THE DRIVE YOU DEMAND

INVESTOR INSIGHTS

Emerging Markets

June 2017 | Global Investment Committee

UBP

UNION BANCAIRE PRIVÉE

EXECUTIVE SUMMARY

- Emerging Market growth has rebounded since commodity prices bottomed in the first quarter (Q1) of last year. World trade growth and rising domestic demand have allowed EMs to outperform the US during its recent soft patch.

- Improved sovereign balance sheets and stabilising inflation rates mean little upside for interest rates in the near term – even with US rates set to rise again. EM FX appears protected by positive real interest rates.

- In Fixed Income, the chase for yield and stable carry continues. We prefer High Yield (HY) vs Investment Grade (IG) and 3-5 year corporate bonds. Credit differentiation will be key in H2 2017. In China, State Owned Enterprise (SOE) related corporates rated BB stand out, especially those with stable credit matrixes and low leverage. They have better yield pickup vs IG and will be less volatile than single B credits if growth deteriorates.

- Local currency bonds offer attractive yields, but mostly in unhedged terms. Expected stability for EM FX adds to selective appeal.

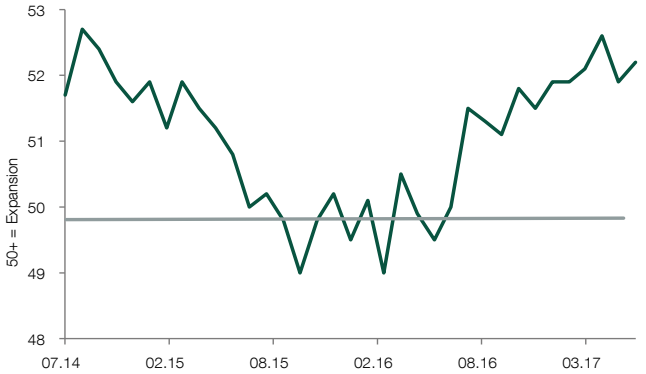
- In equities, as long as the earnings picture remains supportive, we expect that EM will continue to perform. EM trades on a price to earnings (PE) multiple of 13 times (x) vs DM's 17x, but with similar earnings growth expectations of 10-11% per annum. On a price-to-book basis (PB), EM at 1.5x vs 10% Return on Equity (ROE) is attractive compared to DM's 2.2x vs 11% ROE.

- Leaders in this earnings recovery are Korea, Taiwan, Thailand and India. China is the most significant earnings recovery laggard, but the index is the second best performer behind Korea. By sector, leaders are Energy, cyclicals and Technology. Financials and defensives are not yet contributing to the earnings recovery.

- Asia's outlook is superior. We prefer cyclicals, and large regional Financials/Technology stocks in China, Korea and India.

EM growth accelerated as US entered a soft patch

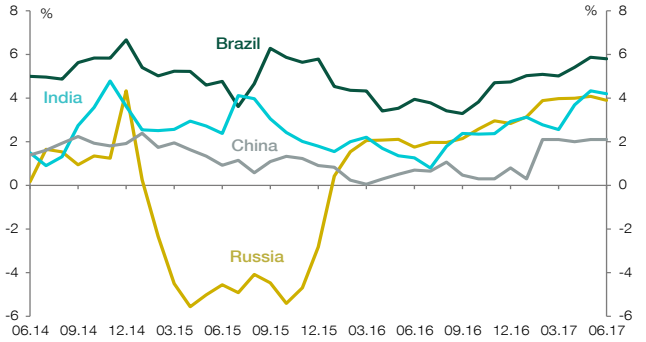
Composite PMI: Emerging Markets



Source(s): Bloomberg Finance L.P., UBP

Real interest rates remain high, supporting local markets and hard currency debt alike

