Ashmore

ANNUAL OUTLOOK 2016

Equities Outlook 2016

By Ashmore Equity Team

Reviewing the year gone by

Emerging Markets (EM) equities delivered the second worst market decline since the financial crisis in 2008, ending 2015 down -14.9% according to MSCI EM Index Net. Eastern Europe held up better than markets in Asia, while Latin American markets declined the most.

There was a confluence of factors, exogenous and endogenous to the asset class that conspired to deliver such disappointing returns. The weak global growth outlook, the exuberance and then sharp correction of the China A share market, and the strength of the US dollar created notable pressure on commodities and currencies. Earnings have also disappointed consistently in recent years, with downgrades affected both by currencies as well as operational challenges.

The A share market hit a high on 8 June 2015 (CSI 300 USD) and then corrected sharply after reaching bubble territory. Government measures to curtail margin lending, which had been a key driver of the market overshooting, and to subsequently support the A share market, hit the Hong Kong H share and Taiwanese markets hard, leading to a correction in otherwise reasonably valued equities, especially technology companies. In turn, investors began to focus on the weak data in China and painted very bleak scenarios for the economy and markets, feeding risk aversion in EM globally.

Slower growth and hence commodity demand in China and elsewhere plus USD strength caused the Bloomberg Commodity Index to decline over 25% since the start of 2015 to levels last seen 16 years ago (mid-1999). By late 2015 oil prices had fallen to the mid USD30 levels – prices last seen only at the trough of the credit crisis in 2009. This represents a fall of nearly 70% from its peak less than 18 months ago.

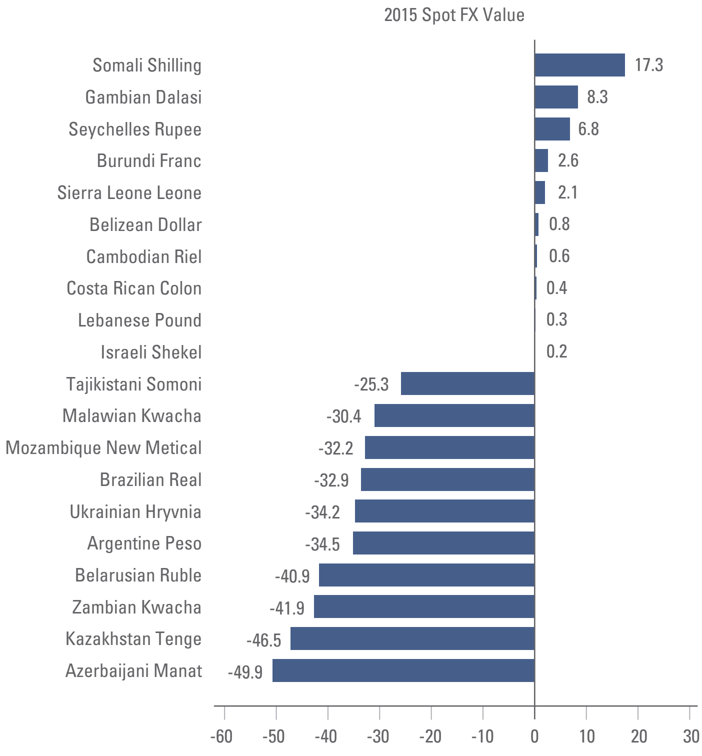
Fig 1: **Oil price – 2013 to 2015**

Source: Bloomberg.

Concerns regarding a weak global growth outlook, volatility in markets such as China, US dollar strength, EM currency weakness, falling commodity and energy prices and downward earnings revisions drove sentiment and returns for EM equities in 2015

Not surprisingly this also impacted currencies in many economies particularly the commodity dependent markets in many parts of EM. The JP Morgan Emerging Market currency index declined -18% in 2015.

Fig 2: **Top and bottom 10 currency changes worldwide – EM and Frontier Markets hardest hit**



Source: Ashmore, Bloomberg, BIS.

EM stocks have also had to endure a year of negative earnings revisions, which only began to turn in the latter part of 2015. According to JP Morgan estimates, EPS growth for 2016 is projected to be 7.8% for the MSCI EM Index universe, compared a decline of 2.4% for 2015.

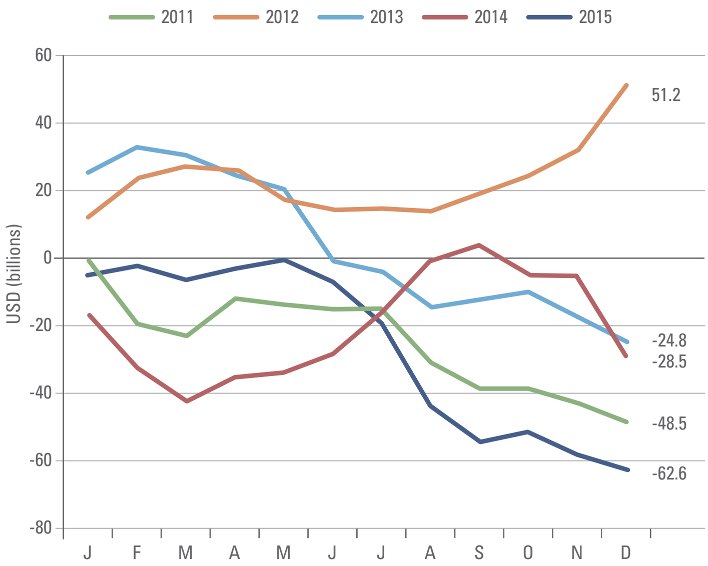
Fig 3: **Earnings Revisions – Emerging Markets equities**

	Index EPS revisions				EPSG Estimates
	1 month	3 months	6 months	12 months	Annual
2015E	-6%	-7%	-17%	-25%	-2.40%
2016E	-7%	-9%	-20%	-28%	7.80%

Source: JP Morgan.

Investor outflows from the broader emerging / frontier market asset classes have been indiscriminate. Like past cycles, we are in a phase where liquidity dislocations have resulted in the 'baby being thrown out with the bathwater'. There are thus numerous examples where strong local businesses (that are navigating the uncertain global environment and emerging stronger businesses) are now trading at valuation multiples that represent compelling value to long term investors.

Fig 4: **Annual cumulative EM equity flows**



Source: JP Morgan.

Looking ahead

Against this backdrop of slower growth, weak EM currencies and a bias towards higher interest rates and below trend commodity prices, EM company managements' ability to execute effectively in the coming year will be key. In that vein, stock selection will be the deciding factor in relative returns in 2016.

We provide our sense of the year ahead by reviewing some of the key EM sub-asset classes, markets and regions in which we invest. These include EM Small Caps, China, South Korea, Taiwan, India, Latin America, Turkey, Indonesia, Frontier Markets, Frontier Africa and Middle East.

