ANNUAL OUTLOOK 2014

Market prospects

By Jan Dehn, Head of Research

Introduction

The outlook for Emerging Markets (EM) going into 2014 is stronger than last year due to a triplet of tailwinds, including better fundamentals, more favourable market technicals and attractive valuations after a sharp technical sell-off in 2013.

We summarise the highlights from 2013 and put them into context. We discuss the EM fundamental outlook in 2014, which is overall stronger than in 2013, while emphasising the plethora of country stories, including numerous elections.

We review the technical picture for the asset class. We discuss the wider global backdrop, which is also better than last year because of fewer imminent tail risks from the developed economies. We discuss how EM will respond to Fed policy changes in 2014 and argue that active management is set for a renaissance.

We conclude with some broad scenarios for EM fixed income returns in 2014 plus a discussion of valuations in EM equities and the likely path for EM currencies.

2013 in a nutshell

The most notable development last year was that EM assets were overbought in the early part of the year and then significantly oversold over the course of the rest of year. It is now widely recognised that the very violent reaction of EM asset prices to the Fed's tapering announcement in May 2013 was mainly due to a very bad technical position in the market rather than a material deterioration in fundamentals.[1]

Indeed, across EM as a whole the fundamental picture improved over the course of the year despite the poor price action. EM economies clocked up a healthy rate of real GDP growth of around 4.5%. We think EM real GDP trend growth rates going forward are likely to be in the 4.5%-5.5% range. This range is somewhat lower than growth rates in the period from 2010 to 2012, when economic activity was temporarily buoyed by the natural bounce back from the global crisis in 2008/2009.

Intra-year, EM economies were caught up in the same global cyclical downturn at the start of the year as developed economies, but then participated in the upturn in the second half of the year.

For individual countries, the fundamental picture was more nuanced. At any one point in time at least 10% of any group of countries – EM or not – will experience some kind of political or economic difficulties. A small number of EM countries faced macroeconomic adjustment as a result of largely self-inflicted problems, including Brazil, India, Indonesia, South Africa, and Turkey. During the year these countries took steps to reduce domestic demand and restore external competitiveness; we believe some, were more successful than others.

Despite the negative sentiment about EM in 2013, not a single EM country ran out of reserves, defaulted, saw its banking system collapse, or experienced widespread or systematic corporate defaults: there was no crisis.

Other countries implemented strong forward-looking reform, notably Mexico and China.

Venezuela, Argentina, and Ukraine continued to sail close to the winds of serious macroeconomic instability in 2013, but this is nothing new.

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EM equity markets equally suffered at the hands of soured investor sentiment, with mega-cap stocks, which are most exposed to the global growth cycle, particularly punished. Frontier Markets however, which are driven by domestic demand, pushed on and delivered 26.3% gross return for the year.

Meanwhile, de-leveraging advanced another year in the developed economies, but has further to run. Growth rates improved but remained below long-term trends while inflation

[1] For more discussion of the technical nature of the 2013 EM sell-off see *"Fed Captain and the World of Tomorrow,* The Emerging View, November 2013.

was nowhere in sight. This allowed monetary authorities to remain dovish for yet another year.

The US Federal Reserve's attempt to taper in May was thwarted before it even began as a result of the US economy's sensitivity to higher real rates, particularly in mortgage markets. Towards the end of the year as US data began to recover the Fed announced that it was having another go at tapering.

Japan unleashed one of the largest election stimuli the world has even seen, but the government, which has yet to follow through with reforms, hedged its bets on the domestic policy front with a more assertive foreign policy.

Europe returned to slow positive growth, aided by the upturn in the global business cycle and the ECB's Outright Monetary Transactions (OMT) programme. But the EU did not find a formula for fixing its insolvent banking system.

The US and Italy had to overcome political crises. Russia's diplomatic victories in the Middle East prompted the US to reach out to Iran, but (so far) without shifting the overall power balance in the region. Oil was firmly range bound.

The underlying global imbalances did not materially change. Developed economies continue to account for the vast bulk of public and private debt, while EM central banks continue to control the vast bulk of FX reserves (about USD 9 trillion or just below 80% of the world's FX reserves).

