THE DRIVE YOU DEMAND

INVESTOR INSIGHTS

Emerging Markets

November 2017 | Global Investment Committee

UBP

UNION BANCAIRE PRIVÉE

EXECUTIVE SUMMARY

- Global growth in 2018 is expected to be unchanged from 2017 at 3%. US policy interest rates set to rise by 75bps to end-2018. Emerging Markets (EM) will again grow at around 5%, with inflation contained. Interest rates have bottomed out but EM FX has some downside risk.

- Mexico is the canary in the coal mine. It faces potential US protectionism, border politics and re-negotiation of the North American Free Trade (NAFTA) deal. If risks recede, it and EMs should gain. If not, EM growth is at risk.

- In Fixed Income, UBP favours hard currency debt with strong fundamentals and a duration of under five years. High yield bonds should continue to see strong demand with investors looking for carry (EM HY spreads are not as tight as US HY). FX and US rates risk make local currency bonds unattractive.

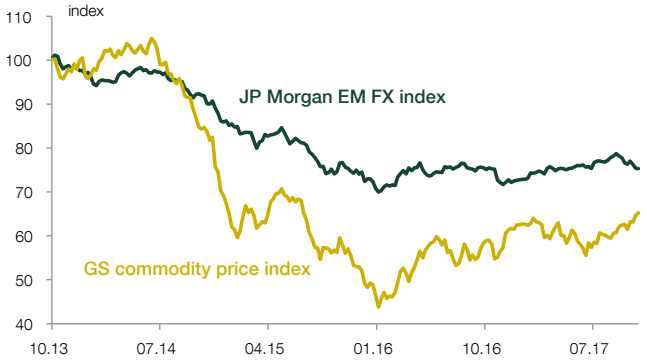
- In country terms, UBP is cautious on high yielding sovereigns like South Africa and Turkey. Yields do not compensate for political risk. UBP has a preference for Chinese credits. These dominate the new issue pipeline in Asia, especially state-owned enterprises. Indonesian and Indian HY bonds are also attractive.

- EM equities have traded at a price-to-earnings discount to DM since 2008. EM is now priced at 14x 2018 earnings vs DM at 18x. EM also offers higher earnings growth at 14% (over two years) vs 9% for DM. On a book value basis, EM at 1.6x vs 12% return on equity (ROE) is better long-term value. DM trades at 2.2x with 11% ROE.

- With appealing valuations and better sustained earnings growth, we expect pro-EM sentiment to remain. Earnings revisions favour north Asia, cyclicals and technology (semiconductors).