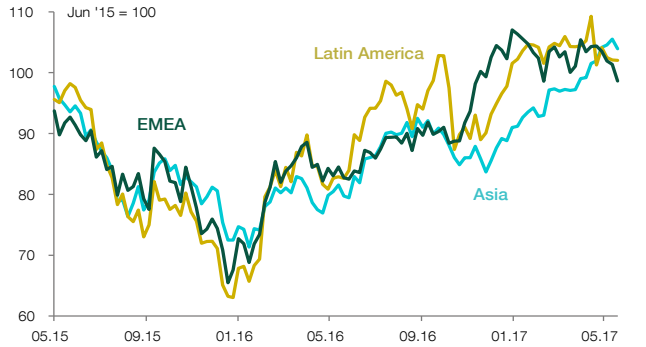
2-year real bond yields



Source(s): Bloomberg Finance L.P., UBP

EM equities have performed since commodities bottomed in Q1 last year

Total returns: EM equities



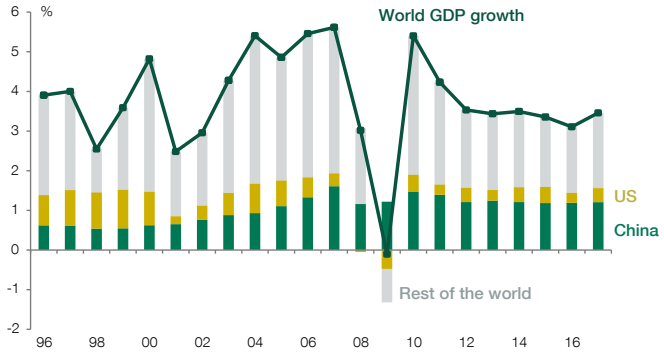
Source(s): Thomson Financial, UBP

ECONOMICS & FX OUTLOOK

- China is key to the EM economic outlook; the contribution of the United States to global GDP growth has fallen to under 20% (from nearly 45% in 1998). China's is over 40%.
- Slower GDP growth in China at 6.5% per annum still adds more to demand than 13% did ten years ago when the economy was a quarter of its current size. Slower Chinese growth is not a sell signal.
- Growth in Global Emerging Markets has been improving since early 2016, when trade began to revive and inflation started to rise. Trade growth in EM rose 6.9% year-on-year in March 2017, the fastest since 2010.
- Inflation's rise has now stabilised in most of Asia Pacific. Inflation continues to be low (and falling) in large parts of Latin America and Eastern Europe and the Middle East (EMEA).
- Stable inflation leaves central banks with little reason to increase interest rates and remove stimulus, despite expected increases in US interest rates. At UBP, we expect two more US rate increases by mid-2018.
- The only countries where rising US rates will push local rates higher are those with fixed exchange rates (e.g. Saudi Arabia), ones fighting excessive credit growth (e.g. China) or others with ultra-low interest rates that now need to normalise (e.g. Mexico). Only in the latter case should rapid increases be expected.
- In the BRICs, China is tightening, but India's monetary policy setting is neutral and Brazil and Russia have room to cut rates as inflation falls.

China's impact on world GDP is greater than the US

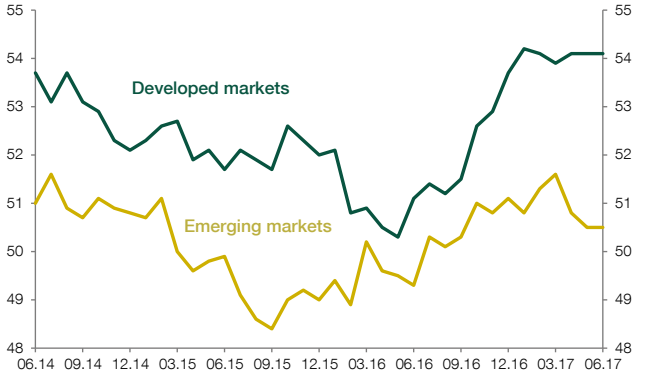
World GDP growth US & China contribution



