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MARKET INSIGHTS ALERT

Pain & Gain: What Happens Now That Emerging Markets Have Submerged?

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During a rather sobering January, several clients wondered whether we were maintaining our generally bullish sentiment on G3 equity markets discussed in our mid-month market outlook presentation. Thus far (January 30, 2014), that conviction has admittedly been severely tested with the Dow down 4.39%; the S&P 500 down 2.39%; the Russell 2000 down 2.09%; MSCI EAFE down 3.57% and Emerging Markets down by a whopping 6.61%. First, let's recall the highlights of our 2014 strategy report:

- We believed that the cyclical bull market in G3 equities would continue in 2014 but with greater volatility **and with a strong possibility of a technical correction of 5% to 10% in light of their 2013 gallop.**
- Among the G3, we were most bullish on the U.S. and Japan and more cautious on the Eurozone. Although expectations for European equities are quite high (i.e., a crowded trade), **we were concerned with continued signs of credit contraction (which could forebode a growth scare) as well as the current elevated level of the Euro which we believe to be too high (and thus deflationary) for the periphery countries.** Our resumption to a more bullish stance on Europe would be premised on a reversal of either condition.
- **On Emerging Markets (or EM), we were unambiguously bearish and believed that their apparently cheap valuations at the end of 2013 represented a value trap.** We were most bearish on commodity intensive countries (such as Brazil, Argentina, Turkey and South Africa) because we thought that they will be further hobbled by soft commodity prices. Additionally, we thought that current-account-deficit countries' reliance on foreign savings will constrain their ability to boost domestic demand and defend their currencies as yields rise in the U.S. Within an EM basket, we were most bullish on north Asia.

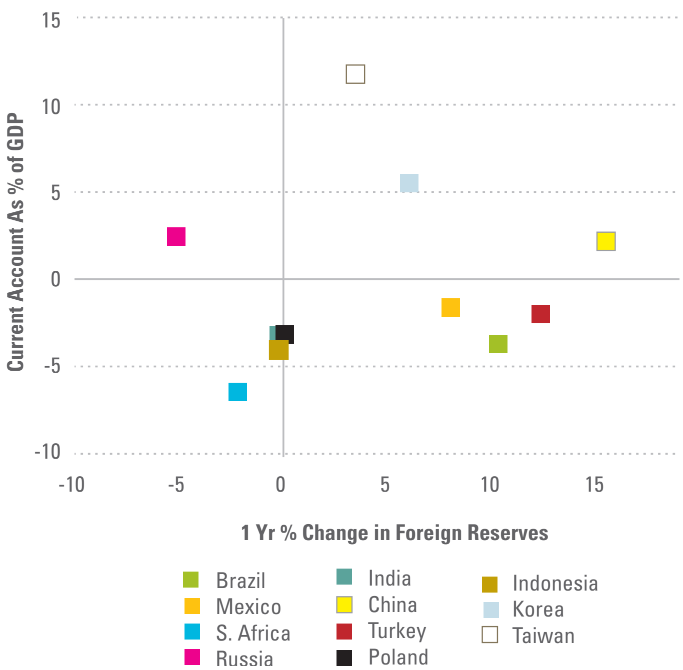
Since the prior EM currency crisis in the mid-1990s, the EM world has become a key contributor to global trade and economic activity. On a PPP basis, EM currently represents over half of the global economy. China now accounts for 10% of global imports and other EM for an additional 31%. In regards to oil, non-OECD countries account for about 50% of total global crude demand. Additionally, EM (particularly Chinese) weakness could create a negative feedback loop because while EM dependence on G7 growth has dramatically diminished in recent years, the importance of intra-EM trade has increased. We believe that EM equities are currently in the midst of a cyclical bear market wherein commodity producers and countries with weak current account balances and foreign reserves will bear the brunt of the downdraft. The fragility of emerging market countries was exposed by the hint of tapering in May 2013. In response to actual Fed tapering, central banks in South Africa, India and Turkey all raised rates in an attempt to defend their currencies. Further interest rate normalization in the U.S. could expose the misallocation of capital facilitated by post 2008 credit excesses. When combined with domestic weaknesses (where more closed economies are facing inflationary pressures and more open economies are facing growing current account deficits), the result could be sharper capital outflows and exchange rate adjustments.

