June 2016

THE BOSTON COMPANY
ASSET MANAGEMENT, LLC
A BNY MELLON COMPANY℠

Emerging Markets: Have We Seen the Bottom Yet?

Authored by: C. Warren Skillman and William J. Adams

Over the past five years, emerging-market equities have significantly underperformed their developed-market counterparts. Although sentiment remains poor, valuations have become quite attractive, potentially setting up the emerging-market asset class for robust returns.

Key Highlights

1. Valuation spreads between the most and least expensive emerging-market stocks are at record levels.
2. EM currencies have been hit by a rising dollar and global risk aversion.
3. Several important structural and fundamental adjustments are supportive of a long-term sentiment shift.

Global Growth: If vs. When?

Questions surrounding a recovery in global growth following the Global Financial Crisis persist to this day and underlie weak non-U.S. returns and persistent defensive positioning. Emerging markets are at the epicenter of this trend, given their high sensitivity to investor sentiment and capital flows. However, we believe they have reached an inflection point that presents a uniquely compelling opportunity for absolute and relative returns versus other asset classes. However, the current playbook may not be enough to fully capture outsized gains; instead, a leadership shift will likely favor the laggards of the past several years.

Emerging markets are well versed in boom and bust cycles. Excess global fund flows lead to weak capital discipline, overinvestment and excess leverage. Inevitably, countries and companies seek to insulate themselves from a receding tide by pursuing protectionist policies and/or capital controls. The buildup of imbalances ultimately becomes unsustainable, leading to a sometimes-violent adjustment process often involving currency devaluation, debt default and sharply curtailed access to capital. The series of debt crises that roiled the asset class in the mid- to late 1990s and the aftermath of the tech bubble are two such examples witnessed in the past 20 years.

However we see significant differences between then and now:

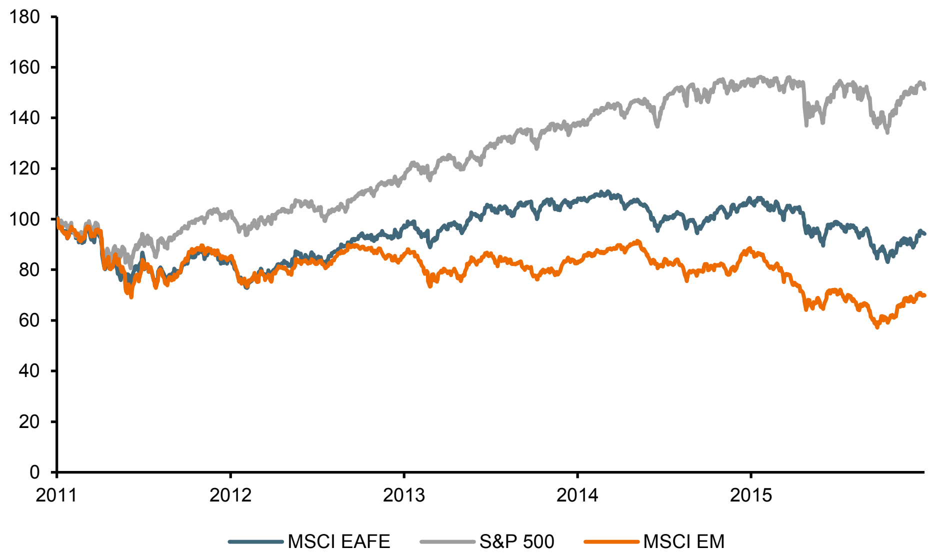
- At the macro level, emerging markets' sovereign debt levels are significantly lower and foreign-exchange reserves higher than those preceding the Asian Financial Crisis of the late 1990s.
- The prevalence of floating currency regimes in most countries is forcing an adjustment process that might have been postponed in the past. Current account balances are repairing, fiscal spending is being curtailed, and companies are right-sizing their businesses.

- Declining commodity prices are minimizing normally high pass-through inflation resulting from weaker currencies, allowing governments to run less restrictive monetary policies than might normally be the case.