Source(s): IMF

Emerging markets growth still has room to catch up

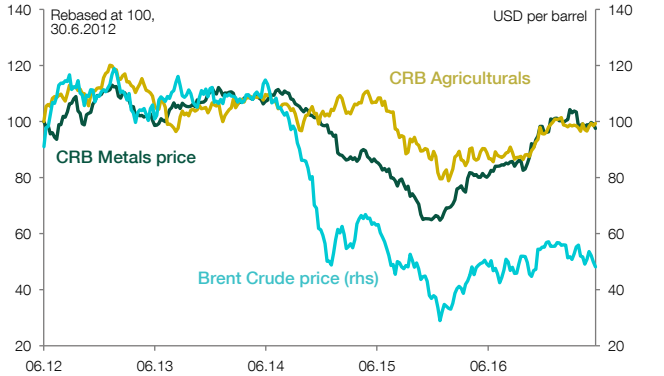
Manufacturing PMI: developed markets vs emerging markets



Source(s): Markit, UBP

Commodity prices have stabilised since 2016

Commodities and oil prices



Source(s): CRB, Bloomberg Finance L.P., UBP

ECONOMICS & FX OUTLOOK

- Attractive carry, surpluses and stabilising inflation make EM currencies less susceptible to rising US interest rates. Capital inflows and surpluses are likely to keep EM FX stable.

- From an FX balance sheet perspective, lower commodity prices forced many commodity producing countries into recession in 2014-2016. The resulting slump in imports has left much of Latin America and EMEA with either smaller external deficits or surpluses. Many Asian nations run large surpluses.

- For the renminbi, a clear signal that downside risk is limited is the apparent bottoming out in deposits held offshore in Hong Kong to shield against depreciation.

FX Technical Analysis

- The US Dollar Index (DXY) is muddled due to political noise. DXY needs to break above 100 to give a bullish signal against all currencies and 95 for a bearish signal. It's currently at 97.

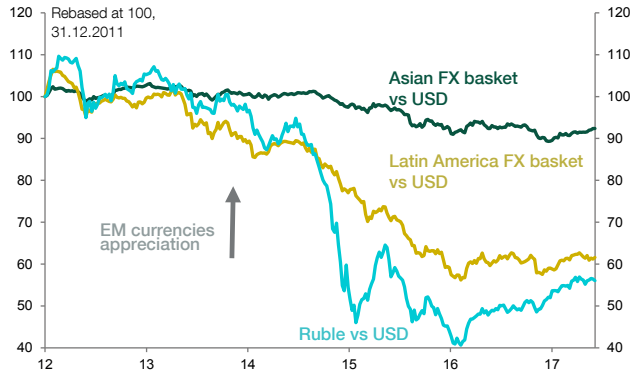
- The Asia Dollar Index (ADXY) is on a long-term downward trajectory but has rallied from December 2016 to May 2017. Most of the Asian and EM currencies except the offshore Chinese renminbi (CNH) have gained versus US dollars. CNH consolidating between 6.85-6.90.

- ADXY is now near the pivot point of the downward shift. The chart to the right shows that a breach of 108 would signal a major break out for Asian FX against US dollars. Failure would be much less bullish.

- While not shown, the Latin America basket index (LACI) gives a different signal. LACI has taken longer to rise to hit a resistance point and therefore may be more susceptible to a reversal.

