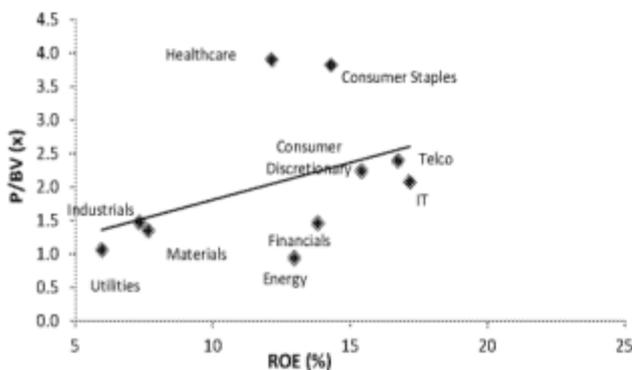




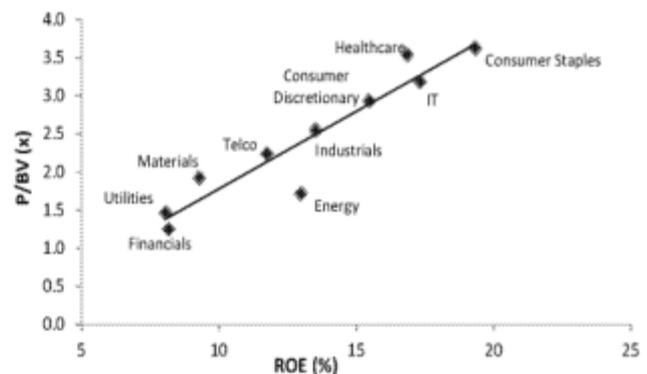
- Much of the relative value resides in the financial sector, where EM price-to-book valuations appear very low relative to ROE both in absolute terms and relative to their historical relationship. We believe that this shift is due mainly to a very high level of investor scepticism about the level of potential NPLs in the BRIC markets in particular, which is entirely rational in our view. By contrast, DM financials are trading in line with their historic valuation/return relationship.
- The majority of non-financial sectors within GEM have margins which have underperformed their DM peers; the overall ROE for EM non-financial stocks is now below the level of DM non-financials, based on an aggregate margin which has now almost converged with DM, having historically been much higher.
- There is a pronounced polarisation of valuations within the EM universe on an ROE versus P/BV basis between sectors both in absolute terms (Figure 2) and relative to DM (Figure 3), where valuations and returns are more closely correlated. Financials and Energy stocks have extremely low valuations, while the Healthcare and Consumer Staples sectors appear very expensive. We identified this gap as the biggest reason to be bearish EM one year ago because it is driven by aversion towards those sectors which face the most severe structural challenges, and nothing has changed in the past twelve months.

Figure 2: EM – P/BV (x) versus RoE (%)



Source: Deutsche Bank, Bloomberg Finance LP

Figure 3: DM – P/BV (x) versus RoE (%)



Source: Deutsche Bank, Bloomberg Finance LP

Better governance and /or growth necessary to unlock value in EM equities

Given the extremely high level of valuations for the better governed higher ROE sectors, the prospects for an upwards re-rating of EM in either absolute or relative terms depends on prospects improving for the value-related markets and sectors in our view. There are two potential catalysts. First is faster global growth, which would revive the more cyclical and commodity-related sectors – China is an especially important source of demand but one which would benefit from an acceleration of economic activity in developed economies via increased export demand. Second is that the markets may begin to detect a marginal improvement in governance within EM, at either the sovereign and/or the corporate level. We are sceptical that DM growth will come to the rescue as in 2002-07, whilst there is very little indication of an incrementally positive shift in governance across most emerging markets in our view, with the partial exception of Mexico, (*Rhetoric versus reality; governance drivers still mainly negative*, 6 November 2013).