- The result is a rapid recovery in export competitiveness and operational leverage, as well as a potential earlier recovery in domestic demand.

Over the past five years, emerging markets have gone from being universally loved to the target of broad skepticism. Over that period, the commodity super-cycle collapsed and many emerging countries succumbed to a strong U.S. dollar regime, causing a sharp cyclical deterioration in domestic growth and currency pressures. As a result, emerging-market equities have materially underperformed their U.S. and developed-market counterparts, as illustrated by Exhibit 1.

Exhibit 1: Emerging Markets Lag Behind



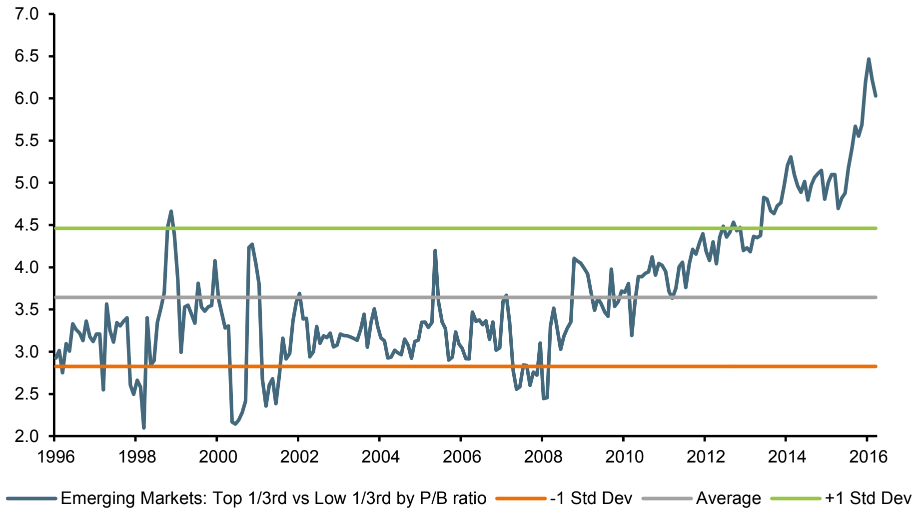
Source: FactSet, as of April 2016. Five year indexed USD performance.

Throughout this five-year period, large swaths of the emerging-markets asset class have become oversold, revealing compelling valuation opportunities. A combination of internal and external factors are driving improved emerging markets sentiment year to date, but the fundamental questions regarding sustainability remain.

The Valuation Opportunity

The Chinese economy's ongoing reorientation toward consumption and away from fixed asset investment triggered a prolonged down cycle in commodity-related markets, industries and companies. That, in turn, drove much of the valuation dispersion shown in Exhibit 2, which tracks the spread of the average price-to-book valuation of the least expensive one-third of the MSCI EM Index versus the average price-to-book valuation of the most expensive third. This spread reached record levels in late 2015 and only very recently started to moderate.

