



that investors should lighten holdings even if they do not share our pessimistic view about the likely endgame for the Chinese economy and equities. Of all the markets in GEM, the risks of extreme outcomes on both the upside and the downside are highest for Chinese equities in our view. The downside risk would materialise with a sudden stop in financing as the debt trap facing local government and the corporate sector becomes more obvious, while there would be significant upside if Beijing could present a credible plan for a complete overhaul of local government finances, which would also include Beijing led consolidation in key manufacturing and commodity-related industries.

- **Russia;** This is by far the cheapest market within GEM on almost any valuation criteria, most notably replacement cost (Figure 7), but we do not share the increasingly widespread perception among our clients that governance at either the sovereign or the corporate level, is about to get better. Indeed, we would actually suggest that any apparent improvement is largely cosmetic given that real economic reform has been almost entirely absent and the interests of minority shareholders in the vast majority of listed companies are increasingly irrelevant to those in control, be they state or private. The market is now so cheap that certain sectors now have option-like characteristics, which can drive sharp rallies, but given the fundamental backdrop and our continued bearish views on commodity prices, we remain underweight.
- **Brazil;** Brazil has been by far the worst-performing major emerging market over the past three years, largely because of the policy shift towards state capitalism, which has taken place since the financial crisis. Just as with Russia, asset-based valuations are low, so there will inevitably be sharp rallies when everyone is bearish, but we cannot identify any positive inflection point which might reverse the government-induced redistribution from capital, at least until the election(s) in the autumn. Our biggest fundamental concern is now the underlying economy where the impact of heterodox policies is likely to have a long-lasting detrimental impact, which cannot be easily unwound.
- **Korea;** This is our lowest conviction underweight but historically a highly cyclical market with a pronounced exposure to Chinese demand and vulnerable to any further depreciation in the yen. Korea, along with its North Asian counterparts, China and Taiwan, has been the beneficiary of sustained inflows on foreign capital due to its perceived status as a safe haven, through the current account surplus and so might prove vulnerable to potential redemptions from EM equity funds. Korea is possibly the biggest consensus overweight among active GEM managers although most concede that it is difficult to find compelling stock ideas.

Overweight

- **Taiwan;** Being one of the best-performing major EM markets over 2013 to date, it owes this status to its perceived defensive qualities and the relative lack of interest among GEM-dedicated investors before taper talk began in May. It has also been the most direct play on US growth via the dominant IT sector, though the non-IT stocks have generally performed better. We have been overweight for over eighteen months as the counterpoint to our stance on Korea, but the positive attractions of Taiwan have diminished, along with the dividend yield and valuation relative to the rest of GEM.