Emerging FX has bottomed out

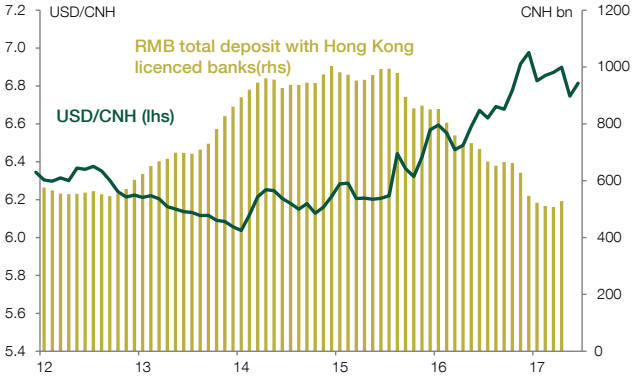
EM currencies vs USD



Source(s): J.P. Morgan, Bloomberg Finance L.P., UBP

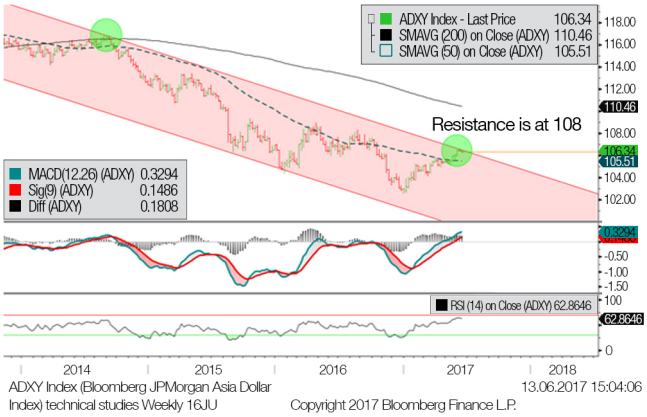
Chinese savers have stopped shipping cash to HK

USD/CNH & CNH deposits in Hong Kong



Source(s): HK Monetary activity, Bloomberg Finance L.P., UBP

Technical analysis looks for stability vs US dollars



Source(s): Bloomberg Finance L.P.

FIXED INCOME OUTLOOK

- As expected, the US Federal Reserve raised the benchmark rate by 25 basis points (bps) in June and pointed towards one more rate hike for 2017. We expect global inflation to continue to stay low and balance sheet adjustment to commence in early 2018. The US yield curve may continue to flatten.

- In this context, the chase for yield and stable carry remains. We expect the US dollar to remain stable and range-bound in the second half of the year (H2), imposing less pressure on EM currencies. This will be positive for fund flows to favour EM over DM.

- With recent spread compression, risk-reward metrics become less appealing. However, we continue to prefer the 3-5 year maturity bucket and favour HY bonds vs IG. This means credit differentiation will be key in H2.

- Credits rated BB with a stable credit matrix stand out; they provide better yield pickup vs IG. They will be less volatile than single B credits should the growth outlook deteriorate.

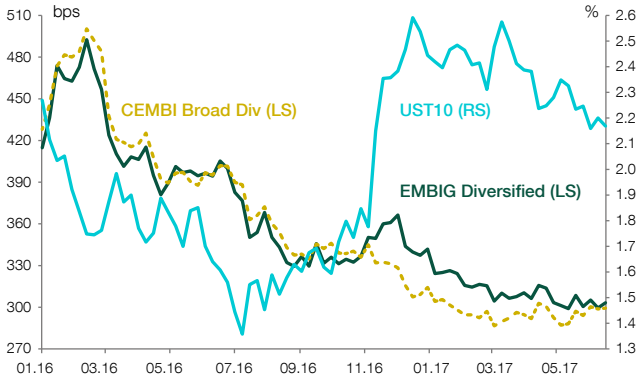
- In China, SOE-related names will be preferred along with corporates on an improving credit matrix. Funding liquidity could be tighter in H2 2017 so the preference is for low leverage companies.

- For investors looking at yield pickup, EM local government debt is an alternative that provides some opportunity. However, investors should also take into account the risk of currency volatility.

- With Asian growth momentum continuing to pick up in H2, we expect fund flows will be steady.