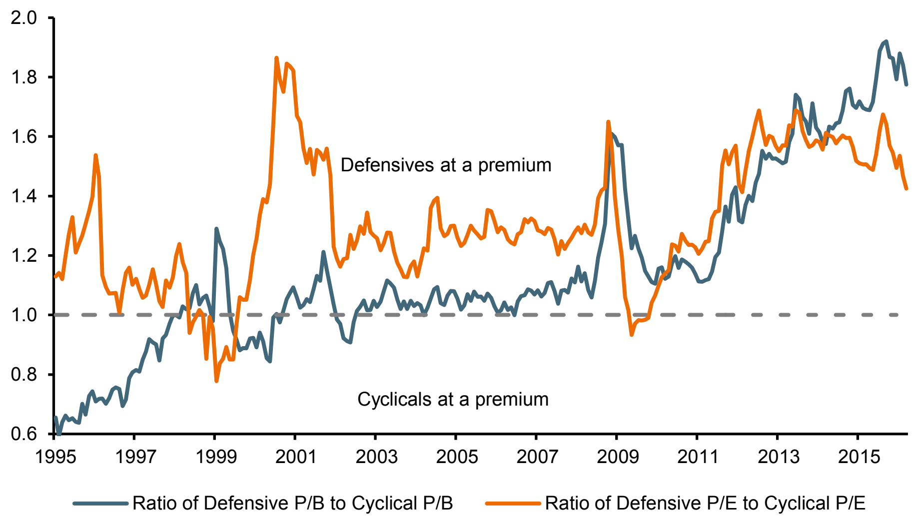
Exhibit 2: Record Valuation Spreads



Source: UBS Quantitative Research, as of April 2016. Top 1/3rd vs. Bottom 1/3rd. The left-hand scale is the difference between the average P/B valuation for the most expensive third and the least expensive third for stocks in MSCI EM Index.

Much of this valuation gap is explained by the underperformance and declining margin and earnings profiles of more cyclically driven companies compared to those with more defensive characteristics. Exhibit 3 illustrates the persistent valuation expansion of defensive stocks versus those with cyclical earnings profiles, on both earnings and book value multiples.

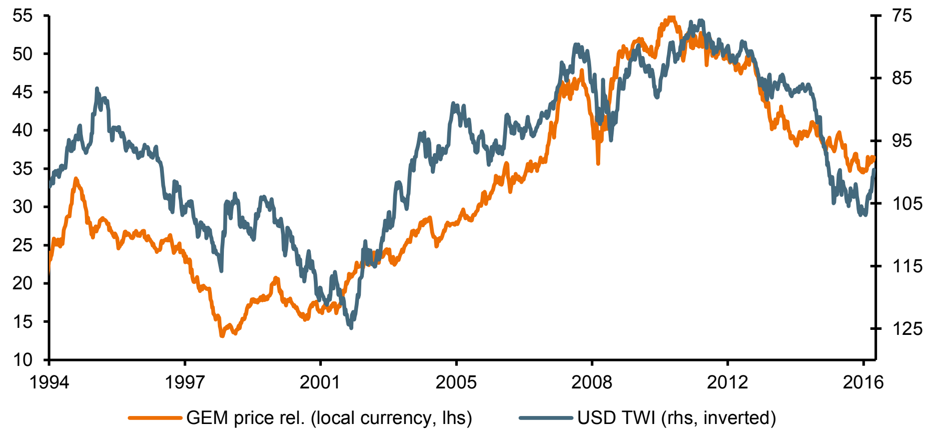
Exhibit 3: Defensive vs. Cyclical



Source: UBS, MSCI, IBES, as of March 2016. The left-hand scale shows ratio of Defensives/Cyclicals valuation. Note: Defensive sectors include Health Care, Telecommunication Services, Consumer Staples, Utilities. Cyclical sectors include Energy, Information Technology, Consumer Discretionary, Materials, Industrials, Financials.

As many emerging economies have grappled with digesting overcapacity built up in anticipation of continued above-trend global growth, corporate and sovereign debt concerns have also conspired to weigh on the more vulnerable currencies, which have been hit hard by a rising dollar since 2012. Exhibit 4 shows the correlation of emerging-markets equity performance with the trade-weighted U.S. dollar index. As the U.S. dollar strengthened, emerging markets underperformed. While this trend created a severe headwind to the asset class, it also triggered significant ongoing adjustments at the micro level, which will ultimately drive better competitiveness for key export sectors as the global backdrop stabilizes or improves.