Growth, inflation, and interest rates – the main long-term directional drivers of currencies – did not change meaningfully in the developed countries, so global currencies continued to trade mainly on sentiment (good stories) and positioning rather than fundamentals.

Aided by Draghi's OMT program, the EUR rallied strongly against the US dollar, which took it back to the middle of its range against the Dollar over the past five years. JPY was allowed to take over from the EUR as the market's favourite short.

EM currencies and especially EM rates were beaten up on the (we believe misguided) view that EM fundamentals are more sensitive to tighter US monetary policy than heavily indebted developed countries (HIDCs). US treasury yields return to their five year average as the 'safe haven' bid from the European debt crisis was priced out of the market.

Heavy money printing by central banks and stock buybacks by firms that are still reluctant to plough cash into the real economy helped to push US stock markets to fresh highs, despite still weak fundamentals.

Bubble-like valuations in financial assets in developed economies began to percolate into real assets in 2013, particularly in US and UK property markets.

Brighter EM fundamentals

We firmly believe that EM growth is likely to be stronger in 2014 than in 2013, but shouldn't pose major risks to price stability except in a select few countries. We think the modest slowdown in EM in 2013 was mainly cyclical. We do not think the world really changed very much structurally in 2013, and we expect EM to be lifted by a generalised global upturn this year. This should take EM growth to 5.0-5.5% in real terms, or about 1% faster than in 2013. This backdrop is particularly good for EM equities, which are trading at near historic lows. The table below shows the IMF's projections for 2014 growth based on its October World Economic Outlook. We think risks are biased to the upside relative to IMF's expectations.

Fig 1: **EM growth in 2014 – all regions to accelerate**

Region	2013	2014
World	**2.9%**	**3.6%**
Developed economies	1.2%	2.0%
US	*1.6%*	*2.6%*
Eurozone	*-0.4%*	*1.0%*
Japan	*2.0%*	*1.2%*
EM	**4.5%**	**5.1%**
CEE	2.3%	2.7%
Asia	6.3%	6.5%
China	*7.6%*	*7.3%*
India	*3.8%*	*5.1%*
Latin America	2.7%	3.1%
Brazil	*2.5%*	*2.5%*
Mexico	*1.2%*	*3.0%*
MEA	2.3%	3.6%
SSA	5.0%	6.0%

Source: IMF WEO.

We do not expect major shifts in external balances or inflation rates. We also do not expect big changes in monetary policy, though on balance we will see fewer cuts and more hikes in 2014 than in 2013 on account of the modest pick-up in global activity. There are far larger shifts in EM macroeconomic fundamentals further down the line once inflation returns in developed economies. Currency adjustments will inevitably follow.

Greater focus on EM fundamentals

While we expect every region of EM to grow faster this year than in 2013 there will (as always) be strong country variations within each region for several reasons:

Firstly, the vast bulk of reformers will be in EM. Mexico and China took the lead on reforms in 2013, building on previous efforts in Peru, Colombia, Philippines, and Malaysia. Others will follow in 2014. The pursuit of reforms raises the level of political noise, changes near-term fundamentals, and enhances the long-term growth outlook in the countries engaging in reform.

Secondly, other countries will do battle with the consequences of their insufficient reforms. The usual suspects – Ukraine, Argentina, and Venezuela – will continue to struggle with intractable political problems and economic mismanagement.

Thirdly, there are a significant number of EM elections due in 2014. Brazil, Turkey, South Africa, India, Indonesia, and several other countries go to the polls in 2014. The general experience of past elections in EM is that:

1. Newly elected governments tend to embark on bold reform programmes in the first year or two following elections, almost regardless of their hue
2. Brand new governments tend to reform more and focus more on economic reforms than re-elected incumbents
3. Sitting administrations tend to do everything possible to maintain economic stability in the period leading up to elections
4. Markets tend to exaggerate the effects of elections, both in terms of the differences between candidates and the significance of their stated policies

We think the elections in India, Turkey, and Indonesia have the greatest potential to usher in broader economic reforms in the post-election period, but we do not rule out positive developments in Brazil and South Africa depending on how the political chips fall.