EM Small Cap

Smaller companies in Emerging Markets did not escape the declines in 2015, returning -6.8% (MSCI EM Small Cap Index net), but they outperformed the broader MSCI EM standard index, and Frontier Markets (down 14.5%). Russia had the top performing small cap market, rising 25%, followed by the Czech Republic and Korea, both up over 12%. In contrast, Colombia fell 50%, Brazil -49%, and Egypt -36%. The disparity in performance across markets was marked, driven by currencies, weak commodity prices, country macro political and economic events, and flows.

With Emerging Markets in their third consecutive year of negative performance (and third year of underperformance versus MSCI ACWI), we are seeing growing opportunities driven by valuations, growth, and anonymity, as analyst coverage, particularly of smaller companies and Frontier Markets, continues to decline with falling trading volumes. We believe key drivers for EM companies will be:

- **Earnings and profitability:** EM corporate earnings and profitability have been consistently downgraded in each of the past several years. Although currencies have played an important role, macro and micro factors have also impinged on EM corporate growth. This year, EM markets are valued at 11.4x and EM smaller companies at 10.5x forward earnings with approximately 8% and 22% respective earnings growth.

EM Small Caps continue to trade at a discount to the broader EM in terms of forward PE and with better earnings growth prospects

Although US and EM corporates have similar earnings profiles this year, MSCI EM standard is selling at an estimated 33% discount to US S&P on a P/E basis.

- **Currencies:** The strong dollar has undermined EM currencies, which have suffered from material outflows in favor of the USD due to relative interest and inflation rate expectations and perceived EM macro risks. Smaller companies operating in stronger currency environments and/or export markets have generally outperformed. In 2016, we anticipate modest RMB depreciation, leading to further weakness in Chinese trading partner currencies. Certain commodity currencies, however, such as the Latin currencies, may have hit bottom after dramatic corrections, especially if we see commodity and energy prices stabilise. The Mexican peso, a favorite proxy for hedge funds betting on EM currencies, looks particularly oversold.

- **Interest rates and inflation:** After an extended period of cheap money, EMs are moving into a new era where capital should better reflect risk. Countries and/or companies that have imbibed too heavily in cheap debt are likely to suffer the consequences, as rates rise globally. The pace of rate increases will greatly influence the level of stress. However, markets will gauge expected risks ahead of time, as they have been doing for the past many months. Across all market caps, we have sought to avoid stressed balance sheets and entities that will suffer as their ability to raise capital becomes more costly, and we will continue to do so with few exceptions. We favor certain markets, such as China, Taiwan and Mexico that have prepared well ahead of time for rate increases in the U.S. and look well positioned to withstand the return to more rational credit markets.

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- **Energy and commodity prices:** Energy and commodity prices cut both ways; importers benefit and vice versa (most of Asia ex Malaysia and to a lesser extent Indonesia and Turkey are winners, while some countries within Latin America, Africa, Middle East and Russia suffer). Smaller companies are often energy/commodity intensive in the manufacturing sector, so they are seeing margin improvements, e.g., auto parts manufacturers. Others, however, have struggled, as consumers in oil rich countries have seen incomes fall, e.g., Avianca (Colombian airliner). Focusing on valuations and asset value – as well as a careful review of balance sheets – we are looking for select opportunities to add to oversold opportunities that will thrive longer term, including good companies located at the wrong address – but with improving (e.g., Argentina) or overly trodden down (e.g., Brazil, Turkey) neighborhoods.

For smaller companies in particular, we see opportunities in:

- **Technology:** After a volatile year, we expect technology companies will outperform in EM in 2016. Cloud computing, the strong secular growth in auto electronics, and internet related retail and services should drive tech earnings. In addition, the Apple supply chain should show signs of recovery by mid-2016, as beneficiaries of the iPhone 7 upgrade emerge. Upgrades could include dual camera, further strengthening of its casing with waterproof features as well as improved forced touch and acoustic experience. Outside of mobile, notebook players should start running into the first meaningful wave of Windows 10 upgrade during the second half of year ahead of the back to school season. Several tech companies offer attractive valuations compared to regional peers, strong balance sheets, healthy cash flows and high dividend yields.

- **Agriculture:** Some of the most productive agricultural land is in Emerging Markets, including but not limited to Brazil, Argentina, Southeast Asia, and the Ukraine. Many smaller companies have focused on these opportunities and are benefitting from weaker domestic currencies and supportive macro policies, such as the elimination of high export taxes on grains in Argentina. With prices at lows, we see ample opportunity for improved revenues and margins in this sector and have sought out specific investments, such as Adecoagro (Brazil/Argentina) and Kernel (Ukraine).

- **Domestic consumption:** Domestic consumption in EMs remains a secular driver, ranging from discretionary to staples. With the services industry rapidly evolving, many interesting companies are smaller firms exploiting opportunities in new territory, including housing, insurance, travel, health care, and education. In China, the services industry continues to evidence growth in spite of the slowdown in the manufacturing sector. Growth for the most basic services in the Western part of the country, where approximately 700 million people are yet to join the middle class lives of their Eastern brethren, is even stronger, as demand grows from a low base. Chinese companies are selling at depressed multiples given the risk premiums applied to the market generally. Regional travel has become a robust industry, with Korea benefitting both from increased travel of the Korean population, as well as from the influx of Chinese travelers. Hence, holdings such as Modetour (a brick and mortar and on line travel company) should continue to prosper.

- **Alternative energy:** Climate change and pollution are challenging the very livability of cities such as Mumbai and Beijing. Hence, we see substantial opportunity for competitive businesses serving Emerging and Developed markets. Government policies, such as those in China, are providing direct support for alternative technologies, benefitting new and smaller players, as well as larger businesses. In small caps, we hold Huadian Fuxian Energy, a leading clean energy company with hydro, wind, biomass and solar power generation capabilities, which is a prime example and selling at 0.7x P/BV.

Smaller companies offer many opportunities in Technology, Agriculture, Domestic Consumption. Alternative Energy, Banking and Housing

- **Banks:** EM banks have suffered a material derating in 2015, as asset quality and net interest margins have deteriorated. While certain banks have benefitted from government policies targeted at stimulating housing/mortgage markets and/or easing pressure on asset quality (e.g. China), others have seen credit contraction and rising rates undermine earnings growth. For those banks with strong capital bases and good management, current valuations represent a good entry point, and an eventual uptick in the macro environments will ease asset quality concerns. Given the low level of banking penetration in many countries, including more 'developed' EMs, such as Mexico, investments in strong banks should pay off medium term. Hence, we have exposures to banks in many countries, including Bank Tabungan Negara in Indonesia, selling at 0.8x P/BV and enjoying continued credit growth as it benefits from the government's mortgage subsidy program.