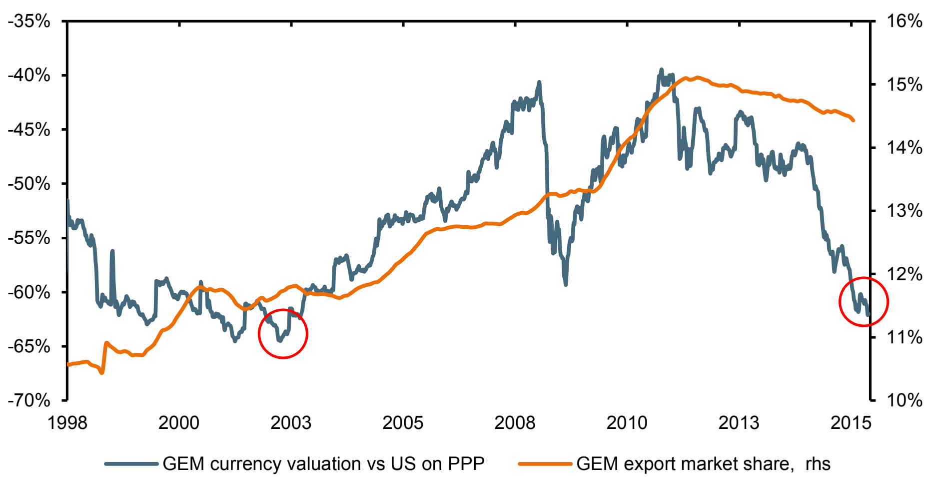
Exhibit 4: Headwinds from the Dollar



Source: Credit Suisse Research, Thomson Reuters, as of April 2016.

This currency adjustment in emerging markets is one of the steepest on record. Exhibit 5 shows that emerging currencies have hit lows that were last seen in 2002 after the Asian financial crisis and global technology bust.

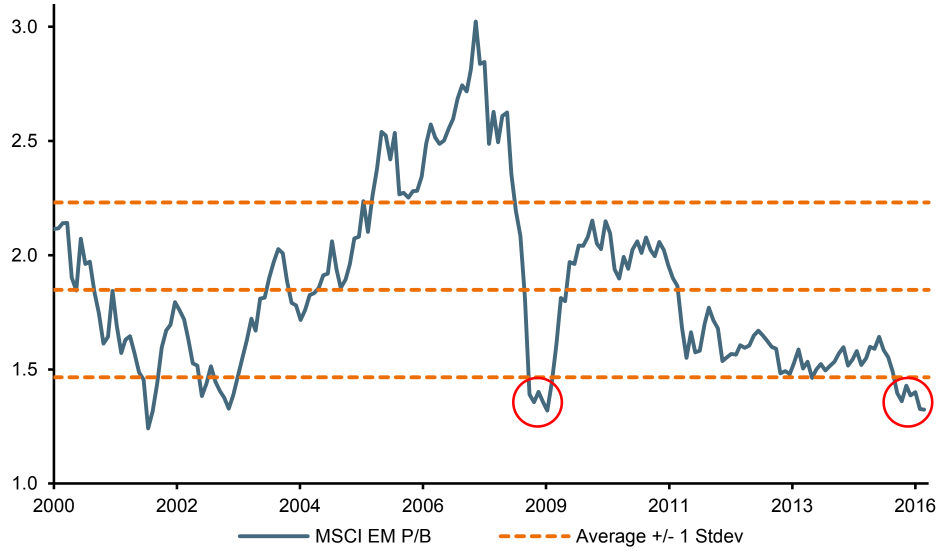
Exhibit 5: Post-Crisis Levels for Currencies



Source: Credit Suisse Research, Thomson Reuters. Data excludes China. Currency valuation as of April 2016. Export market share as of November 2015.

As some key ingredients for a bottoming phase in the asset class take hold, it is also constructive that this correction has translated into attractive, historically low valuations. Exhibit 6 depicts the asset class' profile on a price-to-book value basis, which has approached 2009 lows.

