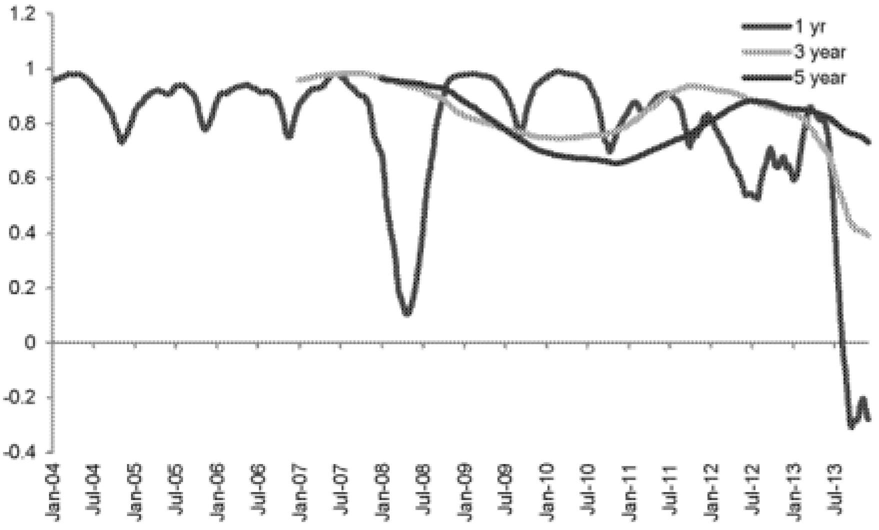
Summary

Negative year in prospect but relative underperformance should slow

GEM equities set to underperform in 2013 by even more than we had anticipated

We intend to review the absolute and relative performance for GEM equities during 2013 in more detail alongside the outcome of our own forecasts later in this document, but with only a few weeks to go, it is very likely that EM will have underperformed DM and in particular the US, by even more than our forecast of 20-25%. The most noteworthy feature of 2013 has been the very sharp decoupling of EM from US equities which has been even more pronounced than during 2008-09 (Figure 1). Whilst discussion of EM markets has been dominated by the potential impact of Fed tapering, we would attribute this sudden shift in the relationship to the structural factors, which we first identified in our initiation of GEM strategy coverage almost exactly three years ago (*Structural challenges drive performance*, 1 December 2010). Whilst we would very much like to become more optimistic about the prospects for 2014, we anticipate another year of negative absolute returns, albeit with higher levels of dispersion and volatility, along with further underpeformance against DM although by a smaller margin than 2013.

Figure 1: 1-year, 3-year and 5-year rolling correlation between MSCI EM and MSCI US



Source: Deutsche Bank, Bloomberg LP

EM relative valuations are not as cheap as they appear at face value

EM equities have been cheap relative to their DM peers on both earnings and asset-based valuations for some time. The value case for overweighting EM appears almost overwhelming now when the asset class is viewed in aggregate against DM, but is somewhat less compelling when the country and sector constituents are examined in a more granular fashion for the following reasons.