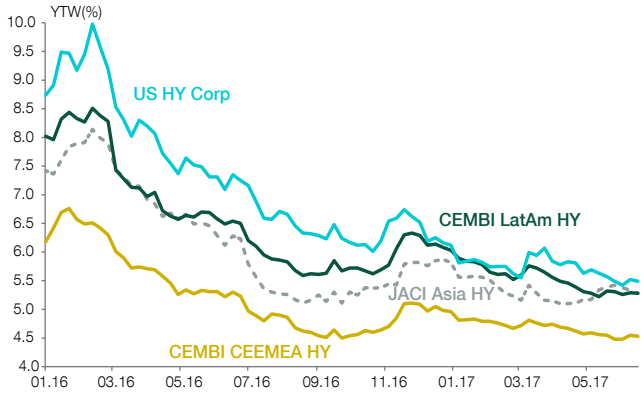
EM spreads against Treasuries

EMBIG & CEMBI Spreads against 10yr Treasuries



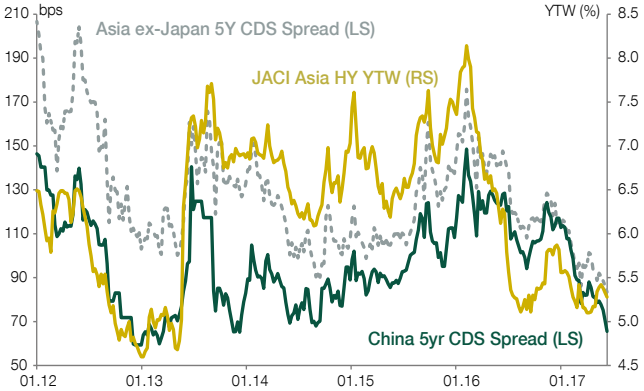
Source(s): Bloomberg Finance L.P., J.P. Morgan

EM/DM HY Yield Comparison



Source(s): Bloomberg Finance L.P., J.P. Morgan

China & Asia ex-Japan 5yr CDS against JACI Asia HY



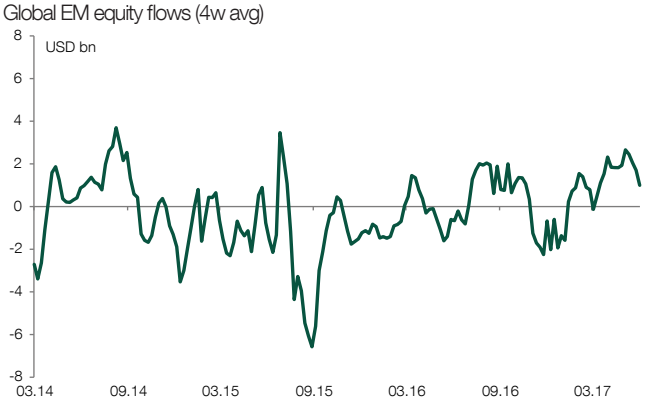
Source(s): Bloomberg Finance L.P., J.P. Morgan

EQUITY OUTLOOK

- Global EM fund flows are on the longest and strongest inflow streak since 2013. Year-to-date total inflow is USD 31bn, of which more than 100% has been captured by dedicated funds.
- The catalyst for improved EM sentiment is a better earnings picture, especially in Asia which accounts for more than 70% of the MSCI EM index and is eight months into earnings recovery.
- There is diversity too in earnings revisions between EM geographies, with Asia clearly leading for the past year while Latin America and EMEA have trailed.
- EM has traded at a discount to DM for some time on headline PE, which is now 13x for EM vs DM 17x, compared to similar earnings growth expectations of 10-11% per annum.
- On a Price-to-book basis, EM at 1.5x vs 10% ROE is attractive compared to DM 2.2x vs 11% ROE.
- Investors are often attracted to performance, so EM's 17% year-to-date total return vs DM's 11% has been a contributing factor to recent fund flows into EM, in addition to the combination of valuation discount vs DM and the catalyst of improved sentiment.
- On a regional basis Latin America (Latam) funds have seen small inflows while EM Asia and Eastern Europe and Middle East (EMEA) funds have seen net outflows.
- By fund type, both long-only and Exchange Traded Funds (ETFs) have reported consecutive inflows for more than three months.

EM fund flows have been strong…

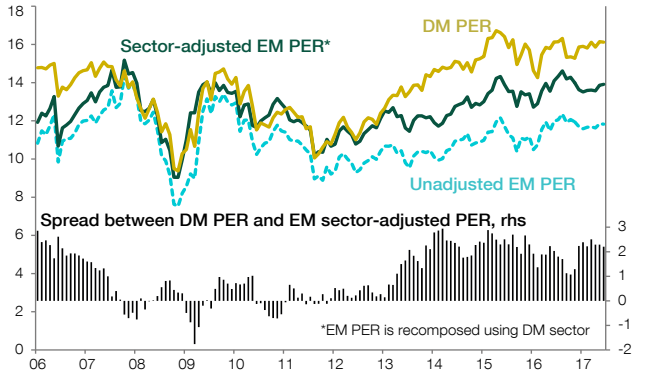
Global EM equity flows (4w avg)