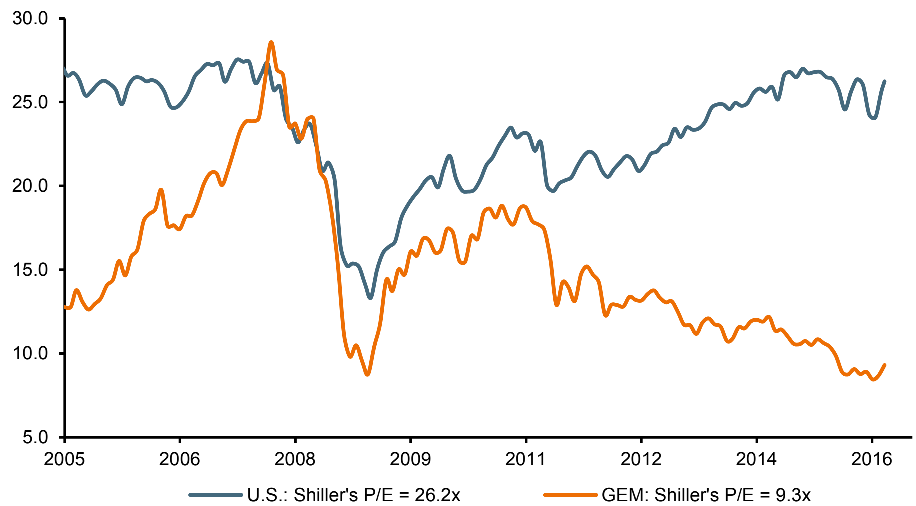
Exhibit 6: Valuations Near 2009 Lows



Source: Credit Suisse Research, Thomson Reuters, as of March 2016. The left-hand scale is MSCI EM P/B.

Additionally, the asset class looks inexpensive when adjusting the price-to-earnings ratio for normalized earnings, as measured in Exhibit 7 by Shiller's P/E, which compares emerging markets on normalized earnings levels versus the U.S. market. Shiller's P/E uses a smoothing technique by measuring price versus the average of the past ten years of inflation adjusted earnings.

Exhibit 7: Adjusting for Normalized Earnings

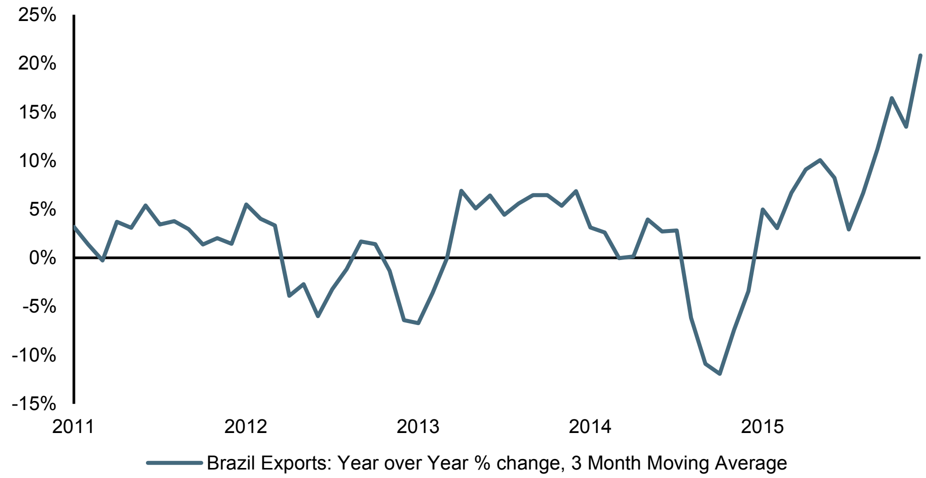


Source: Credit Suisse Research, Thomson Reuters, as of April 2016. The left-hand scale is Shiller's P/E.

Bearish investors may point out that low valuations and modestly improved macro conditions do not necessarily set the stage for a prolonged shift in sentiment and actual follow-through to corporate earnings. While that may be the case, we believe other structural and fundamental adjustments are taking hold, but have been drowned out by the macro noise and focus on the Federal Reserve.

- *Improved export competitiveness:* After absorbing significant currency devaluation and prolonged domestic recession, Brazil has seen its export trends improve markedly over the past 12 months, as seen in Exhibit 8.