- **Housing:** Stock prices of housing companies are at depressed levels in much of EM in spite of the widespread housing shortage. Although short term macro and micro issues have depressed the industry almost globally in EM, demand over the medium term will be robust and supply short. We have taken advantage of cheap entry valuations to build positions in solid companies that should thrive over the long term.

The opportunities to identify small companies with compelling valuation and earnings growth remain substantial. As EMs remain out of favor, many highly competitive companies appear undervalued based on a medium to long term perspective.

China

We are anticipating a mixed economic outlook for China with differentiated equity market opportunities in 2016.

President Xi Jinping highlighted his four key priorities for 2016 as:

a. reducing industrial overcapacity
b. reducing housing inventory
c. controlling financial risks in the marketplace, and
d. cutting corporate red tape.

Reducing industrial overcapacity and housing inventory are of paramount importance for the future growth of China's economy, as industrial output and real estate still comprise a significant weight in China's GDP. Although the government continues to make progress in addressing the real estate issue, industrial overcapacity remains challenging. Many basic industries suffering from overcapacity, notably the steel, cement, aluminum, plated-glass and ship-building industries, have seen declining utilisation for four consecutive years. Consolidation is taking place but closing down excess capacity requires more time.

We are anticipating a mixed economic outlook for China with differentiated equity market opportunities in 2016.

With regards to reducing the housing glut, the government has effectively deployed policy measures that have eased the industry's indebtedness and stimulated home buying, including lowering mortgage rates and down-payments on first and second mortgages within China, and potentially reforming the outdated Hukou system to increase urban migration. Today, Tier 1 and 2 property markets are relatively robust, with most of the outstanding oversupply in housing concentrated within the Tier 3 and Tier 4 cities. The bifurcation of the property markets remains a serious issue but can be resolved with the proper fiscal incentives in place.

Although challenges remain, we see significant investment opportunities within the Chinese equity market based on valuations in well run companies, including those in the clean energy, health care, technology and discretionary sectors

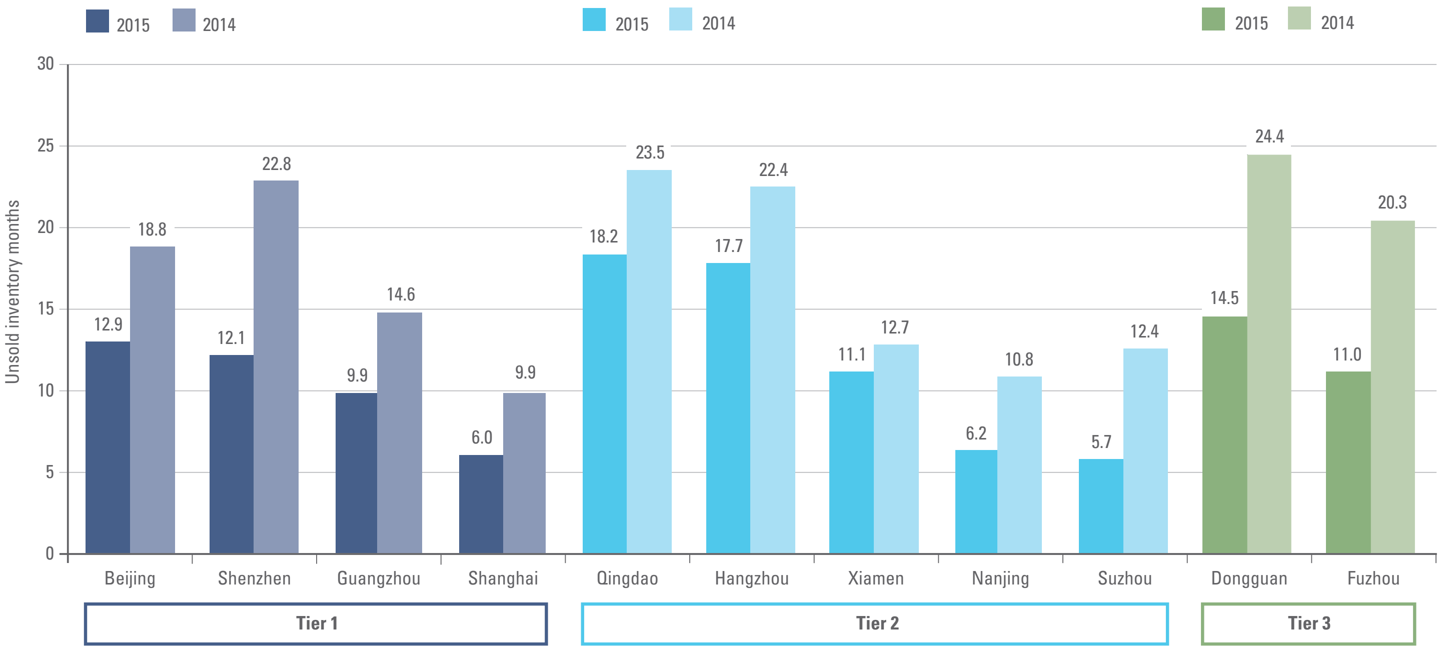
With regard to controlling financial risks, China's financial and monetary reform is key to the appropriate allocation of capital and sustainable long term growth. The IMF's inclusion of the Chinese RMB in the SDR basket is a clear acknowledgement of the government's success in liberalizing capital market policies. Although not yet complete, progress to date is encouraging.

Aside from Xi Jinping's four policy priorities, currency, the evolution of the service sector, and the successful implementation of the Hong Kong-Shenzhen Stock Connect program will be critical to the equity market performance. With the new basket of currencies in which the renminbi is now pegged, the dollar only represents 26.4% and the euro 21.4%, hence, we should see less volatility against the dollar, though not a guarantee. De-pegging the renminbi exclusively from the dollar is the first step in an eventual free float of the RMB.

The service sector has shown encouraging signs of growth in 2015, as the government has sought a better balanced economy. Latest figures show continued growth, which contrasts with the deceleration in the manufacturing sector. We anticipate service related businesses, such as insurance, will continue to see robust growth in 2016.

Although challenges remain of said reforms and policies, we see significant investment opportunities within the Chinese equity market based on valuation in well run companies. In particular, we believe major plays heading into 2016 include environmental/clean energy, health-care, technology and discretionary sectors. We prefer to avoid 'old economy' industries that suffer from overcapacity issues, as well as real-estate companies with large exposures to Tier 3 and Tier 4 cities.

Fig 5: **Unsold housing inventory in months**



Source: Goldman Sachs, 13 December 2015.

