



China likely to be a more negative driver for GEM in 2014

Sentiment towards the Chinese economy and financial assets has once again swung wildly over 2013, because of the relative lack of transparency in terms of the underlying drivers of both the economy and the corporate sector, but the overall influence of China on the rest of the asset class has been relatively neutral. We believe that there is a significant chance of a decisive break in a negative direction in 2014, due to the increasing pressure from the build-up of debt through much of the corporate sector and local government, which raises the risk of a debt trap (Figure 34 and Figure 35) as nominal rates of sales and GDP growth slow. Most investors are ending the year with a relatively positive view of China following the perceived success of the CP Plenum in presenting an agenda for reform. The Plenum represents a strong statement of intent, but did not really lay down a template for implementation in the area which matters most, namely the dysfunctional fiscal relationship between local government and Beijing, which is the underlying cause of rising debt and falling productivity in the broader economy. We do not believe that the authorities in Beijing have sufficient time to implement the policy shifts laid out in the post-Plenum document, and that at some point over the course of 2014, borrowers and investors will begin to lose confidence in their ability to pursue what we see as the irreconcilable objectives of 7%+ growth and financial stability. We therefore see the potential for deterioration in growth expectations for China to influence the rest of GEM in terms of trade, fund flows and commodity prices.

Unresolved structural issues and polarised valuations imply negative returns

Overall, we do not feel that the outlook for absolute returns has changed very much since we made a tentative forecast of a negative return of 10-15% for 2013. At the time of writing, the MSCI EM total return is only -2%, so whilst we may have got the direction right, we were too pessimistic, mainly because Chinese equities have recorded a single digit positive return in contrast to the other BRIC markets. The two main reasons for our negative view have not really changed, namely the structural factors we discussed in the preceding paragraphs and the polarisation of the asset class between what might characterised as the overvalued versus the uninvestible. Accordingly, we are basically just rolling our position into 2014 with a forecast of -10% for the year as a whole, but with increased volatility and dispersion between markets (see below). Once again we would place China, not Fed-driven liquidity flows as the most important driver of absolute returns throughout GEM.

Maintain long DM call though fundamental attractions of US have diminished

By contrast, we were actually too optimistic towards EM in terms of performance versus DM and the US, when we forecast that the US would outperform by 20-25% in 2013, as the figure to date is just under 30% and around 25% against the DM benchmark, MSCI World. We maintain our recommendation for investors to overweight DM against EM in 2014, but it has become a more difficult call as DM has outperformed EM by +39.5% since we initiated coverage on 1 December 2010 while our favoured market the US has outperformed by +52.1%. We were able to make a strong case at the end of 2010 that almost everybody underestimated the strengths and resilience of the US economic and corporate models – following the strong outperformance, it is no longer possible to make that case as the structural advantages of the US relative to EM are now largely priced in as we show later in this report (Figure 30 and Figure 31). US valuations are clearly not in bubble territory though they may get there over the medium term, given the relatively positive outlook for flows, but the US equity market is nothing like the one-way bet that