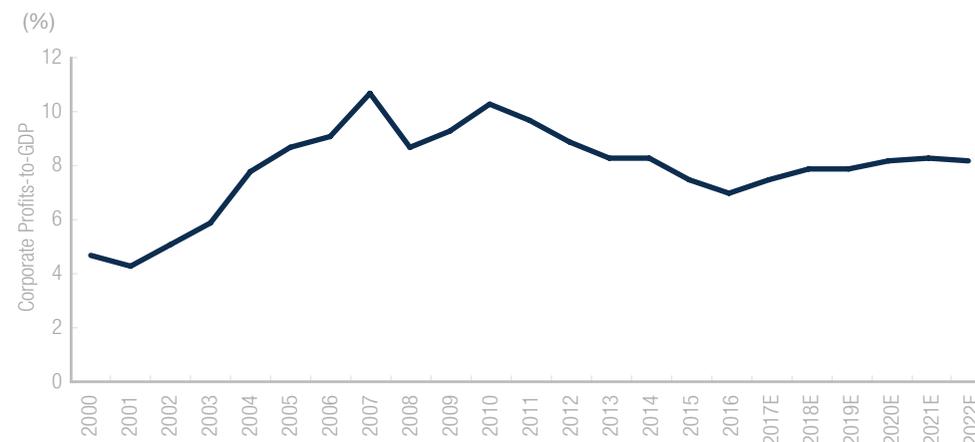
## India

India saw two major reforms over the past year: demonetization and the implementation of the Goods and Services Tax (GST). Though these reforms caused some temporary disruption to the economy, we believe that they have paved the way for stronger medium-term growth heading into 2018. Underlying consumer demand remained fairly strong despite GST related disruption, with the recovery taking place since August. Domestic consumption should continue to be robust, supported by wage growth, and relatively low inflation and interest rates. There is also optimism that the housing sector will help drive capex as the government targets to build 12 million urban and 30 million rural houses by 2022.

We may also see an increase in government spending in the run-up to the 2019 elections which should provide a further boost to growth. The basic premise remains that despite a close fight in upcoming state elections in 2018, the Bharatiya Janata Party is relatively secure for a re-election in mid-2019. With improved economic prospects driven by strong domestic consumption, government spending and global growth, corporate profits-to-GDP will likely trend upwards in coming years.

## India's Corporate Profits Trend Upwards

Source: CMIE, Morgan Stanley Research. E= Estimates



## The Association of Southeast Asian Nations (ASEAN)

The export recovery has lifted cyclical growth momentum in the ASEAN region as both export volume and value have rebounded this year. However, the ASEAN economies have lagged behind the rest of Asian economies.

Domestic demand in Indonesia has been relatively muted this year, triggering the Bank of Indonesia to cut interest rates. However, with commodities picking up, this could provide a positive boost to the economy. In the Philippines, growth momentum has been robust and the twin deficits have risen. We therefore expect fiscal policy to remain supportive. Thailand is expecting a record number of tourists this year and exports have also improved but weak consumer fundamentals may mean that a policy response is needed to provide further growth.

In 2018, we believe the global synchronous recovery will remain on track, supported by corporate capex growth, ensuring a better quality of growth.

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

### ► General Overview

We believe that the equity markets in Latin America and EEMEA are poised to have strong 2018 performance on account of a combination of turnarounds from their respective leading countries, technical trades from names entering the MSCI EM Index, and strong structural peripheral growth stories. Both Brazil and Russia boast inflation rates within their desired targets and are in the midst of monetary easing cycles, which should translate into increased borrowing, consumer and corporate spending, and growth. They are also coming from low bases of growth, which creates the opportunity for strong YoY improvements.

There are also significant potential political headwinds in the region, but we believe that the combination of a low base for earnings, attractive valuations, and high growth rates create strong prospects for 2018 for both Latin America and EEMEA.

