



Strategy
**GEM Equity Strategy
Outlook 2014**

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Strategy Update

Negative year in prospect but underperformance should slow

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GEM equities cheapness at aggregate level is misleading

We would largely discount the apparent cheapness of GEM equity markets for 3 reasons - 1) Much of the value resides in the financial sector where investors are rightly sceptical about the declared level of NPLs, especially in the BRIC markets; 2) There is no sign of a reversal in the degradation of margins of GEM non-financial companies relative to their DM counterparts; if anything, the negative drivers are becoming more pronounced in EM; 3) The polarisation between overvalued sectors on the back of good governance (Healthcare, Consumer Staples) and their badly governed peers (Energy, Financials) remains at extreme levels, highlighting the difficulty facing EM investors.

Investors should focus on the relationship between state and corporate sector, not on short term fund flows as the key driver of EM economies and equities

Investors have become overly focused on the potential impact of short term fund flows over recent years. We believe that their time would be better spent analysing the underlying dynamics of corporate level governance, in particular the relationship between the corporate sector and the state which has been the most important driver of emerging equity markets since the financial crisis. By our reckoning, the relationship is most dysfunctional in the BRIC markets, particularly China, where we can envisage the potential for a debt trap in the industrials/materials sectors, which could eventually trigger an economy-wide financial crisis. By contrast, we believe that the impact of any potential tapering of QE is largely priced in to most of those markets whose economies are running sizeable current account deficits, with the partial exception of Brazil.

Breakout from low dispersion and volatility more likely on downside in 2014

It might not have always felt like it, but the volatility and dispersion of EM equities continued to fall in 2013 which resulted in another year of poor performance for momentum-based strategies. The immediate outlook is for more range bound trading as liquidity and fundamental drivers remain finely balanced, so a contrarian strategy should continue to pay off. It is even possible that emerging equities will begin the year strongly as fears concerning the impact of tapering recede. Nevertheless we believe that the year will be defined by increasingly negative sentiment towards the ability of the authorities in Beijing to manage a soft landing for the Chinese economy. There will eventually be beneficiaries within GEM from lower commodity prices but the initial impact will be to raise risk premiums and redemptions across GEM.

Absolute returns likely to be negative with (lower) underperformance vs DM

We would tentatively forecast a negative return of around 10% for MSCI EMF in 2014, but with a greater degree of volatility and dispersion between constituents. The relative call is harder following massive underperformance in 2014, which has left DM valuations expensive, but economic and governance drivers indicate further potential underperformance from GEM of around 10%. Within EM, we continue to advocate overweight positions in markets with lower exposure to China, beneficiaries of lower commodity prices and improving sovereign and/or corporate governance characteristics.

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