Korea

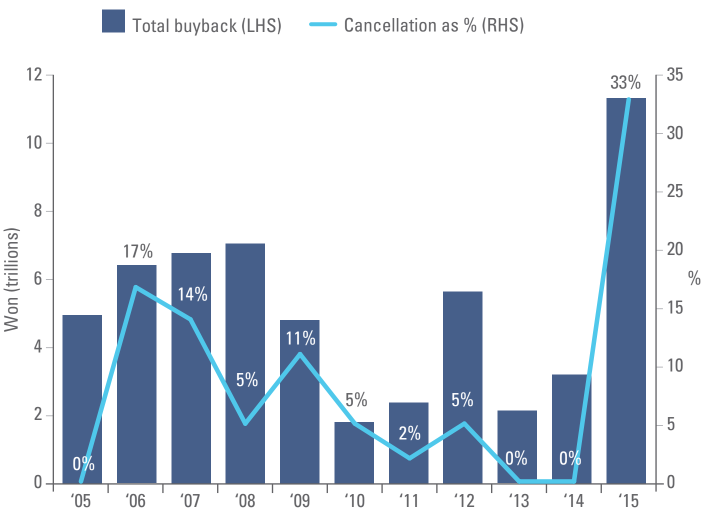
Based on recently released government economic policy plans for 2016, Korea expects a real GDP growth target of 3.1% with CPI at 1.5%. Government is keenly aware of deflationary risks, and has set a nominal GDP growth range in order to avail itself of more flexible monetary and fiscal policies.

On the corporate side, moderate earnings growth is expected for 2016, with consensus EPS growth at 7.6% (+10% for 2015). The fading competitiveness of the traditional manufacturing sector is the main culprit, although the market should remain supported, given the historically low valuation (0.9xP/B, 10.5x P/E), loose monetary policy and low foreign investor holding.

Moderate earnings growth is expected for 2016, with consensus EPS growth at 7.6%. Important for Korea is the improving attention to policies to enhance shareholder return

Important for the market is the improving attention to policies to enhance shareholder return. The most notable was Samsung Electronic's recent announcement regarding share buybacks/cancellation and a clearer dividend policy. Korea has the lowest dividend payout ratio (19%) among major Emerging Market countries. In 2015, we saw more than KRW10 trillion buybacks executed, which is more than three times higher than in 2014. In addition, a few leading companies – Samsung Electronics, Hyundai Motor, Kia Motor – clarified their plans of gradually increasing their dividend payout closer to their global peers. These significant changes in shareholder policies by Korean corporates are very positive and in large part influenced by the National Pension Fund's demand for corporates to pay more dividends.

Fig 6: **Buybacks and Cancellations – Korean equity market**



Source: Quantiwise, Bloomberg, JP Morgan.

Following the US Fed rate hike, the USD is expected to further strengthen vs. the Korean Won. This should be more beneficial to exporters e.g. auto manufacturers, IT companies, home appliance producers, etc. Contrary to the Fed's rate hike cycle going forward, we expect the Bank of Korea to maintain its current accommodative monetary policy. Low commodity and crude oil prices should help keep producer price and imported inflation in check.

Korea will hold its 20th legislative elections on April 13, 2016 for new members of the National Assembly. While generally the ruling party (Saenuri) stresses its focus on reforming the labor market, the opposition party (NPAD) emphasises solving the economic/social gap. Both parties, however, champion boosting domestic consumption which should positively impact retailers and the real estate sectors to some extent.

Companies with a growing dividend payout profile should be winners in this market, as will companies with solid secular growth support. Improving fundamentals for some of the exporters in the auto industry should help portfolio construction in this market, as well as unearthing companies with niche products and which play on the structural life style changes of the Korean consumer.

Taiwan

Our outlook for Taiwan is mixed where specific stock opportunities will lead the markets. On 16 January 2016, the country is set to hold presidential elections where polls are currently indicating an almost sure win for the pro-independent (anti-reunification with China) DPP party's Tsai, Ying-Wen. In this context, Chinese companies may expedite any tech M&A proposals ahead of the anticipated pro-unification KMT loss of power. Tech fundamentals are expected to see an uptick helped by non-Apple segment's inventory restocking from smartphone to TV, which along with the M&A activity could lift sentiment in the early part of the year. Post elections through the first half of the year, investors will likely focus on the impact on Taiwan-China relations following a possible DPP win. Additionally, a disappointing iPhone 6s follow through will weigh on sentiment. We however expect a more robust second half when investor attention re-focuses on Apple's major upgrade for iPhone 7.

Our outlook for Taiwan is mixed where specific stock opportunities will lead the markets. We focus on the tech sector investing in companies with attractive valuations compared to regional peers, strong balance sheets, healthy cashflows and high dividend yields

Stock picking is going to be key in these two periods. We expect Financials to underperform overall given the expected chill in Taiwan-China relations as well as a slow-down in M&A activity. In contrast, we expect the Apple supply chain to lead the recovery during the second half into the year end, as beneficiaries of the iPhone 7 upgrade emerge. Upgrades could include dual camera, further strengthening of its casing with waterproof features as well as improved forced touch and acoustic experience. Outside of mobile, notebook players should start running into the first meaningful wave of Windows 10 upgrade during the second half of year ahead of the back-to-school season. All of these developments should bode well for our holdings in Taiwan, which focus on the tech sector with attractive valuations compared to regional peers, strong balance sheets, healthy cash flows and high dividend yields.

India

India has been held back by lack of earnings momentum and continuing worries on the health of the banking sector. While earnings downgrades have plagued a wide range of industries, the aggregates have been significantly impacted by large downgrades in upstream oil, steel and aluminum companies. The other dominant causes for earnings downgrades are (a) slow revenue growth as low commodity prices have been passed on and (b) soft rural demand as monsoons failed for the second year in a row. Earnings growth for MSCI India are expected at approximately 8% for year ending on 31 March 2016, significantly lower than almost 18-20% expected at the start of fiscal 2015. The government reforms continue to move ahead on a somewhat bumpy trajectory. There has been significant progress in banking and electricity but the proposed amendments to land acquisition act had to be withdrawn. Inflation has been behaving itself, allowing RBI to cut rates.