For long-term investors such as pension funds, it is important to separate the long-term or secular opportunity from the cyclical opportunity. On a strategic asset allocation basis, EM (and would we argue, even more so, Frontier Markets) will be an increasingly important component of the global opportunity set as a result of relative long-term trends in growth, population and productivity. For longer horizon investors, the very same challenges discussed in this report will ultimately provide a fantastic long-term return opportunity. For example, if one were to have purchased the EM index for the ten year period ending January 31, 2014 (which would include both the mid-1990s EM currency crisis and the recent downdraft beginning in late 2010), the cumulative return would have been160.5% (which equates to an annualized return of 10.1%). However, it is important to note that cyclical downdrafts can persist over several years and inflict severe short-term pain. If the holding period referenced above is shortened to three years, the cumulative return would have been -9.71% (annualized return of -3.35%).

During what we believe will be a challenging year for EM assets, we are positive on strong current account/foreign reserve commodity consumer countries that are most exposed to the G3 growth story: Taiwan, South Korea, Poland, Mexico as well as possibly during the second half of the year, China. **In light of significant differentiated risks, we would caution against passive implementation strategies that are least equipped to discern important differences in risk profiles or to take advantage of relative value opportunities.**

Current account balance as a percent of GDP is an important indicator of a country's relative health while the trend in and level of foreign reserves provide an important indicator of its ability to defend its currency from a speculative attack. During the last EM currency crisis in the mid-1990s, fixed currency regimes throughout much of the EM world allowed distortions to accumulate into breaking points. These breaking points caused eventual adjustments that were both massive and cascading for financial markets and the underlying economies. Today, with the exception of China, most EM countries use floating exchange rate regimes which importantly allow for instantaneous and continuous adjustments, which can prevent distortions from culminating into a massive crisis. For example, as a result of declining current account balances, India, South Africa, Turkey and Indonesia have all experienced substantial currency depreciation over the last three years.

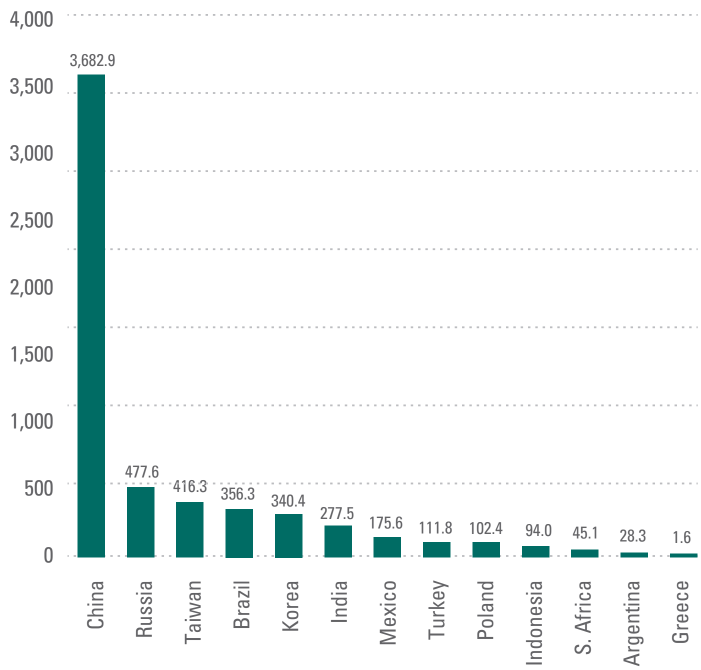
CHART 1 Current Account as % of GDP vs. 1 Yr. Change in Foreign Reserves