Other countries with important elections in 2014 include Hungary, Colombia, Egypt, and Thailand. High beta markets Argentina and Ukraine go to the polls in 2015, but markets have already begun to trade these events.

By contrast to EM, we expect very little in the way of reform in the developed world in 2014. The European periphery countries reformed significantly at gunpoint over the past few years but have scaled back their efforts after the launch of ECB's OMT programme. Europe's politicians are likely to continue to kick into the long grass the thorny question of legacy bank assets, which sits at the heart of Europe's structural problems. Japan is still pinning much hope on Abe's 'third arrow', but so far there are few signs that Japan is willing to do enough to address its underlying structural challenges, including the government's enormous debt burden. The US is saddled with a lame duck administration and a highly divided legislature, which is unlikely to pass major domestic economic reforms, though perhaps a trade bill could make it through the two houses of Congress.

The table below lists key potentially market moving issues in 2014 in a selection of EM countries.

Fig 2: **Key potentially market moving issues in 2014 in a selection of EM countries.**

EM country	Market moving issues	Comments
Argentina	**Holdout investors**	A resolution to the holdout issue is quite likely in 2014
	Macroeconomic imbalances	Domestic demand remains too high resulting in reserve losses
	General election in October 2015	The markets will increasingly focus on the post-Kirchner era in Argentina
Brazil	**General election October 2014**	We expect President Dilma Rousseff to be re-elected, but an alliance of opposition leaders poses a genuine challenge
	Growth	We expect a modest pickup in activity, but falling trend growth rates and less than full restoration of business confidence
	Ratings	The market will focus on Brazil's ratings, which may well received a one-notch downgrade
	World Cup	This event will have no lasting impact on Brazil
China	**Reforms**	We expect decisive implementation of Third Plenum reforms
	Opening of markets	China's markets will continue to open up to foreigners
	Growth of local bond markets	We expect rapid development of local government bond markets at the expense of less transparent means of financing
	Economy growth and resilience	Low debt levels, strong reserves, low inflation, and reforms will ensure continued Chinese growth
Colombia	**Parliamentary election in March 2014**	There is no serious threat to the broad political consensus in favour of market friendly policies
	Presidential election in May 2014	President Juan Manuel Santos is re-elected as pursues a decisive peace accord with the FARC
	Growth	The economy will pick up on the back of past reforms and an investment friendly business environment