Rising commodity prices have stabilised EM FX

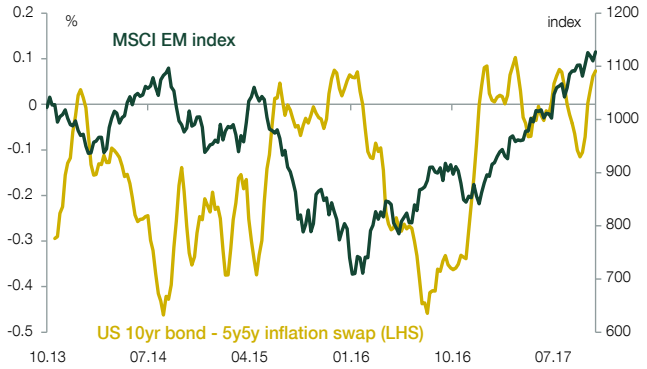
EM FX & commodity prices



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

EM equities have ignored moves in US real rates

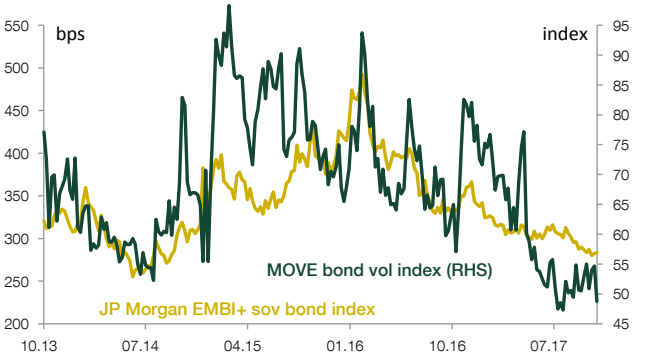
US real yields and EM equities



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

EM debt has been a beneficiary of low volatility

Volatility and EM bond performance



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

ECONOMICS & FX OUTLOOK

- Global growth in 2018 is expected to be unchanged from 2017 at 3% with US policy interest rates rising by 50bps. G7 central banks will reduce balance sheets as predictably as possible (ex-BOJ). EMs will see growth at just under 5% again with inflation contained. Interest rates have bottomed out but FX has some downside risk.

- China's recent 19th Party Congress has proposed tighter regulation and tougher environmental controls, but the country's ambition to remain a driver of global activity remains undimmed.

- Growth in China is expected to drop from 6.7% this year to 6.1% in 2018 as environmental controls bite and the central bank gains a firmer control of credit growth. Debt-to-GDP amongst Chinese non-bank financials was 165% in 2016, up from 105% in 2006.

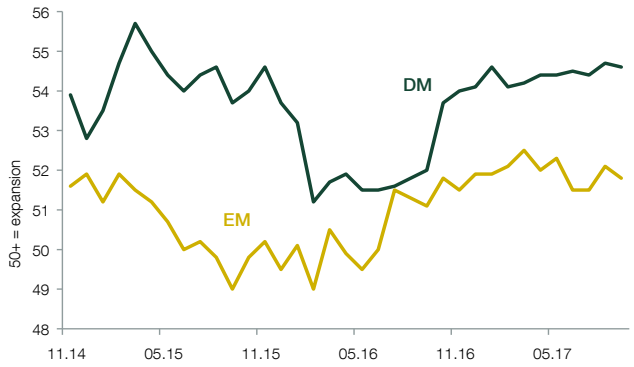
- Outside of China, the outlook for Asia is positive, but country-specific. Better performance is expected in North Asia. It is most exposed to Japan, the demand for technology and capital spending in the G7 (Korean peninsula risk is not likely to cause economic dislocation / recession).

- Latin American policymakers are beating inflation with growth now on the rebound. Banco Central do Brasil (BCB) has reduced the SELIC policy rate from 15% to under 8% and could cut further. Political risk remains but reforms of labour markets / pensions are positive.

- Mexico faces uncertainty from potential US protectionism, border politics and re-negotiation of the North American Free Trade (NAFTA) deal. Mexico is the canary in the coal mine for trade war signals in 2018. If risks recede it should rebound strongly. If not, EM growth is at risk.

PMIs show EM growth keeping pace with DM

EM v DM growth



Source(s): Thomson Eikon

Indebtedness has risen across the board since 2006

Sovereign & non-financial private sector debt (% GDP)

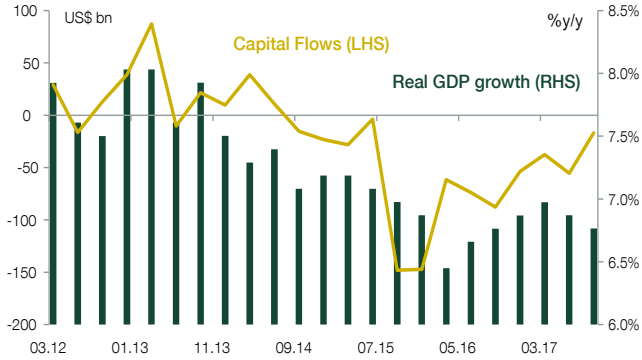
		CH	BR	IN	ZA	TY	MX	RU	SA	AR	ID
Gen govt	*2006*	25	66	78	31	45	38	10	26	70	36
	2016	44	78	70	52	28	58	16	13	54	28
House-holds	*2006*	11	14	10	39	9	12	8	12	4	11
	2016	44	23	10	35	18	16	16	15	6	17
Non-fin co.s	*2006*	105	39	38	33	27	14	32	28	20	14
	2016	165	44	45	37	67	28	52	50	12	23

Note: Shaded area signifies an increase on 2006

Source(s): International Monetary Fund

Capital flight from China has largely stopped

China: GDP growth & capital flows



Source(s): Thomson Eikon

ECONOMICS & FX OUTLOOK

- Eastern Europe has rebounded on higher commodity prices and eurozone growth rates. Bank Rossi is looking to cut policy rates further as inflation is at its lowest since 1998. Turkey and South Africa remain the outliers with political uncertainty a real concern.