Source: FactSet and FIS Group Professional Estimates

CHART 2 Comparative Level of Foreign Reserves

$ Billions of Foreign Reserves



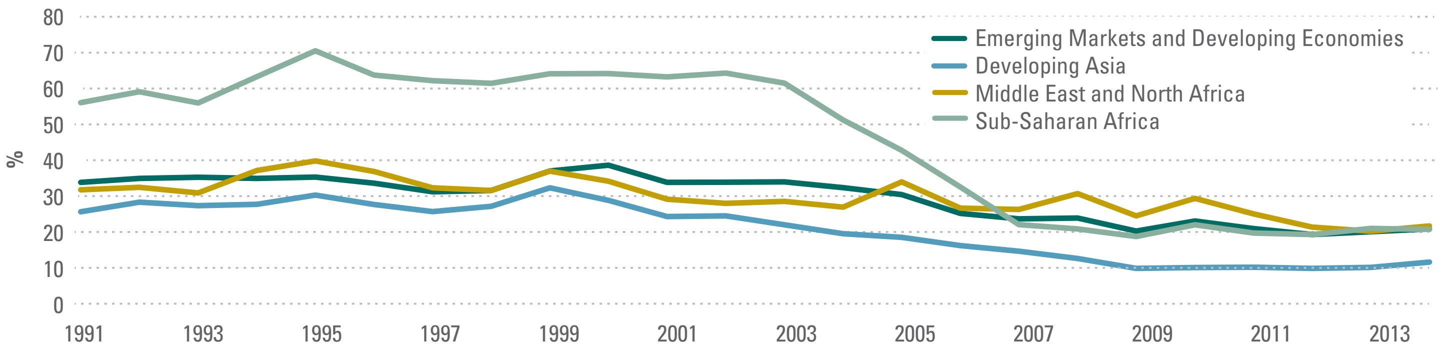
Source: FactSet and FIS Group Professional Estimates

CHART 1 evaluates each of the major EM countries by comparing the trend in their current account position vs. their foreign reserves position. CHART 2 contrasts each nation's level of foreign reserves.

Based on the data in CHART 1, one can observe that only the northern Asian countries—Korea, Taiwan and China—are in a positive trend with respect to both their current account and foreign reserves. Based on the level analysis (CHART 2) we would add Russia, which has experienced some depletion in its flow of foreign reserves as a result of softening commodity prices, to this list. Countries that would appear most vulnerable are South Africa, Indonesia and India, all of which are facing increasing current account deficits, stubborn inflation and declining currencies.

Relative to the mid-1990s, total foreign currency debt in EM and most of the developing world is actually lower (see CHART 3 on next page). It however should be noted that without China (whose foreign currency debt is only 9% of GDP), total foreign currency debt in the EM has been climbing back to the mid-1990s level.

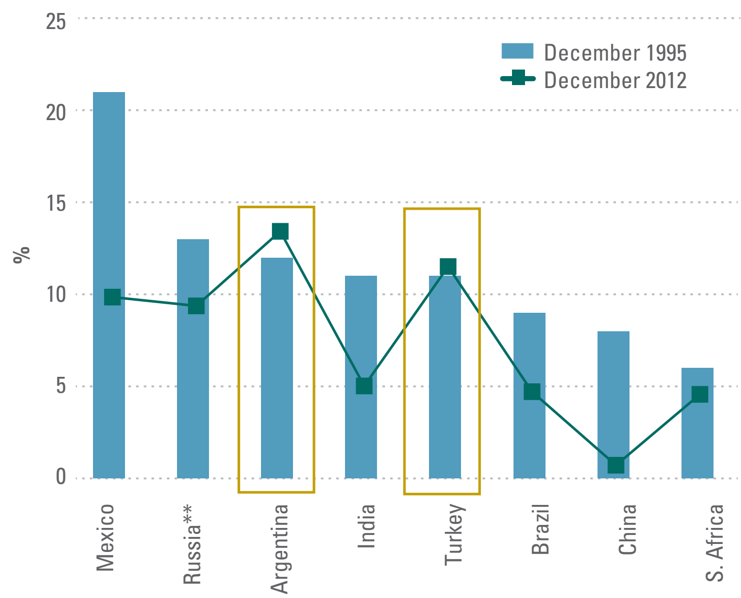
CHART 3 Trend in Total External Debt
As a Percent of GDP



Source: World Economic Outlook, IMF

Even more important than total debt levels is the distribution of debt between domestic and foreign ownership. Vulnerability in this area is highly skewed among select countries. For example, as shown in CHART 4, Turkey, Argentina and to some extent, South Africa are most vulnerable to a credit event because of their relatively large amount of foreign denominated debt, which have matched or are almost at their 1995 levels. Although both Brazil and India run current account deficits, they have limited foreign currency debt and thus would appear to be less exposed to a credit event. Relative to 1995, the distribution of external debt dominated in foreign currencies is about one-half of its prior level for Mexico and Brazil. Also on this measure, China stands out as have very limited exposure to foreign dominated debt.