Continued overleaf

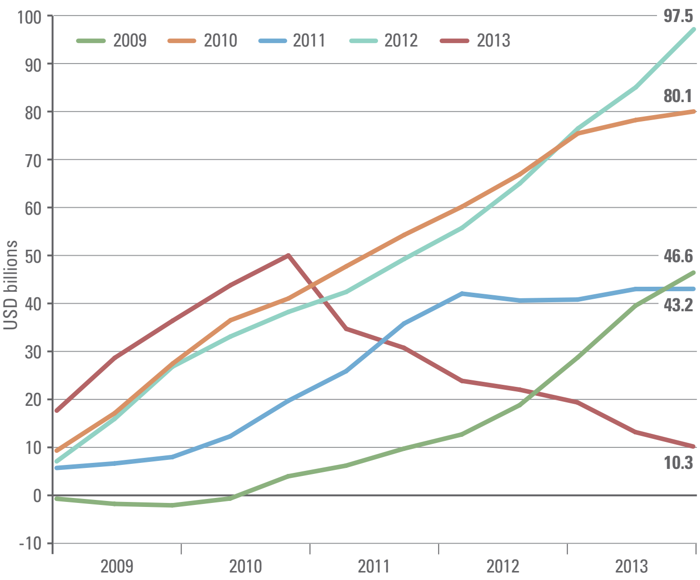
EM country	Market moving issues	Comments
Costa Rica	Fiscal reform	Likely to be addressed once the February election is out of the way
Egypt	Parliamentary and presidential elections in the summer	The transition from military to civilian rule should facilitate economic adjustment, but deeper political divisions will persist
Hungary	Parliamentary election in April 2014	Fidesz is likely to win outright majority, but may lose super-majority
	FX mortgages	We expect further measures by the government to reduce the burden of FX mortgages on households
India	Q2 regional and parliamentary elections	The main contest is between Congress and Bharatiya Janata Party but the balance of power rests with regional parties
	Reforms	The pace of reform is likely to pick up significantly after the elections
	FX mismatches	India's main vulnerability is currency mismatches on corporate balance sheets, so RBI will hike if necessary.
	Markets	India is likely to take further steps towards opening its enormous fixed income market to foreign investors
Indonesia	April parliamentary election	A coalition government is likely, but without final definition until after the presidential election
	July presidential election	Indonesia will have a new president because President Susilo Bambang Yudhoyono does not run; we expect an intense contest
	Economy	Monetary policy adjustment is required, but will likely only happen after the election
Russia	Growth	Russia will experience a cyclical pickup, but higher trend growth requires better supply-side policies
	From FX to rates	Russia will continue to open its markets as the process of shifting from exchange rate to inflation targeting continues
South Africa	Q2 general election	ANC is likely to win, but with a smaller share of the overall vote
	Economy	Macroeconomic management will remain sound, but progress on unemployment, inequality, infrastructure challenges, and corruption seem less likely
Thailand	Elections	We do not think the February election will resolve deep political divisions in Thailand
	Growth	A resolution to the political impasse would free up significant infrastructure spending
Turkey	March municipal elections	We expect the AK party to win a noisy municipal election in March, but also expect a very poor showing due to the recent corruption scandal which could result in earlier than expected parliamentary elections
	Summer presidential election	We expect Prime Minister Erdogan to be elected President
	Reforms	Reforms are necessary, but hostage to electoral calendar
	Economy	Monetary policy will favour a weaker Lira over higher local rates due to vulnerabilities in the property sector
Venezuela	Weak leadership	President Maduro's grip on political power is likely to weaken over time
	Economy	Devaluation solves most problems in the short term; long-term solutions require more investment in the oil sector

Source: Ashmore.

More favourable market technicals

Positioning in EM fixed income markets has dramatically improved since the start of 2013. This bodes well for performance in 2014 once sentiment changes. The last eight months of 2013 saw consistent outflows from the asset class, we believe, mostly from retail accounts, fast money, cross-over investors, and weaker hands among institutional investors. These flows have taken Emerging Markets from heavily overbought in April 2013 to now significantly over-sold.

Fig 3: **Flows in 2013 versus previous four years**



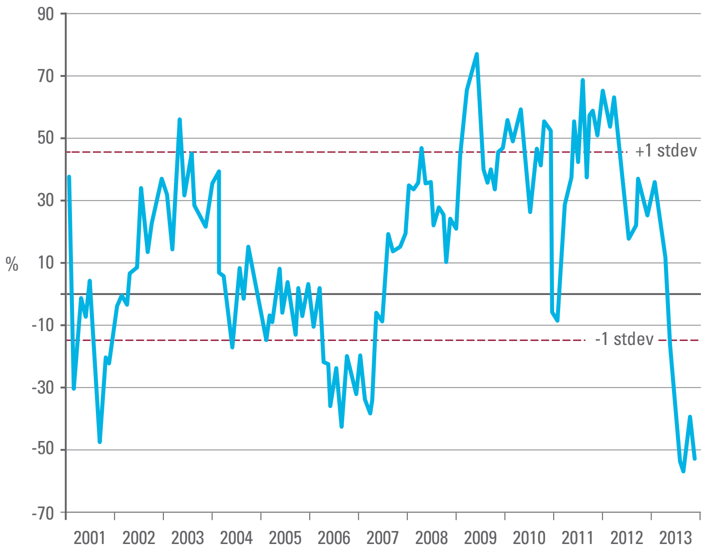
Source: JP Morgan.