We expect very strong earnings growth in smaller companies where broadly our thesis of improving margins and better cash flows has played out over the last year or so

For the year ahead, our outlook can be summarised as follows:

- The effect of reforms in banking, electricity distribution, coal production, natural gas contracts and government spending on roads, railways and urban infrastructure will have a positive rub-off on economic growth and aggregate earnings in the coming year.
- The GST bill is expected to be made into law in 2016. The rollout will take time because (i) a majority of the states need to ratify this bill because it is a constitutional amendment and (ii) the operating rules have to be framed and notified. We expect GST to be implemented with effect from 1 April 2017.
- We think there is little room for rates to be cut from here because food inflation is looking less benign going ahead, though energy and other material prices should remain soft.
- India is a large net importer of energy. Weak crude oil outlook significantly helps India's current account deficit, reserves position, currency outlook and has an ameliorating effect on inflation. India is also witnessing a marked increase in coal production (Coal India output is rising by about 10%yoy in recent monthly figures, and government wants annual production to grow by about 300 million tons by 2020). As a result, India's thermal coal imports will reduce over time. We expect global coal prices to remain soft as a result, and this has a significant effect on inflation via cost of electricity and input costs for steel and cement.
- We are also seeing some green shoots in demand conditions, especially in urban demand and some industrial capex. We expect both trends to get stronger in 2016 as positive real wages over the last 24 months feed through to consumption and as industry gears up to meet investment demand created by government spending in railways, defense, roads and other urban infrastructure. A revision in wages for government employees effective early 2016 should also help.
- Outlook for the financial sector should improve. A majority of government owned banks and some large private ones like ICICI and Axis Bank continue to trade at a big discount to long term average valuation multiples because of stressed assets in the system. Our sense is that the stock of not provided for bad loans is quite large but good loans are not slipping into bad loans at the margin. Hence, given time, the bad loans can be provided for. In any case, some lenders like ICICI, Axis Bank and SBI are probably much ahead on the road to recovery, which is not priced in today.
- We should see very strong earnings growth in smaller companies where broadly our thesis of improving margins and better cash flows has played out over the last year or so. We expect much better topline growth going ahead. Midcaps trade at a premium to larger stocks, which is a source of concern, but stronger earnings may continue to support these valuations in our view.
- We are overweight financials, industrials and consumer discretionary. We do not like base materials, telecom, staples or healthcare – the latter two being expensive. In the smaller cap universe our approach is far more bottom up stock specific where we are looking for stocks which are not overly expensive and offer an exciting growth outlook backed by a decent balance sheet.
- The risks to our outlook include lack of progress on key legislative bills (GST in particular) and political noise is a key sentiment risk for India. Our economic and earnings recovery thesis is based on (i) industrial capex increase, led by government spending. Much of this is executive activity which is not dependent on legislative progress in the Parliament but unexpected rise in political noise or a scandal has the potential to slow this down and (ii) gradual improvement in asset quality of the banking system helped by specific bank related reforms already under way as well as a cyclical recovery in the economy. If global economic conditions become far worse or the BJP government becomes dysfunctional for some reason our investment thesis will be at risk.

The risks to our outlook include lack of progress on key legislative bills, and political noise is a key sentiment risk for India

Indonesia

The Indonesian market did not escape the declines experienced by its Southeast Asian peers, falling 19.5% in 2016. Going forward, the pace and implementation of continued government reforms (e.g., in healthcare and property) as well as increased government spending on public infrastructure should provide the needed support for the equity market. We expect some stabilisation of domestic consumption with companies more focused on the middle income segment to benefit. Industrial real estate developers should also be beneficiaries of stronger FDI and DDI realisation. Interest rate sensitive stocks, primarily banks, should have a better outlook for the coming year. Earnings growth estimates for the market seem to be improving (2016 consensus EPS growth of 14%), while the local JCI index, at 2x PBV, trades well below trend levels.

Turkey

While it was a weak year for EM generally, some Turkey specific issues further pressured Turkish equities, including uncertainties around the general elections, independence of the central bank, geopolitical issues and finally the downing of a Russian jet.

Turkish equities have historically traded in the range of 8.0x – 12.0x 12M blended forward P/E (except for during the financial crisis) which makes the current level of 8.0x P/E attractive on valuation grounds. We believe EPS growth in the banking sector could be a strong catalyst for the market as the sector composes 33% of the local benchmark index. We expect the banking sector to post about 30% EPS growth in 2016 thanks mainly to widening net interest margin. Considering that the banking index trades at 6.2x 12m blended forward P/E, we believe EPS growth should be a strong driver for the banking stocks and the market.

With that said, the market will continue to follow developments on geopolitical issues, talks related to the new constitution and the appointment of a Central Bank governor in 2016. While we acknowledge the potential risks, we believe the risk/reward profile of the market is quite attractive and look for opportunities to increase our position in Turkish equities.

Latin America

The investment outlook in Latin America is a challenging one for 2016. Latin America's larger economies show varied degrees of preparedness to weather a very difficult combination of domestic and external backdrops. In 2015, Latin currencies corrected anywhere between -15% to -35% and equity markets dropped in USD terms by about -31% (MSCI EM Latin America Index). As a result, we enter an unprecedented fifth consecutive annual period of downward earnings revisions resulting in valuations for equities that, in aggregate, do not yet appear to be cheap, despite the correction. In our view this is the perfect environment in which stock picking abilities are key to adding value.

- **Brazil:** Within the larger economies, Brazil appears least well prepared to face this scenario given that for years it has lagged the rest of its peers in terms of much needed structural reforms. The economy is projected to contract -3.8% in 2015 and -3.7% on 2016, dragging the region into a two-year recession, although only Brazil and Venezuela show negative growth. Despite aggressive monetary policy efforts with SELIC reference rate at 14.25% inflation remains high, close to 10.3% in 2015 and projected to drop to 6.5% in 2016, which is still above the Central Bank's target of 4.0% (+/-2.0%).

The main culprits: administered prices driven by government intervention, wage indexation and the pass-through effect from the currency depreciation. Brazil maintains a current account deficit of -4.5% of GDP in 2015, but is expected to narrow and perhaps disappear entirely in 2016 as imports contract. In previous recessions, the external sector has been key in lifting the economy; this time around it seems harder with a slowing China accounting for close to 20% of total exports and, more importantly, with agriculture, industrial metals and oil commodities (prices at a cyclical downturn) accounting for 65% of total exports. The domestic economy is also in a tough spot with unemployment steadily rising – now close to 8% - and wages lagging inflation, both driving consumer confidence to a 5-year low. On the political front President Rousseff has just begun her second term and her approval ratings stand at a multi-decade low of less than 15%. After the corruption scandal involving state-controlled oil company Petrobras and government officials as well as high profile business people, an impeachment process is being promoted by the opposition in a process that might take years and divert attention away from policy, but could also trigger rapid change in sentiment for the better if it fundamentally alters the political outlook.

> In Latin America, we enter an unprecedented fifth consecutive period of downward earnings revisions resulting in valuations for equities that, in aggregate, do not appear to be cheap despite the correction. This is the perfect environment in which stock picking will be key to adding value

- **Mexico:** For Mexico the picture is a lot brighter in economic terms but valuations remain relatively expensive. The economy is expected to grow 2.5% in 2015 and 2.8% in 2016, basically in line with its long term potential level. The economy is less exposed to commodities than its regional peers, with energy just 12% of total exports. Mexico runs a current account deficit of close to 2.5% of GDP in 2015, and contrary to its regional peers commodities represent only 16% of total exports. Over the last two decades the economy has been successfully steered towards increasing dependence on manufacturing exports; trade with the US is key and Mexico remains as one of the top 3 trade partners with the US along with China and Canada. The currency depreciated over 14% during 2015 (Bloomberg) which helps boost its competitiveness against other manufacturing exporting nations like China.