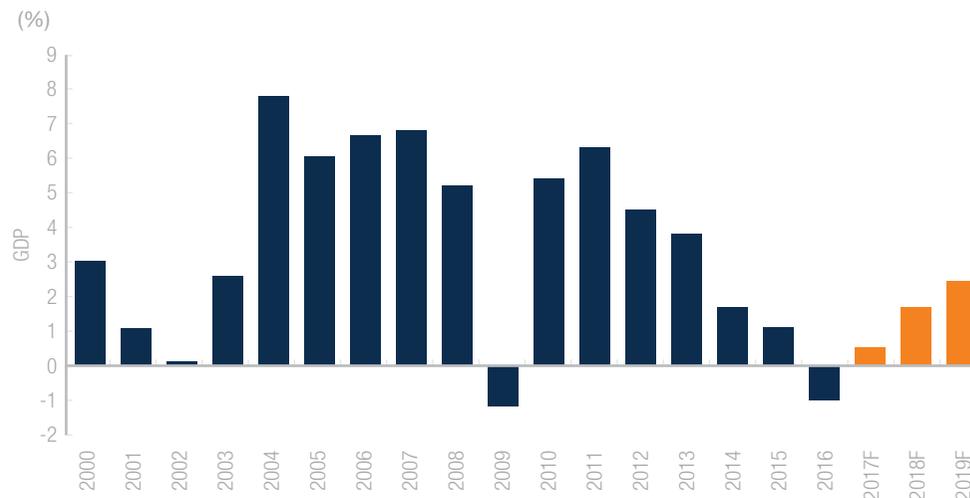
## Latin America

### ► General Overview

Latin American governments appear to be shifting back to 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 leading to growing consumer confidence, stronger currencies, lower inflation, and increased prospects for growth in the region.

## Economic growth rebounds in Latin America

Source: IMF, Mirae Asset. Latin American countries included: Argentina, Brazil, Chile, Colombia, Ecuador, Mexico, Panama, Peru and Venezuela. F= Forecast.



## Brazil

We remain optimistic on Brazil. The country is driven by a combination of lower interest rates translating into increased borrowing, a new capex cycle, lower unemployment and prospects for a market-friendly 2018 election. After two years of negative growth, Brazil's economy appears to have troughed. With inflation under control, the central bank has cut its base rate by roughly 700 basis points. This dramatic cut to lending costs should allow companies and individuals to increase their borrowing levels from the current low base and open the door for a new investment cycle. A commitment to investment will ease unemployment, which appears to have peaked at roughly 13%, and should drive the economy to incremental growth through 2018. At the same time, 2018 will come with a presidential election. Though it is too early to comment

on potential candidates, it is worth noting that the recent movement against corruption in the highest levels of Brazil's economic and corporate sectors, could prohibit candidates the market perceives as "unfriendly" to run for office and open the door for leaders focused on continuing Brazil's recent movements towards fiscal reform and economic orthodoxy.

### Brazil's selic rate reaches a four year low

Source: Bloomberg, as of December, 31, 2017.



## Mexico

Though Mexico's underlying economy and corporate sector remains robust, there is a great amount of uncertainty for the Mexican equity market looking into 2018. This ambiguity stems from both the 2018 presidential elections and the NAFTA trade reforms. On the economic side, Mexico should continue to post incrementally positive YoY growth numbers along with a declining inflation figure, which could allow the central bank to step into an easing cycle. On the other hand, the 2018 presidential election could be a very close race, with the traditional

middle-of-the-road parties being challenged by Andres Manuel Lopez Obrador and the populist National Regeneration Movement (MORENA) party. The NAFTA renegotiations could also create headwinds, as, at this stage, it appears that the US is adamant about changing rules around Rules of Origin and Arbitration in its favor. Positive rhetoric around either topic, or a combination of the two, could also turn into a significant tailwind for Mexican equities.

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

The Andean region boasts a positive outlook. After surprising the market by not including Argentina into its EM index in 2017, MSCI is increasingly likely to announce the upgrade of Argentina from "frontier" to "emerging" status in June of 2018. This should support incremental flows into Argentina's equity market. More importantly, President Macri and his Cambiemos party have increased their political power in the 2017 midterm elections and continue 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 into the country's infrastructure. Peru faces a conflicted outlook. On one hand, President Pedro Pablo Kuczynski had followed through with his centered market-friendly policies and has also made it clear that he is committed to investing in the country's infrastructure. On the other hand, the market is digesting recent corruption allegations against Kuczynski, which could lead to uncertain sentiment. Either way, after a series of natural disasters (floods) in 2017, Peru carries a strong pipeline for 2018 growth.

Chile and Colombia present more lukewarm investment environments. In Chile, growth prospects and valuations are not especially appealing. Though equities have welcomed the exit of President Bachelet and the recent election of Sebastián Piñera, the last government left structural challenges (bi-cameral voting systems) that will make it difficult for the new leader to pass necessary reforms. Colombia, who will also host 2018 presidential elections, depends on a sustainable increase in oil prices, which would allow the country to move forward with its 4G infrastructure program and avoid draconian tax reforms.

## EEMEA

### ► General Overview

EEMEA represents a wide-range of investment opportunities from valuation stories, to growth opportunities, to potential turnaround situations. We believe that Russia continues to be undervalued and is 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. Turkey, which historically struggled with fiscal deficits, now faces the additional burdens of an executive presidency. Lastly, though challenged by geopolitical tension, we see opportunities for outperformance in both Egypt and Saudi Arabia in the Middle East/Northern Africa region.