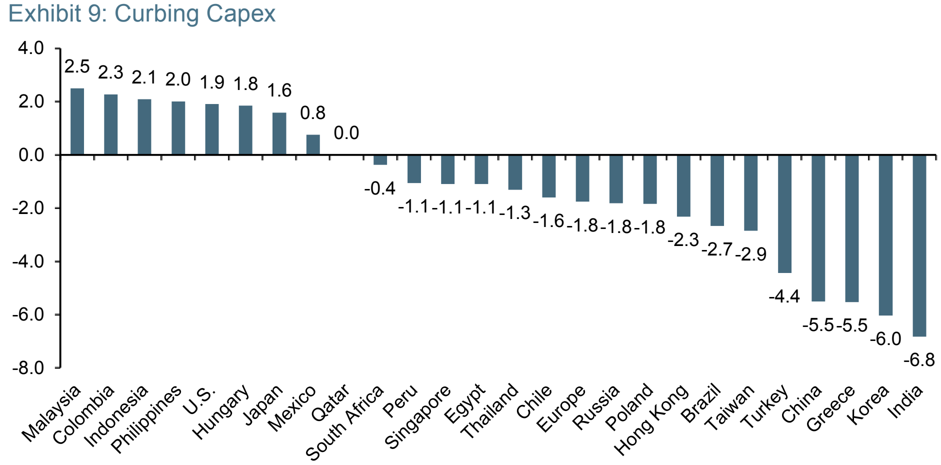
Exhibit 8: Pickup in Brazil's Exports



Source: MDIC, FUNCEX and UBS, as of February 2016.

- *Capital expenditure discipline:* Many emerging economies have curtailed capital expenditures that had largely resulted in excess capacity in certain industries. The countries with negative capex/GDP ratios are arguably set up for aggregate margin expansion in the future. (See Exhibit 9.)

Exhibit 9: Curbing Capex



Source: BofA Merrill Lynch Global Research, IMF, as of May 2016. Capex / GDP change between 2011 and 2016E (% points).

- *Corporate restructuring/deleveraging:* Corporate management teams are responding to the cyclical decline in emerging markets and slower global growth by allocating capital more efficiently. Recent examples include:

  - Chinese food retailer was taken private by its majority owner at a 100% premium.

  - A Brazilian company that was struggling with its debt profile amid a consumer recession sold its noncore cosmetics business, immediately eradicating balance-sheet concern and sparking a re-rating of its shares.

  - The Korean asset management and brokerage services industry has been consolidating, eliminating inefficient competitors

  - SOE reforms have been implemented within Chinese cement manufacturing, consolidating an inefficient, fragmented industry in order to improve profitability

- *Political change/structural reform progress*

  - Brazil's commodity bust and subsequent recession have revealed political corruption that triggered an impeachment process of President Dilma Rousseff. Michel Temer's installment as interim president and his recent appointment of market-friendly former central-bank governor Henrique Meirelles as finance minister have sparked investors' excitement about Brazil's ability to enact more rigorous public spending cuts and instill more fiscal discipline. While near-term challenges remain, change is on the horizon, which will be aided by a rebound in commodity prices, lower inflation and lower country risk premiums – likely spurring a rate-easing cycle over the next couple of years.

  - Under Modi's administration, India has implemented fuel-subsidy reforms and eased foreign direct investment restrictions in a number of industries, particularly those that are capital-intensive. Recently announced public-sector bank reform legislation should also bear fruit over time. For example, the stated goals of professionalizing management practices, reducing the burden of state targeted lending and ultimately lowering state ownership levels from almost 70% to about 51% will lead to better efficiency, lower losses and better capitalization and profitability levels. Finally, if passed, the proposed Goods and Services Tax, or GST (effectively a national VAT) would represent a seminal change in India's tax collection system, where longstanding inefficiencies and regional differences have resulted in chronic shortfalls to national tax receipts. The GST is viewed as a complete game changer as it would overhaul and streamline a broken system of indirect taxes that have little commonality among the country's 29 states and seven Union Territories.