Source(s): EPFR, UBP

…drawn to more attractive valuation vs DM…

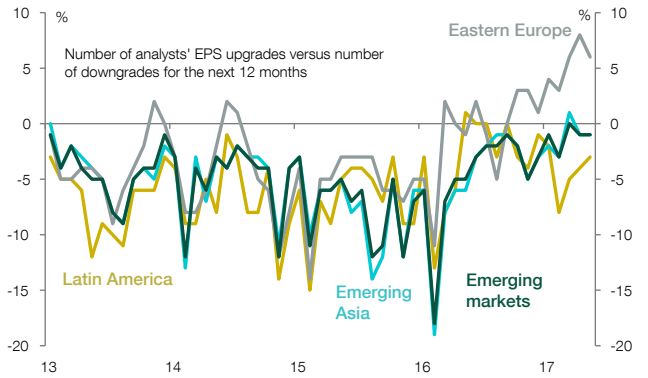
Emerging vs developed markets: adjusted 12-month forward PER



Source(s): Thomson Financial, UBP

…and an improving earnings picture

Earnings revision ratio: emerging markets



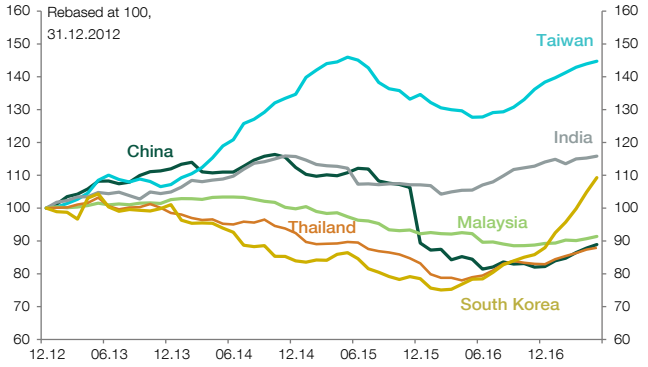
Source(s): Thomson Financial, UBP

ASIAN EQUITIES OUTLOOK

- Earnings in Asia bottomed in Q4 last year and are up more than 11% over the past 8 months; MSCI Asia ex-Japan (MXASJ) has gained 14% since then.
- Initial dollar strength following the US election has not been sustained, and neither the move above 103 on DXY or subsequent fall back to 97 has had any significant negative impact on Asian earnings or the region's markets.
- The standout best performing sector during the current earnings recovery is Technology, which is the largest sector in Asia. Financials is the second largest sector, and has almost kept pace with MXASJ performance despite not contributing to the earnings recovery story.
- The apparent disconnect between lagging earnings recovery vs strong index performance for China and Financials can be viewed as a pointer to the next step up for earnings growth, or as the most likely area for negative surprises.
- While the earnings picture remains supportive, we expect that EM can continue to show strength vs DM, led by Asia.
- In terms of the chart to the right, MSCI Emerging Markets has formed an inverted head and shoulder pattern (a bullish signal) but with the potential for a period of consolidation before moving higher again.

Asia EM earnings have been recovering

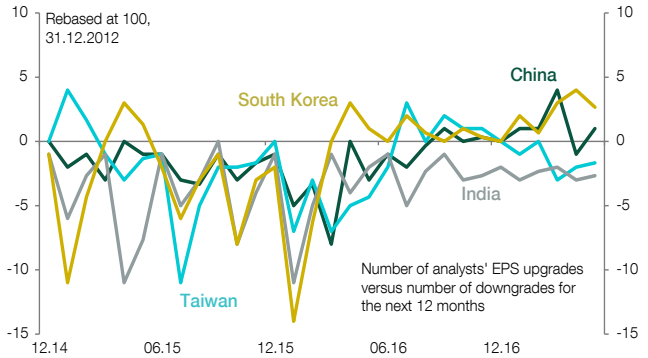
Selected Asian countries: 12-month forward earnings