CHART 4 Foreign Currency Denominated Debt
As a Percent of GDP



Source: FactSet and FIS Group Professional Estimates

MACRO AND MICRO ECONOMIC RISKS

On the whole, we expect below trend growth out of the EM with commodity producers bearing the brunt of the cyclical down-trend. First, post Lehman credit excesses are still working their way through several EM economies and thus present a cyclical headwind for both commodity producers and consumers. Second, EM and particularly Chinese weakness could create a negative feedback loop because EM dependence on G7 growth has dramatically diminished in recent years, while the importance of intra-EM trade has increased. In other words, the DM and EM growth story could diverge further.

Unfortunately **China** is undergoing its structural reform at a time when its importance to other developing countries has risen much more due to its huge intake of commodities. For example, China's capex accounts for 40-45% of world industrial metals consumption. Therefore, what matters for EM growth is China's capex, commodity prices and their domestic demand. On all three fronts, the risks are still tilted to the downside for now. While the January 23rd report suggesting a slowdown in Chinese manufacturing partially reflects the seasonal effect of workers returning home for the Chinese New Year, it primarily reflects a less favorable credit and exchange rate environment, which is consistent with the slowing loan and money supply growth, that we we observed in prior FIS Outlooks. Meanwhile, credit excesses from 2008-2010 have yet to be fully cleaned up.

RISKS PRESENTED BY LOANS COMING DUE IN THE CHINESE TRUST INDUSTRY

The near default of the $505 million China Credit Trust Company (CCTC)'s "Credit Equals Gold" fund represents the most recent casualty of prior credit excesses. Like many Chinese trust companies (which unlike their developed country counterparts, do not have access to a broad array of publicly traded financial securities), CCTC invested in actual business ventures, including infrastructure, to underwrite high yielding structured fixed income funds. According to McKinsey, such arrangements represented 39% of the total revenue sources for the Trust firms in China in 2012. CCTC's primary investment was in a coal producer which ultimately could not support the 10% coupon which it underwrote. The real question is whether CCTC represents the proverbial "canary in coal mine" to a larger potentially systemic problem. The probability of another such trust company default or near default is indeed material. The primary risks relate to the substantial growth of such products since 2009, the known mismatch between the duration of trust loans and their underlying investments and the risk of continued softness in energy and industrial product prices—would obviously increase the default risk embedded in those loans.

The fact that the typical maturity of trust company loans in China is 1.5 to 2 years means that the loans due in calendar year 2014 were mainly launched in the second quarter of 2012 and the first quarter of 2013. However, the anomalous high funding launched during that period increases the amount of trust loans due in 2014 by more than 5 times compared to last year. It is estimated that the "loan-due peak" will occur in May 2014 with the due amount around $0.28 trillion. More troubling, the majority of the trust loans were launched to fund real estate projects. According to Haitong Security Industry Research, since August 2012, there are at least 16 trust loans at risk of default and 10 of them are related to real estate projects. On the positive side, Chinese trust companies are not allowed to take on leverage. The concern is the size and the recent rapid growth of the industry and their exposure to more subdued nominal growth (because of its impact on the return of their underlying investments). As of the 3rd quarter of 2013, total funding of trust firms had increased from $.33 trillion to $1.67 trillion since 2009. While the average coupon offered by Chinese trust companies is about 6%, the average rate for loans underwritten since 2009 is 11.5% and the average rate paid to the Banks that distribute these products to Chinese investors is 8%. Therefore, nominal growth below the currently projected nominal GDP growth of 7.5% could be problematic. In the end, Beijing does have the resources to bail out creditors but the impact of several such events would significantly undermine investors' confidence in EM markets. In any event, the government's attempt to squeeze out prior excesses will be a long and drawn out road which is filled with such minefields. For the rest of the EM world, unless China embarks on cyclical demand management to support the structural adjustment it is pursuing, there seems little immediate prospect of an acceleration in activity.

Elsewhere in the emerging world, in the more trade and capital restricted EM economies, domestic demand is hampered by mounting inflation. On the other hand, the more open economies have been hampered by expanding current account deficits. Growth will be especially challenging for commodity producers. While we are cyclically neutral on commodities (because one cannot rule a possible bounce from improved global supply), we are strongly bearish from a secular perspective. The commodity bull market which began in the mid 2000's was built on three key drivers: a sustained decline in the dollar between 2001 and 2008, a delayed supply response from producers and booming Chinese demand. Today, all three have reversed course. Commodity supply is expected to increase materially for key commodities such as copper, iron ore and oil following a decade of aggressive mining investment, new technologies and, in select cases, new substitutes. Commodity demand growth will likely remain soft (in-line with the structural trend) in most of the developed world, and growth in China is unlikely to accelerate from current levels. Finally the dollar has reversed its structural downtrend.

