Emerging markets: Broader opportunities and declining systematic risk

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April 25, 2013
EM portfolio management and research

**Equity**

**Portfolio Manager**
Alexander Muromcew

**Research**
Hari Bagai – Financial Services; Asia (ex-Japan)
Yelena Bobyor – Regional Specialist; Europe, Middle East, and Africa
Henry Garrido – Regional Specialist; Latin America
Bart Grenning – Consumer; Asia (ex-Japan)
Lilian Li – Industrials; Asia
Navaneel Ray – Materials; Global
Muthu Sankar – Regional Specialist; Southeast Asia, India
Willis Tsai – Technology; International

**Fixed Income**

**Portfolio Manager**
Katherine Renfrew

**Research**
Karina Bubeck – Corporates; Latin America
Anupam Damani – Sovereigns; Central/Eastern Europe, Middle East, and Africa
Aaron Enriquez – Generalist
John Espinosa – Sovereigns & Corporates; Asia
Klim Fedoff – Corporates; Central/Eastern Europe, Middle East, and Africa
Chelsea Konsko – Generalist
Douglas Smith – Sovereigns; Latin America
Jessica Zarzycki – Sovereigns; Developed Markets

**Trading**
Dan Boudreau
EM investments by regions and sectors

EM Equity AUM: $3.5 billion*

EM Fixed-Income AUM: $7.1 billion*

EM equity regions
- Africa/Middle East: 24%
- Asia: 13%
- Europe: 8%
- Latin America: 55%

EM fixed-income regions
- Asia: 17%
- Europe: 43%
- Latin America: 20%
- Middle East/Africa: 20%

EM equity GICS sectors
- Financials: 27%
- Information Technology: 15%
- Materials: 12%
- industrials: 10%
- Consumer Discretionary: 11%
- Consumer Staples: 8%
- Energy: 9%
- Telecomm Services: 4%
- Utilities: 2%

EM fixed-income sectors
- Sovereign - USD: 42%
- Quasi-Sovereign - USD: 28%
- Corporate - USD: 6%
- Asset Backed - USD: 1%
- Local Currency: 23%

*As of 12/31/2012  GICS: Global Industry Classification Standard
Growing importance of emerging markets

**EM share of global GDP rising since 1990s**

- EM share of global GDP* close to exceeding developed markets (DM)
- Key drivers: Population growth, natural resources, economic development, globalization

Source: International Monetary Fund, World Economic Outlook Database, April 2013

*GDP based on purchasing power parity
Growing importance of emerging markets

Growing share of global equity market cap and GDP

- 13% of global market cap in 2012
- 35% of GDP (nominal)

Source: JP Morgan economics
Emerging markets — long time in the making

Comparing growth rates: EM vs. developed markets

- EM reflect consistently higher growth rates since early 1990s.
- Growth rates remain volatile in short-term, impacted by developed markets.

Source: International Monetary Fund, World Economic Outlook Database, April 2013
EM economies leading global growth

EM growth rates vary by region

- Emerging Asia is growing significantly faster than Latin America and EMEA

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<td>2.1</td>
<td>1.5</td>
<td>-0.3</td>
<td>0.1</td>
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<td>6.2</td>
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<td>9.3</td>
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<td>4.8</td>
<td>4.8</td>
<td>2.7</td>
<td>2.9</td>
<td>3.5</td>
<td>4.1</td>
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</table>

Source: Bloomberg
Declining systematic risk

EM credit fundamentals steadily improving

- 58% of the EM debt asset class is now investment grade
- Credit fundamentals for large constituents, such as Philippines and Turkey, suggest more upgrades to come
- Reflects broad improvement in sovereign debt, current account, inflation, and GDP growth

Share of investment grade vs. non-investment grade debt
Based on JPM EMBI Global Diversified Index Quality %

Source: JP Morgan
Systematic risk refers to market risk.
Macroeconomic/structural improvements

- BRICs have come a long way: Improved growth, better balance sheets and liquidity
- Non-BRICs looking even better: More robust exports, healthy balance sheets, improved liquidity