- PMIs for EMs continue to show little upside risk for inflation and therefore policy rates. Companies appear unable to pass on higher costs, despite many reporting tight supply chains. Productivity gains are necessary, otherwise margins will be shaved.

- For FX, higher US rates in 2018 will bring some US dollar appreciation pressure to bear. This leaves little room for further policy loosening outside of large commodity producing countries in Latin America and Eastern Europe.

- Brazil, Russia, India, Mexico and Indonesia will all have elections in 2018. EM policies will thus be key to investment returns rather than simply guessing the direction of US rates.

FX Technical Analysis

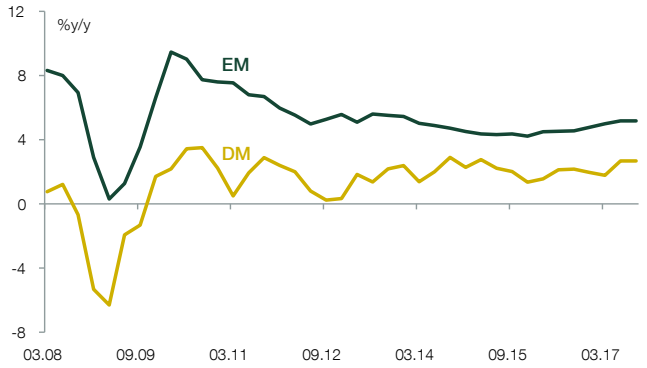
- The US Dollar Index (DXY) is poised for a bullish breakout. DXY is likely to get stronger with a target of 96.80 to 97.20 (currently 94.60). Those targets represent a gain of 3-4%.

- The Asia Dollar Index (ADXY Index) is in a long-term downward channel. The ADXY Index is near the pivot point of the downward channel. Any failure above 108.50 would trigger a sell off (see chart). After testing 6.55, CNH appears set to fall towards 6.95.

- The same trend is visible in Latin America, suggesting most Latin American currencies could give back some of their recent gains.

Inflation's rise since 2016 has tapered

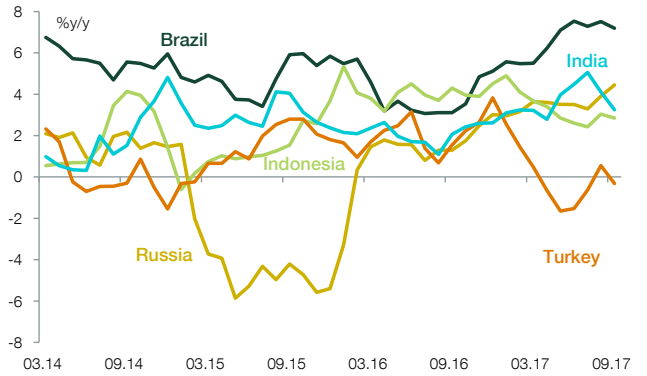
Global Inflation (CPI)



Source(s): Thomson Eikon, OECD

Lower inflation leading to prospect of lower yields

EM real 10yr bond yields



Source(s): Thomson Eikon

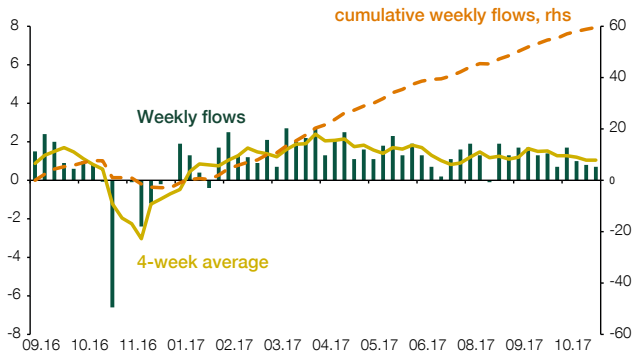
Technical analysis looks for lower L/T Asian FX

Source(s): Bloomberg Finance L.P.