> Within larger economies, Brazil appears least well prepared, lagging the rest of its peers in terms of much needed structural reforms. For Mexico, the picture is a lot brighter in economic terms but valuations remain relatively expensive. Here, we favor stocks in the materials sector for large caps, and industrials for small caps

Unemployment remains low at close to 4% in 2015 and is projected to further decrease in 2016, even as wages have stagnated. Consumer confidence is relatively sanguine with inflation at a low 2.4% in 2015 and well below Banxico's target, allowing it to simply follow the Fed in terms of policy rate movements. Another significant factor that differentiates Mexico from its regional peers is credit to the private sector, which after the Peso crisis of 1995 has not fully recovered and stands at about 18% of GDP (by comparison, Brazil is 55% and Chile, 73%); this provides tremendous opportunity for growth for the banking sector and for households to gradually add on more debt and incentivise consumption for the long term.

In terms of reforms, center-stage is Mexico's energy reform with the historical opening up of the oil and energy sector to private players. The first three oil field development auctions have taken place with relative success particularly given the weak oil pricing environment. In 2016, fixed asset investments in the energy sector should also provide support to economic growth.

On politics President Peña Nieto suffers from low popularity ratings after some scandals involving suspicious real estate transactions and a massive kidnapping and killing of 43 students in the state of Guerrero in 2014; violence, in particular drug gang-related, remains a top challenge for the Peña Nieto administration but does not pose immediate threats to overall stability. In this more favorable context, consumption stocks would be ideal but in Mexico these trade above 20x forward earnings making them too expensive. We thus favor stocks in the materials sector for large caps and industrials in small caps, as these stocks trade at attractively discounted levels.

- Chile: Chile's economy is expected to grow 2.1% in 2015 and 2.3% in 2016 but still below its full potential of 3.5% GDP growth. In Chile, consumer confidence and private investment have suffered after the tax reform introduced in 2014 in which the complexity within the system increased while corporate income tax expanded from 20% to 25%-27% with negative knock-on effects on growth. Other structural reforms announced and currently under discussion include labor, education, pension, healthcare and a constitutional reform, all extremely positive long term but could pose risks on implementation shorter term.

Chile is the economy in the region with the second largest exposure (after Colombia) to commodities with commodity exports representing more than 17% of GDP, heavily concentrated in copper. In 2015, mining output in Chile has seen a marked contraction along with lower copper prices and will likely face a tough 2016 with state-owned CODELCO's copper cash cost close to USD 2.00/lb; in terms of energy the economy is a net beneficiary of low oil prices as it remains a net importer. Chile's current account deficit stands at close to 2.5% while the currency has depreciated broadly in line with copper prices.

Consumer confidence in Chile is expected to recover along with employment and wages, both of which have shown steady gains in 2015

Consumer confidence is expected to recover along with employment and wages, both of which have shown steady gains in 2015. Valuations are relatively attractive at 12.5x PE 1.7x PB and 10.6% ROE (well below 10-year averages) but with a negative earnings outlook of -9.3% EPSG in USD terms. In this context we remain cautious on the market.

- Colombia: Colombia is most exposed to commodities within the larger Latin American economies. GDP in Colombia is expected to grow 2.8% in 2015 and 2.2% in 2016, well below its full potential of 4.0% with oil revenues representing 21% of total GDP and more than half of total exports. Consequently, the Colombian Peso has the highest correlation with its top commodity, oil, and currency moves virtually in tandem with energy prices. As expected, Colombia's current account balance has experienced a significant deterioration from a -5% GDP deficit in 2014 to -6% GDP in 2015. The FX pass-through effect on inflation has been a key concern prompting Banrep to hike rates twice over the last 12 months to 5.5% currently. On the positive side for 2016, Ecopetrol's new refinery in Cartagena is expected to be fully operational through the year adding 0.4% points to GDP while the so called 4-G infrastructure investment program has had a successful set of initial auctions and financing for a total of at least 6 new large scale projects that could add another 0.6% points to GDP in 2016.

Colombia is most exposed to commodities within the larger Latin American economies. Peru's economy will be likely driven by large investments in the mining sector as well as large infrastructure investments

- Peru: Peru's economic growth has decelerated in 2015 to 2.7% after being the fastest growing economy in the region over the last 5 years; in 2016 it is expected to grow 3.2% also below its full potential of 4.2%. In addition to the downturn in commodity prices in 2015 Peru suffered from a significant lag in public investments as the country held regional elections earlier in the year and the new local administrations were slow in deploying either new or existing investments. The economy is still substantially dollarised so the currency has had a much more attenuated correction of only 11%. In 2016, the economy will be likely driven by large investments in the mining sector, including Las Bambas and Cerro Verde copper mining expansions, as well as by large infrastructure investments, including Line 2 of Lima's metro, Southern Peru gas pipeline and the Talara refinery modernisation.

After the recent presidential elections in Argentina, a new chapter of economic reform and normalisation begins. We favor banks, real estate and agro-industrial stocks

- Argentina: After the recent presidential elections in Argentina, a new chapter of economic reform and normalisation begins. After years of economic mismanagement, Argentina's economy is expected to grow 2.0% in 2015 and 0.6% in 2016 which should be a year challenged by the implementation of policy normalisation, positive long term but impacting short term growth. Some of the key measures already implemented include the elimination of capital controls with the immediate devaluation of close to 35% of the official Argentinean Peso exchange rate, the elimination of bans and restrictions on exports, particularly agricultural soft commodity exports, and a gradual normalisation in utility rates, which until now had remained heavily subsidised; other immediate policy changes include the elimination of subsidised loans through the commercial banking system all of which are necessary steps towards a normalisation in the economy. Inflation, still running at 39%, is expected to gradually come down to more manageable levels as policy implementation starts to take effect in 2016. Given the significant distortions embedded in valuations we monitor our stock picks very closely as we start to assume stronger fundamentals driven by this normalisation scenario: we favor banks, real estate, and agro-industrial stocks.

Frontier Markets

Frontier Markets did not escape the general EM equity market declines in 2015, beset with similar sentiments, primarily weak commodity prices and currencies, slower global growth and the prospect of higher interest rates. Our view within Frontier Markets has been to steer away from the opportunity being seen as a binary theme, or a beta play on oil, or EM growth or lack thereof, etc. We believe value investing in this space can continue to yield results and as a result looking forward to 2016, there should continue to be an abundance of opportunities to invest in under-researched equities that are off the beaten path.

We believe the key drivers for Frontier Markets will be:

- Oil: Clearly important for many markets. We take a benign view on oil from here (i.e. flattish) and try to find value under the current prices rather than imposing a specific view on commodity prices and investing accordingly. Because of this, and the speed with which oil has collapsed, we tend to find more opportunities in the importers versus exporters.