We believe that outflows will not be reversed immediately due to herd mentality in capital markets, despite the better fundamentals and attractive valuations. Also, many investors still trade EM as punts on global risk appetite instead of looking at actual EM specific risks (the probability of material permanent loss over the cycle). Others trade last year's performance, which was poor. Add to the cocktail prejudice about EM, which remains rife. Incentive problems among institutional investors are also pervasive and bank regulation encourages pro-cyclicality in liquidity, which increases volatility and in turn acts as a further deterrent for some investors.

Yet, when the market does turn higher the technical position becomes very important as index-hugging investors, who are now underweight investors are forced back into the market. It is precisely these inefficiencies that explain why a value approach with strong focus on active management (and liquidity) can produce significant outperformance over the cycle for rational investors.

The technical position in EM equities is also significantly stronger at the start of 2014. The asset class saw net outflows in 2013 due to concerns about a hard-landing in China (which never materialised), the Eurozone sovereign debt crisis (which were materialised), and Fed tapering (which did not derail EM fundamentals). About USD 20bn flowed out of EM equities in net terms compared to net inflows in DM equities of an astonishing $251 billion, according to EPFR and BAML as of Dec 31 2013. On the back of this, sentiment towards EM equities relative to DM equities finished the year at its lowest levels in the last 13 years.

Fig 4: **Relative positioning of EM vs Eurozone equities**



Source: BofAML Fund Manager Survey, December 2013.

From a technical point of view, this is good news. Most of the bad news and bearishness we witnessed throughout most of last year has been priced in. We believe there is more room on the upside through positive earnings surprises and as a result, the large moves we experienced last year are behind us. We are already seeing improving sentiment towards China and with valuations across EM equities at historic lows, taking a valuation approach makes sense to maximise on the mispricing opportunities in the market.

Tail winds from the global backdrop

The global backdrop in 2014 is going to be broadly supportive for EM. We expect fewer immediate tail risks in developed economies, though developed countries continue to pose the biggest risks to investors due to their large debts, inflationary policies, and inability to reform.

Europe's OMT programme will continue to prove effective in containing speculative attacks against peripheral countries, while the US Fed will keep rates on hold throughout 2014 and probably through 2015 as well. The US congress faces another debt ceiling challenge in the spring of 2014, but will probably raise the debt ceiling again, albeit temporarily.

EM sentiment will be impacted by the Fed's efforts to taper via the US treasury market. Bond vigilantes will likely take on the Fed again by shorting Treasuries and thereby posing a threat to the housing recovery. The US stock market would find it difficult to rally in such circumstances, and could adjust sharply lower at some point. We also think the US economy remains fragile, because it is not anywhere near fully de-leveraged yet.

In Japan, we expect the reform efforts of the Abe administration to be insufficient to address deep-seated structural problems, excessive public debt, and deflation. After the enormous stimulus of 2013 a 'hangover' in 2014 is now on the cards. If economic policies fail at home the nationalist government in Japan could become more vocal in foreign policy, resulting in rising tensions in the South China Sea.

Europe remains vulnerable on account of its insolvent banking system and excessive levels of debt in most countries. We do not think Europe's politicians will find a solution to the question of bad legacy assets on bank balance sheets in 2014 and we think Europe's growth recovery will be both weak and patchy. Ultimately, a weaker EUR will do little to ease the debt burden, because unlike the US most of Europe's debt is held within Europe.

Taper tantrums – even markets grow up

Over the course of the year, we believe that US treasury yields will drift higher and ten-year yields should end the year around 3.5%. At that level, there should be no concern for EM on fundamental grounds. The vast majority of EM countries source up to 80% of their financing from local markets that currently yield nearly 7%, so no single mainstream EM country would struggle with ten-year treasury yields at 3.5%, or even at 4.5%. After all, US ten-year yields traded at 3.5% in 2009, 2010, and 2011, and at 4.5% in the period from 2003 to 2007.

Active management is so important, because companies have different exposures to global cyclical demand.

In fact, we think EM markets would welcome the end of QE, which has become the single largest source of uncertainty in global fixed income markets (and uncertainty always disproportionately hurts EM). A post-QE world would be free to focus on relative value rather than speculate about QE related flows; this should strongly favour EM assets over developed market assets, in our view.