Source(s): Thomson Financial, UBP

Revisions have been positive in Korea and China

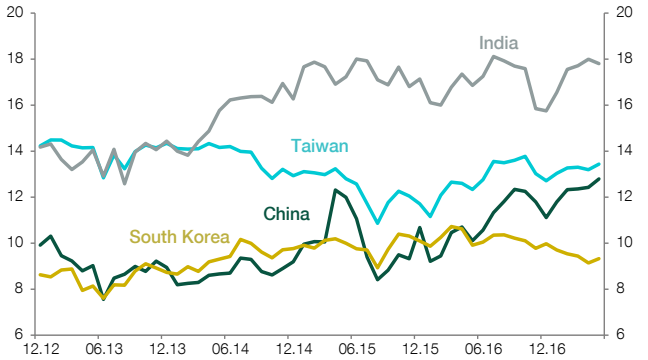
Selected Asian countries: earnings revision ratio



Source(s): Thomson Financial, UBP

Most attractive Asia EM markets – Korea and China

Selected Asian countries: 12-month forward PER



Source(s): Thomson Financial, UBP

Authors

Michaël Lok
Group Chief Investment Officer (CIO)
and Co-CEO Asset Management

michael.lok@ubp.ch

Norman Villamin
Chief Investment Officer (CIO)
Private Banking

norman.villamin@ubp.ch

Patrice Gautry
Chief Economist

patrice.gautry@ubp.ch

Mark McFarland
Chief Economist, Asia

mark.mcfarland@ubp.com

Disclaimer

This document constitutes marketing material and is not the result of a financial analysis or research and therefore not subject to legal requirements regarding the independence of investment research. It is furnished for general information purposes only and does not constitute an offer or recommendation to enter into any type of financial transaction or to conclude any type of mandate with Union Bancaire Privée, UBP SA, or any entity of the Group (hereinafter «UBP»).

This document is not directed to, or intended for distribution to or use by, any person or entity who is a citizen or resident of, or is located or incorporated in, any jurisdiction where such distribution, publication, availability or use would be contrary to applicable laws or regulations, or which would subject UBP and/or its subsidiaries or affiliates to any registration or licensing requirement within such jurisdiction. **This document may not be distributed, reproduced or referred to (in whole or in part) without the express written consent of UBP.**

This document refl ects the opinion of UBP as of the date of issue. The information, opinions and analysis contained herein have been based on sources believed to be reliable. However, UBP does not guarantee their timeliness, accuracy, or completeness. All information, analysis and opinions are subject to change without notice at any time and with no obligation to update.

This document is not intended to provide a sufficient basis on which to make an investment decision and is not a personal recommendation or investment advice. It is intended only to provide observations and views, regardless of the date on which the reader may receive or access it. Each person is urged to determine whether any investments suit their particular circumstances and to independently assess, with professional advisors, the specific risks incurred, including without limitation at the financial, regulatory, legal, accounting and tax levels.

Past performance and/or financial market scenarios are no guarantee of current or future returns. Where these materials contain statements about future performance, such statements are forward looking and subject to a number of risks and uncertainties. The opinions, analysis and information herein do not take into account circumstances, objectives, or needs of any specific person.

Investments may be subject to risks that are difficult to quantify and to integrate into their valuation and significant fluctuations in their value or return may occur. Products with a high degree of risk, such as derivatives, structured products, or alternative/non-traditional investments (hedge funds, private equity, real estate funds, etc.) are suitable only for sophisticated investors who are capable of understanding and assuming the risks involved. Investments in foreign securities or currencies involve additional risk as the foreign security or currency might lose value against an investor's reference currency.

This document is without express or implied warranties or representations of any kind and UBP will not accept any liability whatsoever for any loss or damage resulting from the use of, or reliance on, the information, analysis or opinions contained herein.

Copyright UBP. All rights reserved.

Union Bancaire Privée, UBP SA I Head Office
Rue du Rhône 96-98 I P.O. Box 1320 I 1211 Geneva 1, Switzerland
ubp@ubp.ch I www.ubp.com

Signatory of: PRI Principles for Responsible Investment