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<tr>
<td>GDP Growth 3-yr Avg</td>
<td>2.8%</td>
<td>3.8%</td>
<td>6.6%</td>
<td>4.0%</td>
<td>4.7%</td>
<td>6.9%</td>
<td>8.6%</td>
<td>9.2%</td>
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<td>Current account balance % GDP</td>
<td>-1.5%</td>
<td>-2.3%</td>
<td>7.8%</td>
<td>5.2%</td>
<td>1.2%</td>
<td>-4.1%</td>
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<tr>
<td>Inflation (end of period)</td>
<td>12.5%</td>
<td>5.8%</td>
<td>15.0%</td>
<td>5.1%</td>
<td>6.0%</td>
<td>6.6%</td>
<td>-0.4%</td>
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<tr>
<td>Budget balance % GDP*</td>
<td>-4.4%</td>
<td>-2.9%</td>
<td>1.9%</td>
<td>0.6%</td>
<td>-5.9%</td>
<td>-5.6%</td>
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<td>-1.7%</td>
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<td>External debt % GDP</td>
<td>45.2%</td>
<td>25.5%</td>
<td>40.5%</td>
<td>32.0%</td>
<td>22.5%</td>
<td>20.2%</td>
<td>12.7%</td>
<td>9.6%</td>
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<tr>
<td>Exports % GDP (merchandise only)</td>
<td>11.9%</td>
<td>10.7%</td>
<td>31.1%</td>
<td>28.2%</td>
<td>10.3%</td>
<td>16.4%</td>
<td>22.4%</td>
<td>25.3%</td>
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<td>FX reserves/Ext. Debt Service</td>
<td>74.0%</td>
<td>555.4%</td>
<td>197.0%</td>
<td>541.0%</td>
<td>570.5%</td>
<td>963.1%</td>
<td>1087.9%</td>
<td>8459.5%</td>
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<td>6.6%</td>
<td>4.1%</td>
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<tr>
<td>Current account balance % GDP</td>
<td>-2.2%</td>
<td>-0.5%</td>
<td>0.8%</td>
<td>-6.2%</td>
<td>1.3%</td>
<td>3.7%</td>
<td>3.9%</td>
<td>-1.9%</td>
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<td>3.6%</td>
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<tr>
<td>Budget balance % GDP*</td>
<td>-1.2%</td>
<td>-2.4%</td>
<td>-1.4%</td>
<td>-5.3%</td>
<td>2.2%</td>
<td>1.7%</td>
<td>-1.3%</td>
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<tr>
<td>External debt % GDP</td>
<td>24.7%</td>
<td>28.0%</td>
<td>30.6%</td>
<td>32.7%</td>
<td>23.1%</td>
<td>36.7%</td>
<td>65.6%</td>
<td>27.4%</td>
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<tr>
<td>Exports % GDP (merchandise only)</td>
<td>24.8%</td>
<td>32.2%</td>
<td>28.5%</td>
<td>25.7%</td>
<td>28.2%</td>
<td>49.1%</td>
<td>29.6%</td>
<td>22.1%</td>
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<tr>
<td>FX reserves/Ext. Debt Service</td>
<td>144.2%</td>
<td>254.4%</td>
<td>113.4%</td>
<td>404.6%</td>
<td>680.1%</td>
<td>592.5%</td>
<td>126.4%</td>
<td>520.3%</td>
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Source: Bloomberg, Moody's and S&P's Foreign Currency LT Debt rating, Institute of International Finance
EM fiscal policy creating stronger balance sheets

EM have lower debt-to-GDP ratios than DM

Total government debt (% of GDP) 2012 and 2013

- **Japan**: 242% (2013) vs 234% (2012)
- **United States**: 104% (2013) vs 101% (2012)
- **France**: 93% (2013) vs 90% (2012)
- **Germany**: 81% (2013) vs 81% (2012)
- **India**: 64% (2013) vs 65% (2012)
- **Brazil**: 58% (2013) vs 59% (2012)
- **China**: 48% (2013) vs 48% (2012)
- **Russia**: 12% (2013) vs 11% (2012)

Source: 3/2013 Fitch Comparator
Maturing profile of sovereign debt

Declining volatility reflects debt market recovery since 2008 crisis

- Increased liquidity, greater access to capital supports economic growth and equity markets

Source: J.P. Morgan. Volatility data as of 03/28/2013

* J.P. Morgan Emerging Markets Bond Index Global
** J.P. Morgan Emerging Markets Bond Index Global Diversified

Sovereign debt refers to bonds issued by a national government in a foreign currency.
Equity market showing increasing stability

Volatility declining overall since peak in 2008

- Macro event-related spikes continue, but reactions tend to be more subdued

Annualized volatility for MSCI EM Index

![Graph showing annualized volatility for MSCI EM Index from 1990 to 2013.](image)

Source: Bloomberg

*Right Hand Side: Reflects the ask or offer price of a foreign exchange rate*
Investment opportunities beyond the BRICs

BRICs underperforming rest of EM
- BRICs underperformed rest of EM by 36% since 2010.
- BRICs, South Africa, Korea, and Taiwan underperformed rest of EM by 30% since 2010.
- Rest of EM* have **outperformed** the index, demonstrating value of country selection.

Share of EM index performance: BRIC vs. non-BRIC

Source: J.P. Morgan and Bloomberg. Note: Indices constructed assuming equal weights across countries.

* Excluding BRICs, South Africa, Korea, and Taiwan
BRICs refer to Brazil, Russia, India, and China.
## BRICs facing structural challenges to sustaining peak growth rates

### Brazil
- Low private sector investment because of uncertainty over government policy.
- Weak infrastructure is still a major bottleneck.
- 2014 presidential elections risk more government intervention.