We expect the US treasury market to be volatile. There is a fundamental asymmetry in the Fed's credibility. The Fed is super-credible when it comes to easing policy – after all it can print money without limit. On the other hand, the Fed's credibility is low and likely to be tested when it comes to tightening policy. Bond vigilantes are aware that the Fed cannot easily reverse its asset purchase programme via outright sales and the Fed can easily be forced to reverse its course if real rates rise too far, or even too quickly. This is because the US economy is still too indebted to handle materially higher real borrowing costs (total US debt as a share of GDP stood at 383% as of Q3 2013). This means that bond vigilantes can take on the Fed with a high probability of winning, just as it did last summer.

How will EM fare with volatile, but ultimately very gently rising US rates? Taper tantrums should prove far less onerous in 2014 than they were in 2013. Firstly, 2013 showed that the sensitivity of EM's fundamentals to higher US rates is actually quite low (EM fundamentals recovered throughout the period of maximum EM pessimism in summer and autumn last year). Secondly, the bad technicals that explained the violence of the EM sell off in 2013 are now gone. Thirdly, EM asset prices have adjusted to levels that already price in more tightening than the Fed is likely to deliver in 2014 and even in 2015, in our view. Longer-term, we favour shorter duration and active trading of Treasury-sensitive assets.

Bigger role for active management in 2014

EM now comprises sixty-five vastly different investable sovereigns and hundreds of companies that issue stocks, or bonds, or both. Waning developed market tail risks are giving way to a greater number of elections, reforms, and adjustment across the EM universe in 2014. This means that simplistic risk on/risk off trading should prove less profitable than credit-focussed trading strategies. Passive management is becoming even less efficient.

Active management should be applied not just credit and stock selection, but also to allocation decisions across sub-themes within the broader EM fixed income universe. The difference between the best and worst performing sub-theme in EM fixed income over the past decade has never been less than 5% per year. This is a very sizeable difference in returns in a single year.

Similarly in equities country and sector allocation will likely have a measurable impact along with active stock selection. Within countries, last year alone saw a wide divergence in returns, with the spread between best and worst performing equity markets (excluding Greece) at a whopping 36%, compared to an annualised 5-year spread of 24%, according to MSCI data as of Dec 31 2013. The difference is even more significant when Frontier markets and small caps are included.

Active management is so important, because companies have different exposures to global cyclical demand, while others are more domestically oriented and benefit from lower exposure to the effects of the Fed tapering.

On the earnings front, we also expect earnings growth to be widely divergent across markets and sectors – some countries will clearly disappoint while in other markets we expect companies to surprise on the upside. With the significant wholesale market correction we witnessed in 2013 a number of companies within select markets and sectors are unjustifiably cheap, yet have solid earnings growth and can deliver a sustainable return on equity. This is the case not only in markets such as China and Korea, but also in out-of-favour markets such as India, as well as lesser known Frontier markets.

Valuations across markets and within sectors in our view must take precedence over making a broad-brushed global EM equity allocation. Stock selection is clearly important even in markets with perceived weaknesses – understanding the business and its growth outlook as well as what you are paying for their earnings stream will make the difference between winners and losers in 2014.

Global currencies – market is still too simplistic

The broader economic backdrop across G3 currencies remains one of low rates, low inflation, and weak growth. As long as these important directional drivers of currencies continue to be low and stable we do not expect sustained directional moves in EURUSD. Instead, we should see a continuation of the tendency towards mean reversion of the past five to six years.

EURUSD rallied nearly 15% against the US dollar in 2013 as European break-up fears were priced out of the market. EURUSD has now returned to the middle of its post-Lehman 1.20-1.50 range and from this point developments in the cross are likely to come down to specific news rather than mean reversion from starting points of large technical imbalances or mispricing.

Seen in this light, the two currencies that are far away from their recent ranges are JPY and EM currencies (the latter of which still largely and irrationally trades as a group rather than individually). With respect to JPY, we expect that Japan will struggle to escape the clutches of its structural problems, despite enormous stimulus, which should favour a stronger JPY over the next few years. By contrast, EM currencies have upside at current levels, particularly if sentiment changes back in favour of EM rates. However, we expect EM FX to continue to trade in a very volatile fashion in the next couple of years on account of strong liquidity preferences and still high levels of risk aversion in global markets.