CHART 5 (on next page) contrasts key macroeconomic data for each of the countries shown relative to their five year average. Perhaps most striking is that most of the countries are below their five year average (as measured by the combination of the trend in Leading Indicators and Industrial Production) with the notable exception of Greece, Taiwan and South Korea. Money growth is notably strongest for South Africa, Indonesia and Turkey; all of which are facing sharp currency devaluations. The trend in credit creation is poor among all of the countries shown; a troubling trend since credit creation typically leads both economic growth and equities.

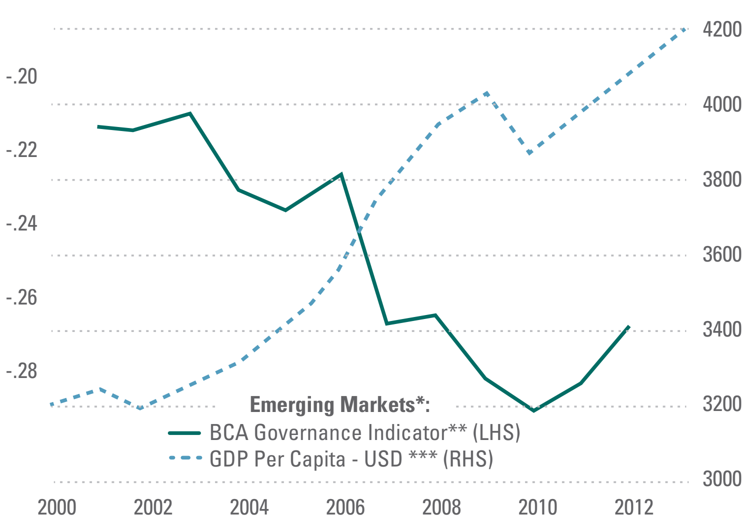
CHART 5 Relative Macro Economic Indicators

Source: FactSet and FIS Group Professional Estimates

MIGRATING GEOPOLITICAL RISKS

For most of the post crisis period, the fallout from deleveraging as well as political machinations in Europe and the US captivated investors' concern as a source of negative tail risk. We believe that geopolitical risks are gradually subsiding in the DM world and migrating to the EM world. Much of the elevating geopolitical risks among EM countries stems from economic growth which has not been sufficiently complemented with improvements in quality of life and governance. After a decade of growth, there is a crisis of expectations among the lower and middle class. While measures of governance in many non-EM developing countries (i.e., Frontier Markets) have improved substantially over the same period, most independent measures of governance, such as those reported by the World Bank, on EM countries depict overall depreciation. CHART 6 contrasts the economic growth of the major EM countries (such as China, Brazil, Russia, India, Mexico, Indonesia, Turkey, Malaysia, The Philippines, Thailand and South Africa) with the trend in governance on key measures such as government effectiveness and accountability, political stability and level of violence, rule of law and control of corruption.

CHART 6 Governance vs. Growth



Source: BCA Research
**Includes China, Brazil, Russia, India, Mexico, Indonesia, Turkey, Malaysia, The Philippines, Thailand, and South Africa*
***Equally-weighted average of the following measures: government effectiveness, voice and accountabilitiy, political stability and violence, rule of law and control of corruption*
****Weighted by population*

TABLE 1 The Upcoming Year of Elections in Emerging Markets

Country	Election Date	Government in Power Since
Turkey	Aug-Oct 2014 - Presidential June 2015 - Legislative	2002 (AKP)
India	May 2014 - Legislative	2004 (Congress)
Indonesia	April 2014 - Legislative July 2014 - Presidential	2009 (Demokrat)
Brazil	Oct 2014 - Presidential Oct 2014 - Legislative	2002 (PT - Lula/Rousseff)
S. Africa	April 2014 - Legislative	1994 (ANC)
Russia	Dec 2016 - Legislative March 2018 - Presidential	1999 (Putin)
Mexico	July 2015 - Legislative July 2018 - Presidential	2012 (PRI)