### Russia
- Political reforms look unlikely with the return of Putin.
- Investment climate remains challenging due to institutionalized corruption and lack of reform.
- Aging population and rising health issues suggest the need for pension and social reforms.

### India
- Macroeconomic challenges – weak fiscal position, rising current account deficits, and structurally high inflation.
- Raising potential growth levels by clearing regulatory roadblocks that deter private investment.
- Domestic politics slowing growth-related reforms.

### China
- Rebalancing and reforming the economy away from investment and toward consumption.
- Growing contingent liabilities from the domestic financial system (LGIVs, trust financing).
- Rising social and geopolitical risks (North Korea, Taiwan/HK, maritime border disputes, pollution/health concerns).
Debt market composition

Sector characteristics differ by country and region

- Non-BRICs dominate the sovereign debt market
- BRICs more significant in corporate bond issuance than sovereigns
- Latin America is prominent due to Brady crisis legacy

BRIC vs. non-BRIC debt market composition

<table>
<thead>
<tr>
<th></th>
<th>EMBI Global(^1) (EM Sovereigns)</th>
<th>CEMBI(^2) (EM Corporates)</th>
<th>GBI-EM Global(^3) (Local EM Sovereigns)</th>
<th>MSCI EM(^4) (EM Equities)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Brazil</td>
<td>7%</td>
<td>22%</td>
<td>25%</td>
<td>13%</td>
</tr>
<tr>
<td>Russia</td>
<td>10%</td>
<td>14%</td>
<td>7%</td>
<td>6%</td>
</tr>
<tr>
<td>India</td>
<td>0%</td>
<td>5%</td>
<td>0%</td>
<td>7%</td>
</tr>
<tr>
<td>China (ex HK)</td>
<td>2%</td>
<td>9%</td>
<td>0%</td>
<td>13%</td>
</tr>
<tr>
<td>Non-BRIC</td>
<td>80%</td>
<td>50%</td>
<td>69%</td>
<td>62%</td>
</tr>
</tbody>
</table>

Source: Bloomberg, JP Morgan
\(^1\)J.P. Morgan Emerging Markets Bond Index Global
\(^2\)J.P. Morgan Corporate Emerging Markets Bond Index
\(^3\)J.P. Morgan Government Bond Index-Emerging Markets
\(^4\)MSCI Emerging Markets Index

The Brady crisis refers to the emerging market debt crisis of the 1980s ultimately resolved through a refinancing plan named for then-U.S. Treasury Secretary Nicholas F. Brady.
BRIC fixed-income markets have been relatively good sources of return

- Sovereigns and corporates have generally performed well due to solid balance sheets

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<tbody>
<tr>
<td>Brazil</td>
<td>3.8</td>
<td>0.9</td>
<td>3.1</td>
<td>3.5</td>
<td>3.5</td>
<td><em>Upside Risks</em>: Infrastructure building and presidential elections in 2014.</td>
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<tr>
<td>Russia</td>
<td>1.6</td>
<td>3.4</td>
<td>3.1</td>
<td>3.6</td>
<td>4.0</td>
<td><em>Downside Risks</em>: Lack of structural reforms and lower commodity prices hurt growth potential.</td>
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<tr>
<td>India</td>
<td>7.8</td>
<td>5.2</td>
<td>5.1</td>
<td>6.1</td>
<td>6.8</td>
<td><em>Balanced Risks</em>: Recent reforms offset growing reliance on portfolio flows and political uncertainty over 2014 elections.</td>
</tr>
<tr>
<td>China</td>
<td>9.6</td>
<td>7.8</td>
<td>8.1</td>
<td>8.0</td>
<td>8.0</td>
<td><em>Downside Risks</em>: Weak global macro environment and tighter monetary policies risk reversing cyclical rebound.</td>
</tr>
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</table>

Source: Growth estimates from Bloomberg
EM countries have different economic drivers and GDP sources

Macroeconomic progress

- Smart fiscal and monetary policy has built credibility and resistance to external shocks
- Relatively low wage growth has fostered a significant manufacturing export base, particularly autos
- New President Pena-Nieto is pushing for important, long-needed reforms in telecoms, education, fiscal, and energy policies
- Three main political parties have agreed on need for key reforms despite a weak track record of cooperation

However, some concerns still bear watching:

- Energy reform could significantly improve potential growth and investment in Mexico
- Increased trade with Asia, particularly oil exports to China, will diversify the export base and reduce reliance on trade with the United States