- Nigeria: In the context of Global Frontier Markets, we are cautious on Nigeria, primarily because of the growth adjustment that the country faces, which ultimately will result in slack demand for the sectors represented in the equity market. Consumer companies face weakening demand and rising cost of imported materials (via black market FX rate). This is bad news for margins and growth. Banks face abrupt deterioration of asset quality and an increase in regulatory interventions / state direction, which means capital raising is a question of when, not if. We expect to remain underweight until either valuations or outlook changes.

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- Other Africa: Within other Africa, like Kenya, opportunities are more attractive given the more balanced terms of trade and more moderate adjustment required in a strong USD world. The banks are the clearest value.

- Kuwait and other GCC: we are still cautious for similar reasons as Nigeria, although here the governments play a larger role. Governments are currently on an unsustainable fiscal path that will lead, at some point, to cut backs that may not bode well for certain industries such as contractors. However, industries leveraged to social spending may remain supported.

- Frontier Asia: We continue to like the opportunities present in Pakistan and Sri Lanka as valuations offer a margin of safety, and growth opportunities remain intact. These are economies growing at 5-6% annually, relatively uncorrelated to global growth due to their low export intensity, and both benefit from commodity price tailwinds. In a world with slowing growth, valuations should be higher in these markets which could be amongst the few and far between that continue to grow.

- Within Latin America, we believe in the reform led opportunities that the newly elected Macri's government will bring to Argentina. Returning to conventional economic policy and unwinding populist fiscal drag should help incubate a strong growth backdrop in an economy that largely sat out of the excesses (or even sustenance) of the past two decades. This is base effect growth; where sluggishness of the past helps set up opportunities for the future. Banks are the preferred exposure given the low penetration of banking and the wide impact an improving macro has on a bank's business.

- In the Frontier Markets universe, there is an entire spectrum of FX regimes, from the fundamentally broken Naira (where policy makers are hesitant to take the pill of weaker FX, higher inflation, higher interest rates), to fundamentally strong currencies like the Pakistani rupee. That said, even the Pakistani rupee should move in line with other key EM currencies, like the RMB, to maintain real effective exchange rates and relative prices. In other words, the best one can hope for is a low beta currency in a strong USD market.

We view Frontier Markets as the 'emerging' Emerging Markets, offering investors access to local/domestic leveraged assets, which while not immune from EM issues, are still able to more directly respond to internally driven dynamics.

Frontier Africa

African markets experienced a challenging year in 2015, with currency weakness and commodity price weakness being the most oft attributed sources of pain. Commodity dependent countries such as Nigeria and Zambia saw stresses on their respective currencies, in spite of, in the case of Nigeria, attempts to support the local currency in the official market. As of 31 December 2015, three of the ten worst performing currencies for the year were from Africa. The width of the dislocations has been severe with 11 African currencies losing in excess of 10% of their value this year versus the USD (a figure that is understated given currency controls in a number of key countries like Egypt and Nigeria that has contained currency moves). Acute power shortages across many parts of Africa, caused in some parts due to droughts and lower hydropower generation, have hindered output in many countries.

Weak global markets, commodity prices and investor outflows translated to notable weakness in a number of African markets. The six-country MSCI EFM Africa ex South Africa Index lost 19.5% of its value in 2015. The broader S&P All Africa ex-South Africa Index that covers 12 key Frontier African markets and African companies listed outside the continent witnessed a more pronounced weakness declining 29% in 2015. Some of the more notable declines in USD terms include Zambia (-46%, local index), Ghana (-25%), Egypt (-24%), Nigeria (-20%) and Kenya (-18%) per MSCI index data . Note that in local currency terms Zambian markets were actually mildly negative for the year (-6.7%, local index) for the year - illustrating the impact that currencies have played on foreign investors' returns.

The number of near term macro headwinds in Frontier Africa may seem daunting. However this is a region with a diverse set of economies

The number of near term macro headwinds in Frontier Africa may seem daunting. However, this is a region with a diverse set of economies – while lower oil prices may weigh on economies such a Nigeria, they benefit net energy importers such as Egypt and Kenya. Challenging macro environments create political and economic imperatives for many countries to push forward difficult, but constructive reform agendas. This creates opportunities as markets open up, regulations are relaxed and the private sector/international capital is sought to bridge the much needed investment in their domestic economies.

As fundamental stock pickers, we focus on identifying the best long-term investment opportunities. While the region faces a number of potential headwinds in the near term, we remind ourselves that in evaluating investments, at the core of good decision making are valuations. While impossible to call a bottom, commodity prices are at decades-old levels, limiting the downside risk from here, and currency weakness, a central theme on the continent, has weighed on USD returns. The opportunity in Frontier Africa remains very compelling if one is prepared to look through global headlines and fickle sentiment and remain well exposed to a cross-section of companies whose fundamentals are attractive. We focus on finding high quality businesses with demonstrable pricing power and sustainable growth. Valuations then direct our capital allocation decisions. We are excited about valuations that now represent levels last seen in the credit crisis and given the extent investors are underexposed to equities and commodities, find that Africa offers a compelling opportunity.

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Our exposure in financials tends to be in banks, many of which are focused on underlying consumption demand in their economies. We are also well-represented in consumer businesses (consumer staples, discretionary, healthcare and telecommunications). With a population of over 1.1 billion, there is a significant opportunity to tap a young and rapidly growing African consumer base.

At a country level we maintain our largest weight in Egypt where, despite the challenges, we note the longer-term growth prospects and find value in healthcare, banks and real estate development companies, as well as consumer stocks. Business sentiment is positive in Egypt coupled with a strong domestic growth outlook. Many Egyptian corporates are looking through the near term currency pressures as they focus on re-commencing capital projects that have been stalled since the start of the Arab Spring in 2011, notwithstanding the tight availability of foreign currency. Banks are guiding to fairly robust demand for credit in the next couple of quarters and generally stable asset quality trends. The new gas find by ENI is a structural game changer that could make Egypt energy self-sufficient. The Suez Canal expansion will help offset the prospects of disappointing tourist arrivals (that was not built into the base case outlook anyway). Companies in Egypt have tremendous operating leverage (given the difficult period that they are emerging from). Hence, while near-term multiples look fair, the longer-term growth potential offers compelling value. We like consumer plays, healthcare and banks.

We are focused on developments in Nigeria. The drop in oil price has increased pressures on the fiscal situation, but too little attention has been focused on positive changes made by the new administration, which are starting to bear fruit. We view market weakness as an opportunity to cautiously rebuild exposures to attractively valued high quality banking assets that now offer

The challenge is finding businesses that are navigating the current macro environment and have robust business models relatively insulated from near term issues

deep value and are able to withstand stresses in the local environment, but we remain wary of consumer staples companies, which remain fully valued, as weak consumer demand and a challenging operating environment are not yet built into analysts' forecasts. Future fiscal reforms will likely emphasise growth, domestic investment and the key role of private sector. However, the parallel currency markets suggest notable risks for the Naira ahead, although policy makers express confidence that USD demand is artificially inflated and there are numerous leakages that can be addressed to ease pressure.