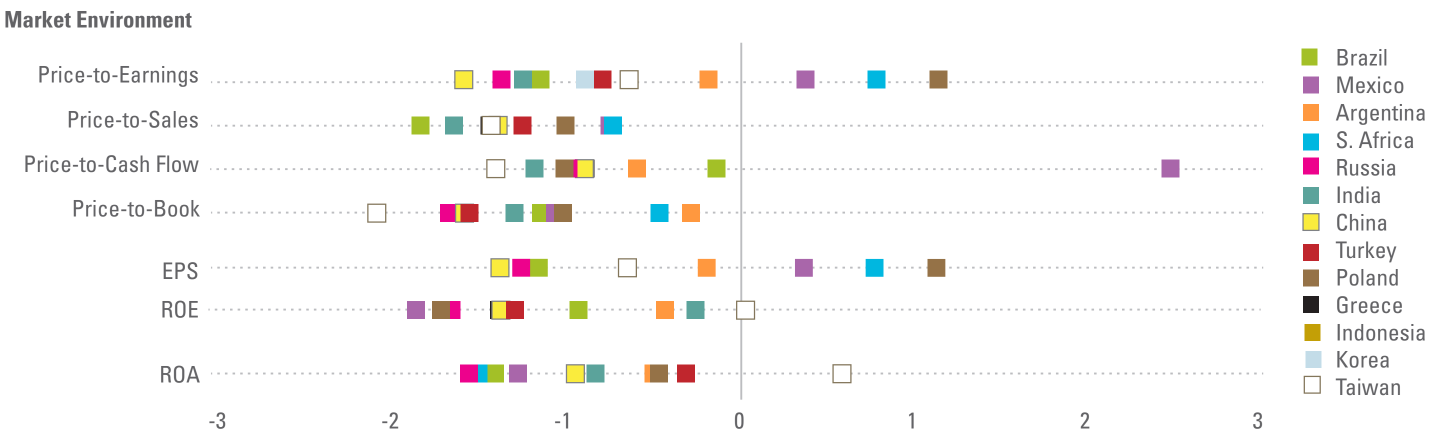
Source: BCA Research, Inc.

Undoubtedly, long-term, structural reforms and corporate restructuring are needed to lift EM growth and profitability. While China and Mexico have begun very ambitious structural reform agendas, it will take some time to implement them. While bullish in the long run, these reforms could trigger further growth retrenchment as companies shed excess capacity and reduce their capex in the coming year. In other countries like Brazil, Russia, South Africa and India, corporate restructuring and improving efficiency could result in labor layoffs. If this occurs, it will jeopardize household spending – the main and very critical growth driver at the moment.

Structural reforms however typically involve a mixture of deregulation, reduced subsidies, increased international competition and labor flexibility; all of which involve some measure of short term pain and dislocation. The key geopolitical risk going forward is whether, given the decline in corporate governance during the growth period, there will be buy-in from the general population during the painful adjustments typically required by structural reforms. Countries with upcoming elections that investors should watch are delineated in TABLE 1 (on previous page).

FUNDAMENTAL DATA COMPARISON

CHART 7 Relative Fundamental Data



Source: FactSet and FIS Group Professional Estimates

In examining current fundamental data relative to their five year average, it is striking that for both valuation and earnings related variables most of the EM countries shown are currently below their five year average. This suggests that shorter horizon investors may get caught in a value trap in light of the somewhat dismal earnings trend. The most attractive standout is Taiwan, which is trading below its five year trend but has a ROE and ROA above its five year trend. Taiwan, as discussed previously, also has a healthy current account balance and foreign reserves. From a more granular perspective, after a 20 year slump, Taiwanese domestic demand as represented by retail sales and building permits is improving. Another important potential upside is their concentration in IT, a sector on which we are highly bullish. Two countries that also stand out are South Africa and Poland, both of which are currently trading above their five year valuation on a P/E basis and are showing EPS variables above their five year average. We are less sanguine towards South Africa because of its concentration in commodity exports and the previously discussed structural imbalance there and more sanguine towards Poland because of its greater exposure to a recovering Europe. The other standout country is Mexico, which is well priced on both a price/earnings and price to cash flow basis but has a reasonably healthy EPS. Mexico's exposure to the healthier U.S. economy is also plus.

Putting it all together, we remain bearish on EM. In the context of a difficult year for EM assets, within the EM opportunity set, we are positive on strong current account/foreign reserve commodity consumer countries that are most exposed to the G3 growth story: Taiwan, South Korea, Poland, Mexico as well as possibly towards the second half of the year, China.