FIXED INCOME OUTLOOK

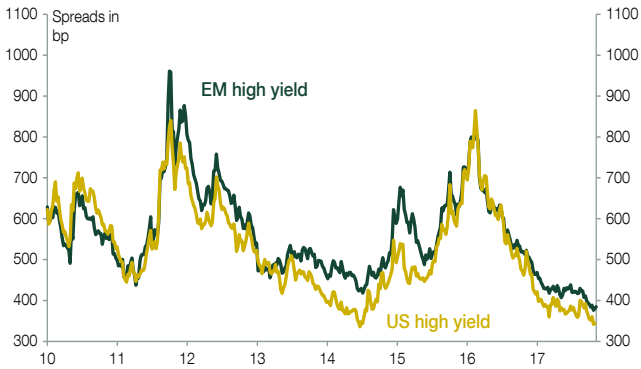
- In the EM space, credit selection and duration management will be key in a rising interest rate environment. Though we may not see a sharp rise in US Treasury yields, UBP expects the Federal Reserve will keep tightening policy.
- We favour EM credits with strong fundamentals and bonds with duration of under five years. High yield corporate bonds will continue to see strong demand with investors looking for carry trade opportunities.
- With spread differentials narrowing between BB- and B-grade credits, we prefer solid BBs for yield pickup (better fundamentals).
- Chinese credits expected to continue to dominate the new issue pipeline in Asia especially in the state-owned enterprises (SOEs). UBP prefers credits with strong government support, especially in sectors of strategic importance.
- In addition to Chinese names, UBP prefers Indonesia and Indian high yield bonds with improving fundamentals.
- In 2017, we have seen a strong inflow to EM debt that has driven EM credit spreads lower. A stronger US dollar will exert pressure on EM currencies and domestic interest rates.
- In early 2018, we anticipate local currency bond yields continuing to go up on the back of tightened liquidity.
- Latam currencies and the upcoming election in Brazil will be closely watched and could lead to volatility in EM credit spreads. We will be cautious on Turkish and South African credits for now until politics have stabilised.

Net fund flows to EM debt (US$ bn)



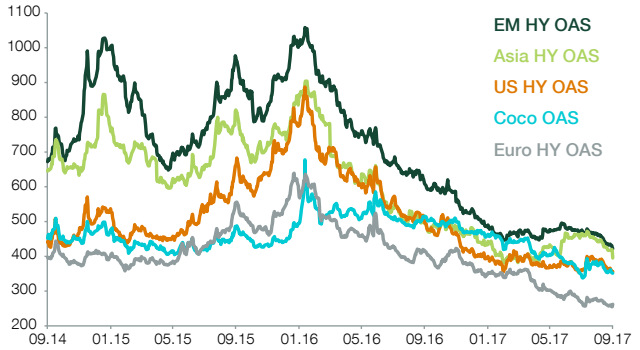
Source(s): BofA ML, EPFR, UBP

EM/DM HY Corporate Spread Comparison



Source(s): US HY: BofA Merrill Lynch US High Yield Index
EM HY: JP Morgan CEMBI Diversified High Yield.