The challenge as investors is finding businesses that are navigating the current macro environment and have robust business models relatively insulated from near-term issues.

Middle East

While the decades old pegs with the US dollar have helped GCC states escape some of the sharp currency declines seen by other commodity exporters, weak local sentiment and continued outflows from international investors have translated to declines of 17% in the S&P Pan Arab LMC Index. Some of the more notable declines in the region have been in the larger markets where foreign investors were more active. This includes Egypt (-28%), UAE (-16%), Qatar (-15%), Saudi (-17%).

The biggest challenge for investor sentiment in 2016 is going to be oil prices and regional stability. While clouds on the horizon indicate that risks to the near term oil supply remains to the upside, we are starting to see the impact that lower oil prices and lower capex on oil & gas projects could have on incremental output. With demand for oil remaining relatively stable, analysts expect that demand-supply could move towards equilibrium globally in late 2016 / early 2017 and oil prices should adjust upwards to the USD50-60 levels (over 50% higher than where it is now). In the interim, what differentiates the GCC is staying power – their production costs are at the bottom quartile of the cost curve and hence at low risk. They are simultaneously increasing capex on increasing output and should eventually win over market share from Europe / North America producers given the latter's declining output and lower incremental capex.

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Investors will look closely towards budget announcements in Q4 for the direction that governments will take in dealing with the difficult macro environment. Unlike many other commodity-driven economies in the Frontier Markets space, governments in the Middle East have prudently used their surpluses over the last decade to build reserves and repay debt. They are now fortunate to have significant fiscal room to continue their domestic development plans even if oil prices remain weak for a protracted period of time.

However, the region's vulnerable geopolitical status rears its head from time to time, as evidenced by the recent diplomatic spat between Saudi Arabia and Iran. This and any other such events will weigh on investor sentiment for the region's equity markets, notwithstanding the possible positive implications for oil prices.

Difficult times creates opportunities for reform, and we have seen that many countries are using the opportunity to make structural changes, diversifying government revenue, reducing subsidies, and focus on the contributive role of the private sector

In the past, countries like Saudi Arabia have demonstrated their commitment to domestic spending with the country running fiscal deficits for 16 years between 1983-1999 (sustaining over 10% for over a decade). For Middle East focused investors, that means greater focus on what Governments could do to support the local environment. We think non-essential capital expenditure will be deferred (hurting contractors, material, and construction related sectors), but current expenditure i.e. public sector pay will be hard to curtail. We expect little change from Governments in the areas of social welfare programs (healthcare, education, employment generation, and housing) and this presents the earnings stream which is at least risk.

Difficult times create opportunities for reform, and we have seen that many countries are using the opportunity to make structural changes to diversifying government revenue streams (such as potential introduction of VAT), reducing subsidies (on fuel, energy, etc.) and focus on the role that the private sector can play in providing capital, building out infrastructure and generating employment.

With the US Federal Reserve having raised interest rates in late 2015, the stage is set for an unwinding of the low rates that have flooded global markets with liquidity. The GCC region, given their fixed currency pegs to the US Dollar will also see rates move up. Lower oil prices and shrinkage in current account surpluses have already translated to some pressure on local liquidity (and rates) as Governments have started borrowing to maintain their domestic agenda. As rates rise, we highlight the opportunity in banks in the region as they will benefit from rising spreads as their assets re-price quicker than their liabilities and hence see a boost in their profitability. With strong capital adequacy, healthy provision coverage and generally well managed balance sheet risks we think valuations provide compelling value relative to risks that are embedded in current share prices.

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As fundamental stock pickers, we focus on identifying the best long-term investment opportunities. While the region faces a number of potential headwinds in the near term (political and economic), we remind ourselves that in evaluating investments, at the core of good decision making are valuations. In evaluating the risks (and upsides), we draw comfort from commodity prices which today represent trough cycle levels and are at levels last seen in 1999. Hence, there should be limited downside risk from here.

The structure of the portfolio should help us ride out the intervening period of uncertainty. Currency risks are minimal with most of our holdings being in USD-pegged currencies. With interest rates at cyclical lows globally, any improvement in the growth outlook could be supportive of a recovery in rates, and given the currency peg of many regional governments to the USD, this should be favorable for Middle East banks as interest rates rise, driving spreads and return on equity higher. We have over a third of our portfolio exposure in Banks. Over half of the portfolio is comprised of companies that are beneficiaries of local consumer demand (an area where there is low risk of governments cutting expenditure due to political and social imperatives). In general these companies tend to have less volatile cash flows and share prices. We currently have zero exposure to chemicals and materials.

At the country level, a third of the portfolio is invested in UAE companies, where the Government has very little reliance on oil and must spend on infrastructure ahead of its commitment to host the EXPO 2020 conference. The country could attract interest as a beneficiary of the opening up of Iran to foreign investors. UAE real estate markets have indeed given back some of their recent gains as currency weakness in other economies make it less attractive for investors from those countries to invest, travel or spend in USD-pegged countries such as the UAE. However, most of the demand in recent years is tangible, and largely funded upfront with little leverage to inflate prices. Asset quality for banks continues to see improvement and business sentiment (as evidenced by the PMI) remains at a robust 54.5 at the end of November.

Our Middle East holdings reflect a strong consumption bias and manifests itself in strong profitability and compelling valuations

Valuations in Saudi Arabia have retraced substantially with the TASI index now trading at a P/E of 10.9x based on forecasts for 2016. This is compelling relative to historical levels, particularly given the catalyst of the opening of the market to foreign investors. With its market cap at USD 418bn it would become the sixth largest EM economy (larger than South Africa, Russia or Mexico) and would see a notable rise in foreign ownership from its current level of approximately 1%. While the opening of the Saudi equity markets to direct foreign ownership has received a lukewarm response, we think investors will eventually become more comfortable with the registration process and the structural hurdle of only being able to access this market through swaps or P-Notes will be removed. There is a strong cross section of consumer businesses that are accessible in this country and liquidity is superior to most other Frontier Markets.

Our Middle East holdings reflect a strong consumption bias (comprising over half our investments in the region) and manifests itself in strong profitability (forecasted average return on equity of 20.4%). Despite the high quality of businesses we own, valuations on 2016 forecasts are compelling with a P/E of 9.1x and a price to book value of 1.3x with a forecast USD-based dividend yield of 4.6%.

Ashmore

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

New York
T: +1 212 661 0061

Riyadh
T: +966 11 483 9100

Singapore
T: +65 6580 8288

Tokyo
T: +81 03 6860 3777

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