Longer-term, we believe the outlook for EM currencies remains very strong, particularly for larger currencies. We expect Dollar weakness to play a major part in deleveraging the US economy as inflationary pressures gradually emerge over the next few years. Unlike Europe, the US is more likely to be able to generate inflation, because the US recapitalised its banks early in the crisis. A weaker US dollar will eventually force EM central banks to diversify their USD 9 trillion of FX reserves and their strong liquidity preferences should end up favouring the larger EM currencies.

Attractive valuations in EM fixed income in absolute and relative terms

It would be naïve to assign too much confidence to specific return forecasts 12 months because of the millions of unpredictable events that will undoubtedly occur in the course of the year. However, it is useful to provide a sense of the range of possible returns for EM fixed income under different plausible scenarios for US treasuries, currencies, and spreads. To this end we lay out four scenarios for returns, which are summarised in the table below. Our main conclusions are:[2]

(a) Valuations in EM fixed income are attractive going into 2014.

(b) Most fixed income markets in developed economies would struggle to match these returns

(c) EM returns are relatively robust to change in the US treasury market

Fig 5: **Possible scenarios for returns in 2014**

	Scenario 1 Status Quo	**Scenario 2** Partial absorption	**Scenario 3** US rate shock with partial absorption	**Scenario 4** US rate shocks without partial absorption
External debt	5.8	7.4	4.2	-0.5
Corporate high yield	7.5	9.5	9.0	3.3
Local currency government bonds	6.8	9.3	0.7	-3.2
Local currency corporate bonds	7.8	10.3	1.8	-2.1
FX forwards	3.9	3.9	0.0	-3.9
Blended (33%.33%.33%)	6.7	8.7	4.7	-0.1

In Scenario 1 we simply assume that EM spreads, EM currencies, and EM local government and corporate bond yields remain at current levels and that the US treasury curve converges on what is currently priced into the forward markets.

In Scenario 2 we assume that the move higher in US treasury yields is partially absorbed into EM spreads. Historically, EM sovereign spreads have absorbed about 50% of any move higher in US treasury yields, while corporate high yield spreads have narrowed to absorb about 80% of any move in treasury yields. Similarly in local markets, we assume that 30% of the move (higher) in Treasuries gets reflected in (higher) local yields (both corporate and sovereign). Historically, this has been the 'pass through' from US treasuries to local rates over shorter periods, though the long-term correlation zero (as indeed you would expect since local rates are a function of local inflation, local growth, and local monetary policy decisions). We assume no change in spot FX and we keep the US treasury curve at the forwards.

In Scenario 3 we allow for a larger sell off in the US treasury market, which brings the ten-year to 4.5% (roughly equivalent to the currently priced terminal rate). We maintain the same partial off-set on local rates and spreads as in Scenario 2, but we now allow EM FX to depreciate sufficiently to wipe out any carry (roughly -4%).

Finally, in Scenario 4 we take ten-year treasury yields to 4.5% and remove the off-set in spreads and local yields, such that the full whack of higher US rates is reflected in higher spreads and yields in EM (i.e. no shock absorption via spread compression or less than 100% correlation in local markets). In this scenario we also let EM FX spot fall by twice the carry.

We think Scenario 4 is the least realistic scenario: After all it would likely require a very bullish growth scenario for the US to push ten-year yields to 4.5%, but such a bullish growth scenario would also be bullish for EM and would cause fixed income investors to move into spread products, such as EM fixed income. Hence, this scenario would probably require both strong US growth and a widespread collapse in EM fundamentals, which does not appear likely. We think the market is more likely to trade somewhere between scenarios 1 and 2.

Expected performance of EM equities

EM stocks have underperformed US stock markets by more than 25% in 2013, resulting in the largest valuation gap since 2007. The relative underperformance reflects weaker earnings in EM over the past year and higher risk premiums due to macro, political and social uncertainties.