HY Performance post-oil price collapse



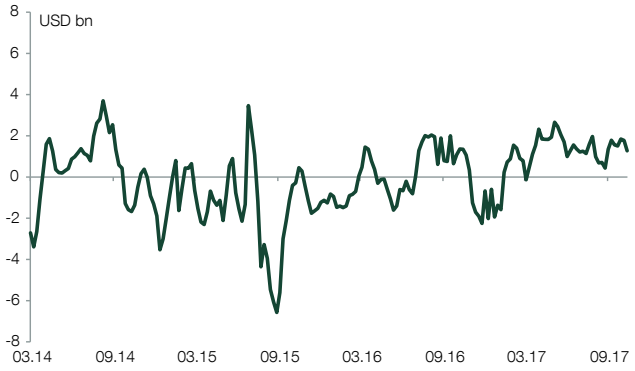
Source(s): Bloomberg. EM HY: BOFA ML Emerging Markets Corporate Plus Index, Asia HY: BOFA ML Asian Dollar High Yield CorpIndex; CoCo: Bloomberg Barclays CoCo Index; US HY: BOFA ML US HY Master II Index, Eur HY: BOFA ML EUR HY Index

EQUITY OUTLOOK

- Attractive valuations and improved sentiment, sparked by earnings recovery, have driven global EM equities up 34% so far in 2017. This has been led by EM Asia at +40%.
- Year-to-date total EM inflows of US$56bn (tracking slightly behind 2010), have mostly gone into dedicated EM funds. On a regional basis, Latin America has seen significant inflows. EM Asia flows are marginally positive while Eastern European (EMEA) funds have seen net outflows.
- The catalyst for improved EM sentiment has been a strong recovery in corporate earnings, especially in Asia (74% of the MSCI EM) which is now more than one year into its earnings recovery.
- Earnings revisions are currently positive for EM overall but with diversity among geographies, as Latin America lags EMEA and EM Asia.
- EM equities have traded at a price-to-earnings discount to DM since 2008. EM is now priced at 14x 2018 earnings vs DM at 18x. EM also offers higher earnings growth at 14% (over two years) vs 9% for DM. On a book value basis, EM at 1.6x vs 12% return on equity (ROE) is better long-term value. DM trades at 2.2x with 11% ROE.
- With still-attractive valuations and higher sustained earnings growth, we expect EM sentiment to remain positive and supportive of continued outperformance.
- From a technical point-of-view, the global EM index formed a bullish inverted head and shoulder pattern at the beginning of the year and is now in a rising channel with positive momentum indicators.

EM fund flows continue to be positive…

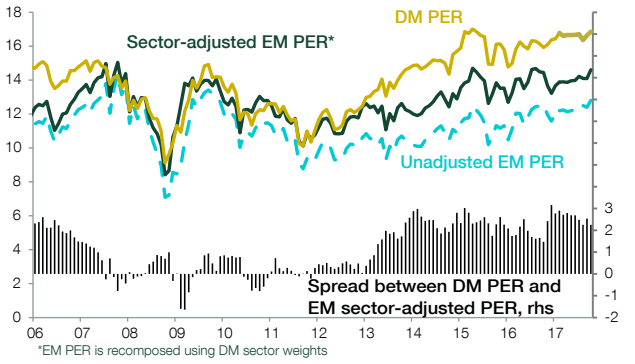
Global EM equity flows (4w avg)



Source(s): BofAML, EPFR, UBP

…attracted to compelling valuation vs DM…

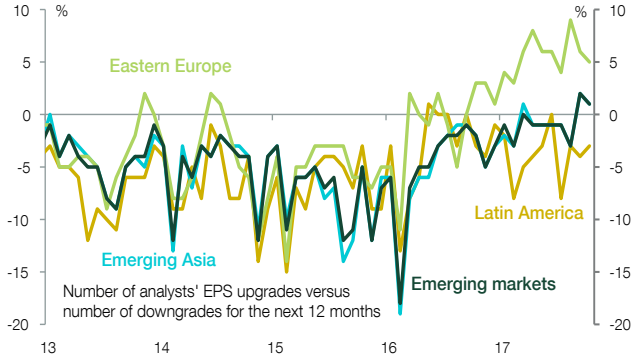
Emerging vs developed markets: adjusted 12-month forward PER



Source(s): Thomson Financial, UBP

…and an improving earnings picture

Earnings revision ratio: emerging markets



Source(s): Thomson Financial, UBP

ASIAN EQUITIES OUTLOOK

- Earnings recovery began in late 2016 and has gained strength – regional EPS is now 21% higher. This has driven 39% YTD total return for MSCI Asia ex-Japan (MXASJ), led by technology +61% and China +48%. Earnings revisions favour north Asia, technology and cyclicals.