### Russia

Russian equities present an attractive opportunity in 2018. Despite a return to GDP growth, a significant year-over-year increase in oil prices, and the continuation of the central bank's easing cycle, Russian equities have not kept up with the positive 2017 run in emerging

### Russia's Cuts its Key Rate as Monetary Easing Continues

Source: Bloomberg, Bank of Russia. As of December 31, 2017



markets. Western sanctions and continued US media headlines around speculations of involvement in the 2016 presidential elections have left an overhang on the equity market and created a dislocation in valuations. Russian equities have the lowest average multiples in the EM asset class, despite positive momentum on both the country and corporate level. Also, 2018 is an election year in Russia, which means that the government should increase spending to keep the economy moving forward. Political headlines could remain an overhang.

### South Africa

South Africa finished 2017 with reason for optimism into the new year. After a close election for the African National Congress (ANC) leadership, Mr. Cyril Ramaphosa has been elected the 13th President of the ANC. The election of this market-friendly candidate and the signaled demise of the Zuma camp should bring a wave of confidence to the rand, which should reduce inflation and provide the central bank room for rate cuts. Looking forward, the main drivers for momentum could include a movement for an early recall of President Zuma and progress for structural reform, which could cover mining, energy, state-owned enterprise corporate governance, and South Africa's fiscal outlook. On the other hand, South Africa still suffers from structural challenges and Mr. Rampaphosa will have to navigate a diverse political arena to push his agenda, which could prove difficult.

### Turkey

Though valuations and the structural story in Turkey appear attractive, the political scenario and macroeconomic uncertainty in the country remain a concern. President Erdogan now operates with the absolute power of an executive presidency. Though this has allowed him to drive short term growth via subsidies, the government is beginning to repeal these unsustainable policies, which will likely hamper growth in 2018. We are also concerned about the country's growing current account deficit, as oil prices have risen and regional instability puts pressure on tourism. That said, valuations are attractive and the market could rebound with global macroeconomic movements.

## Other EEMEA Countries

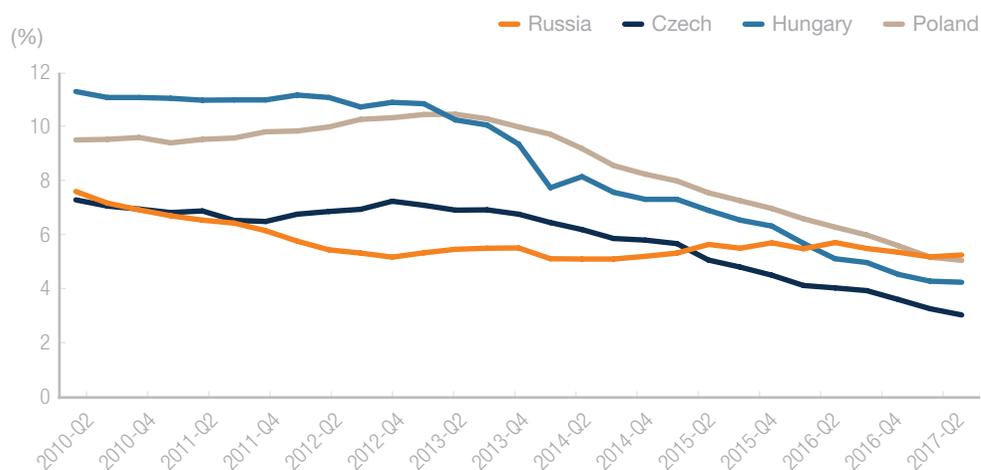
The Middle East and Northern Africa are presenting two interesting stories via Egypt and Saudi Arabia. In Egypt, the government has committed to austerity and unpegged its currency, which has already led to improvements to the country's twin deficits. Inflation has begun to stabilize and the central bank could begin an impactful rate cutting cycle, which should translate into growth. Saudi Arabia is going through all the necessary requirements to open itself up to foreign investors and obtain inclusion into the MSCI EM index. As a region, macroeconomic dynamics appear stable on the back of a rebound in oil prices, but geopolitical uncertainty remains prevalent.

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 quantitative easing programs, which would bring down risk premiums and allow investors to focus on fundamentals.

The CE4 (Poland, Czech Republic, Romania, and Hungary) should continue to boast some of the highest GDP growth figures in the world, as the countries benefit from a normalization of economic policy and growth across Western Europe along with the divestment of European Union infrastructure funds. Each of these countries present relatively educated population bases with attractive tax rates and low costs of labor, which should continue to attract investment through 2018.

## Unemployment rates point to tighter labor markets in CE3 and Russia

Source: OECD (Accessed in December 2017)



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