In 2014, we expect earnings growth to recover as the global growth cycle picks up. This is particularly beneficial to large caps, which often derive a majority of revenues overseas. Many EM equities have been oversold as fundamentals continue to strengthen. Valuations in EM equities are trading at more than 40% discount to developed markets, yet benefit from strong domestic fundamentals, growing consumer demand and a recovery in foreign demand for products and services. As valuations become too cheap to ignore, we expect investors to return in earnest to the asset class.

[2] The scenarios are based on performance of the main indices rather than Ashmore funds.
The indices we use are: JP Morgan's EMBI GD for external debt, GBI-EM-GD for local currency bonds, CEMBI HY for EM corporate high yield, and BAML's LOCL for local currency corporate bonds.

Fig 6: **Valuations as at January 2014**

2014 Bloomberg estimates	MSCI Emerging Markets	MSCI EM Small Cap	MSCI Frontier	S&P 500	MSCI Europe
P/Earnings	10.5	11.7	6.4	15.47	13.5
P/Book	1.36	1.21	0.95	2.38	1.65

Source: Bloomberg.

China, Korea, Russia and Peru offer some of the most attractive opportunities, based on market multiples and growth outlook. China has taken significant steps to support its growth cycle, get inflation under control and reform its financial system. After a disappointing start to the year, Korean equities have had a strong rally and we believe remain one of the most attractive areas of the market, supported by a recovery in global demand and attractive valuations.

We maintain a cautious stance on ASEAN markets, mainly on macro and political risk; however, we are finding selective opportunities in specific stocks where the market has been oversold and fundamentals are strong and stable. We expect markets in India to recover as the political outlook fuels domestic sentiment. Valuations are looking somewhat attractive after a challenging year where currency played a significant role in returns for foreign investors. We maintain an underweight position in South Africa on an unfavourable outlook in earnings and economic weakness.

Mega-caps are particularly attractive across the board following the market correction in 2013, which has driven several stocks to historic lows. As the cycle recovers, we expect these companies to revert to long-term average.

Within small caps, we also maintain an overweight position as we expect these companies to do particularly well due to a recovery in domestic demand and sales to suppliers of larger global companies responding to a pickup in foreign order flow. We are finding consumer and industrial stocks attractive, as well as a few technology companies enjoying accelerating demand for mobile internet services.

Fig 7:

2014 Bloomberg estimates	P/Earnings	P/Book
Consumer discretionary	11.82	1.88
Consumer staples	21.1	2.26
Energy	6.86	0.76
Financials	8.77	1.19
Health care	21.67	3.19
Industrials	13.99	1.37
Info Tech	10.89	1.83
Materials	12.24	1.22
Telecoms	12.67	2.07
Utilities	11.08	0.97
MSCI EM	10.5	1.36

Source: Bloomberg.

Within Frontier Markets, we remain bullish after a strong 2013. Middle Eastern stocks have surprised significantly on the upside, despite the constant spate of negative news stemming from the civil war in Syria and unrest in Egypt. The relative outperformance of these markets indicates the degree to which they can be insulated from domestic issues in neighbouring countries. The announcement by MSCI to upgrade the UAE and Qatar to EM status in June 2014 provided a big boost to equity markets there; however, Saudi Arabia, which is not in any major index, also delivered strong positive returns.

Africa continues to remain a destination for investors seeking long-term, uncorrelated growth opportunities. Nigeria is set to overtake South Africa as the continent's largest economy, other markets such as Ghana and Botswana are shining on improved governance standards, and liquidity is improving as foreign investor flows grow. Last year alone, trading volumes tripled in frontier markets against strong fundamental results. We expect these positive trends to continue in 2014.

Contact

Head office

Ashmore Investment Management Limited
61 Aldwych, London
WC2B 4AE

T: +44 (0)20 3077 6000

@AshmoreEM

www.ashmoregroup.com

Beijing
T: +86 10 5764 2601

Bogota
T: +57 1 347 0649

Jakarta
T: +6221 2953 9000

Istanbul
T: +90 212 349 40 00

Mumbai
T: +91 22 6608 0000

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