Time to Get Back In

We believe the long-term investment case for emerging markets remains compelling, underpinned by favorable demographics, greater development upside, and the potential for continued GDP per capita catch-up vs. developed markets. This demographic dividend, coupled with ongoing infrastructure development, efficiency and productivity

gains, financial-market maturation and a growing middle class, remains an attractive structural growth story that can withstand periodic cyclical downturns.

As always, emerging markets are a more volatile asset class than developed equities and are prone to varying shifts in sentiment. Historically, however, investors have been rewarded for allocating to the asset class after long periods of poor absolute and relative performance coupled with attractive valuations. With a lot of bad news priced in, even a stabilized U.S. dollar environment and modestly higher commodity prices could spark a meaningful improvement in emerging markets' corporate earnings profile.

As the recovery unfolds, we view the value-oriented areas of the market, which have lagged over the past five years, as the key beneficiaries. The aforementioned improvements in export competitiveness, capex discipline, M&A and political reform serve as an appealing complement to the valuation opportunity we see in the asset class today, underpinning what we believe will be an attractive absolute and relative return environment over the next couple of years.

About the Authors

C. Warren Skillman
Senior Managing Director, Senior Portfolio Manager

Warren is the lead portfolio manager on The Boston Company's Emerging Markets Value strategy; his primary research responsibilities include Latin America, Europe, the Middle East and Africa. Prior to joining The Boston Company, Warren was a portfolio manager with Newgate Capital, where he headed Latin America and South Africa for its Global Emerging Markets strategy. Previously, Warren spent several years at State Street Global Advisors, where he held many roles, including Emerging Markets portfolio manager and Global Active Equity product analyst. Warren received a B.A. from Boston College and an M.S. in finance from the London School of Business.

William J. Adams
Managing Director, Senior Portfolio Strategist

Bill is a senior portfolio strategist for The Boston Company's Non-US and Emerging Markets investment disciplines, involved in the daily activity of the investment teams without stock decision-making responsibility. He is responsible for communicating the teams' strategies to clients, prospective clients and consultants, serving as the critical interface between client-facing staff and investment teams. In this role, Bill guides the messaging and positioning of investment strategies, helping to create marketing materials and content, responding to investment-related client inquiries, and ensuring that relevant investment insights of the portfolio-management teams are delivered internally and externally in a timely and effective way. Prior to joining The Boston Company, Bill was an associate at Deutsche Bank, where he was responsible for European equity research sales. Before that, he was a senior account officer at Putnam Investments, where he managed 401(k) relationships, and a senior account administrator at State Street Research and Management Co. Bill earned a B.A. in political science from Boston College and an M.B.A. in finance from the University of Maryland.

Disclosure

Any statements of opinion constitute only current opinions of The Boston Company Asset Management, LLC (TBCAM), which are subject to change and which TBCAM does not undertake to update. Due to, among other things, the volatile nature of the markets and the investment areas discussed herein, they may only be suitable for certain investors.

This publication or any portion thereof may not be copied or distributed without prior written approval from TBCAM. Statements are correct as of the date of the material only. This document may not be used for the purpose of an offer or solicitation in any jurisdiction or in any circumstances in which such offer or solicitation is unlawful or not authorised. The information in this publication is for general information only and is not intended to provide specific investment advice or recommendations for any purchase or sale of any specific security.

Some information contained herein has been obtained from third party sources that are believed to be reliable, but the information has not been independently verified by TBCAM. TBCAM makes no representations as to the accuracy or the completeness of such information.

Listed securities are being presented for illustrative purposes only. This is not a recommendation to buy, sell, or hold these securities.

No investment strategy or risk management technique can guarantee returns or eliminate risk in any market environment.

For more market perspectives and insights from our teams, please visit,
http://www.thebostoncompany.com/web/tbc/literature

BNY メロン・アセット・マネジメント・ジャパン株式会社
BNY Mellon Asset Management Japan Limited