- Dollar strength following the US election quickly gave way to a prolonged 11.6% slide until DXY bottomed out in late 2016. This rate expectations-driven volatility has not had any significant negative impact on the Asia earnings recovery story or equity markets.

- Earnings recovery leaders are Korea and Hong Kong, as well as Pakistan. China is the most significant earnings recovery laggard, with earnings 11% higher YTD but +12% since bottoming out in February.

- By sector, earnings recovery leaders are energy, cyclicals, technology and real estate. Financials are the biggest laggard, while defensives are not contributing to earnings recovery.

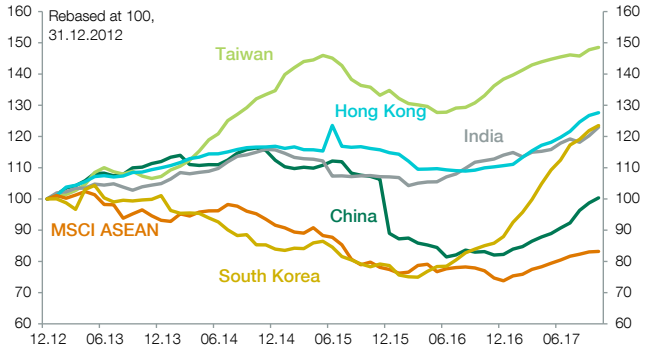
- Technology is the largest Asian sector. Strong performance has been driven by 46% earnings growth. Positive revisions momentum points to continued strength; we favour semiconductor plays in north Asia and Chinese internet names.

- Financials have almost kept pace with MXASJ performance despite lagging earnings growth. Going forward, rising interest rates can improve earnings and prompt a sector re-rating.

- Earnings growth laggards China and Financials are also among the cheapest segments of the market on headline PE, which suggests that there is room for earnings recovery in these two to support further gains and outperformance vs DM.

Earnings from Asia have been recovering since 4Q last year…

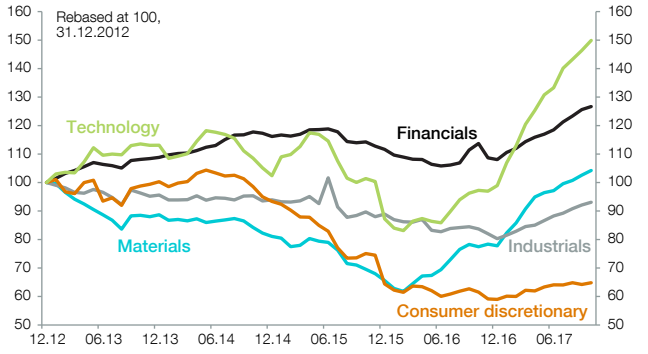
Selected Asian countries: 12-month forward earnings



Source(s): Thomson Reuters, UBP

…led clearly by Technology

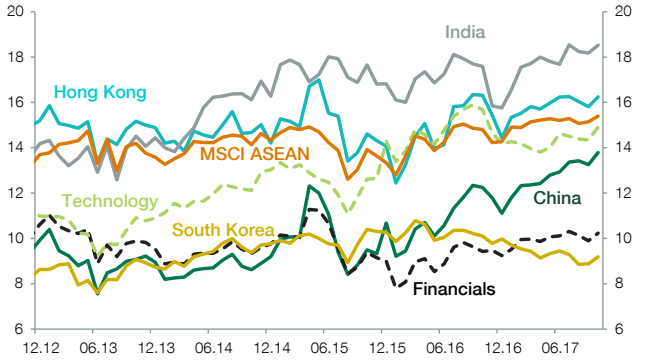
Selected Asia ex Japan sectors: 12-month forward earnings



Source(s): Thomson Reuters, UBP

Korea, Financials and China are the cheapest on PE

Selected Asian countries & sectors: 12-month forward PER



Source(s): Thomson Reuters, 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

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