<table>
<thead>
<tr>
<th>Metric</th>
<th>2012</th>
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<tr>
<td>Sovereign rating</td>
<td>Baa1/BBB</td>
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<tr>
<td>GDP growth 3-yr avg</td>
<td>4.4%</td>
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<tr>
<td>Current account balance % GDP</td>
<td>-0.5%</td>
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<tr>
<td>Inflation (end of period)</td>
<td>3.6%</td>
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<tr>
<td>Budget balance % GDP</td>
<td>-2.4%</td>
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<tr>
<td>External debt % GDP</td>
<td>28.0%</td>
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<tr>
<td>Merchandise exports % GDP</td>
<td>32.2%</td>
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<tr>
<td>FX reserves/ext. debt service</td>
<td>254.4%</td>
</tr>
</tbody>
</table>

Source: Institute of International Finance
Foreign direct investment in Mexico

- FDI expands rapidly following NAFTA adoption in 1994
- Investment is heaviest in industrial/manufacturing sector, particularly autos
- 72% of Mexican exports go to the United States

Source: UBS

* North American Free Trade Agreement
Mexico wages declining relative to China attracts manufacturing FDI

- Mexico industrial wages rising 5% – 6% vs. nearly 20% in China
- Weaker peso vs. stronger renminbi supports manufacturing growth

Mexico Wage Differential with China (monthly wages in USD)

Source: UBS
EM equity exposure for performance and diversification potential

EM equity has outpaced developed markets over the past decade

Equity market index performance since 2002
S&P 500 vs. foreign developed- and emerging-market benchmarks*

*Month-end, through February 2013. Indexed January 2002 = 100. Sources: MSCI, S&P
It is not possible to invest in an index. Performance for indexes does not reflect investment fees or transaction costs.
Market valuations favor emerging markets

EM equity is less expensive, with higher earnings growth, than developed markets

<table>
<thead>
<tr>
<th>Index</th>
<th>Current PE</th>
<th>12–month fwd PE</th>
<th>PVB</th>
<th>ROE</th>
<th>2013 earnings growth</th>
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<tbody>
<tr>
<td>MSCI EM</td>
<td>12.5</td>
<td>10.3</td>
<td>1.6</td>
<td>13.0%</td>
<td>14.3%</td>
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<tr>
<td>MSCI EAFE</td>
<td>15.9</td>
<td>12.5</td>
<td>1.5</td>
<td>9.6%</td>
<td>11.0%</td>
</tr>
<tr>
<td>S&amp;P 500</td>
<td>15.0</td>
<td>13.5</td>
<td>2.4</td>
<td>15.2%</td>
<td>7.6%</td>
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</table>

Source: DataStream, Bloomberg, UBS. Data as of April 10, 2013.
EM correlation to developed markets is declining

Exposure to EM can provide diversification benefits

<table>
<thead>
<tr>
<th>Year</th>
<th>EM vs. EAFE</th>
<th>EM vs. S&amp;P 500</th>
<th>EAFE vs. S&amp;P 500</th>
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<tbody>
<tr>
<td>2008</td>
<td>0.98</td>
<td>0.84</td>
<td>0.90</td>
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<td>2009</td>
<td>0.90</td>
<td>0.86</td>
<td>0.94</td>
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<td>2010</td>
<td>0.97</td>
<td>0.93</td>
<td>0.91</td>
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<tr>
<td>2011</td>
<td>0.85</td>
<td>0.86</td>
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<tr>
<td>2012</td>
<td>0.88</td>
<td>0.79</td>
<td>0.87</td>
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</table>

Source: CLSA, Bloomberg, Datastream. Annual correlation is calculated using weekly price performance for indexes.

Correlation is a statistical measure of how two securities move in relation to each other.
Equity investment opportunities and outlook

Three major trends

1. Growing middle class and growing per capita income lead to changes in consumer behavior: aspirational buying
2. Infrastructure: Most countries desperately need to improve infrastructure
3. Healthcare: Now affordable for new middle class

Outlook

- BRICs likely to improve somewhat in 2013 and 2014
- Brazil growth forecast much stronger
- China's new government will have positive impact in second half of 2013
- Overall, non-BRIC countries likely to do better
- Investors must be highly selective, given structural challenges of BRIC-dominated index
Fixed-income opportunities and outlook

Three pillars for better risk-adjusted returns
1. Improved government debt stock and fiscal policy
2. Reduced vulnerability to external shocks: Flexible exchange rates, inflation targeting, monetary policy frameworks
3. Greater political stability and smoother democratic transitions

Outlook
- **Hard currency debt:**
  - Returns lower in 2013 than 2012
  - Potential for 3%–5% yields for IG sovereigns
  - Potential for 4%–6% yields for BIG sovereigns
- **Corporates:**
  - Offer compelling value over their sovereign benchmark
  - Many provide solid relative value versus global competitors
  - Quasi-sovereigns derive support from the underlying sovereign
- **Local currency:**
  - Higher yields than developed markets, potentially ranging between 4%–7%
  - Inflationary pressures largely in check
  - FX remains the wildcard
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