

Deutsche Bank
Markets Research
Global
Strategy
GEM Equity Strategy
Outlook 2014

Negative year in prospect but
underperformance should slow

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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decision. DISCLOSURES AND ANALYST

CERTIFICATIONS ARE LOCATED IN APPENDIX 1. MICA(P) 054/04/2013.

Date

11 December 2013

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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 underperformance

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

Rolling Period	Correlation
1 yr	0.2
3 year	0.4
5 year	0.6

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.

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Jan-04

Jul-04

Jan-05

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聖 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.

聖 The majority of non-financial sectors within GEM have margins which have underperformed their DM peers; the overall ROE for EM nonfinancial 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.

聖 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 (%)

0.0
0.5
1.0
1.5
2.0
2.5
3.0
3.5
4.0
4.5
Healthcare
Consumer Staples
Consumer
Discretionary
Industrials
Financials
Materials
Utilities
5
Energy
10152025
ROE (%)
Source: Deutsche Bank, Bloomberg Finance LP
Telco
IT

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

0.0
0.5
1.0
1.5
2.0
2.5
3.0
3.5
4.0
5

Healthcare
Consumer Staples
Consumer
Discretionary
Telco
Materials
Utilities
Financials
Industrials
Energy

IT
10152025
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).

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P/BV (x)

P/BV (x)

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Global growth is unlikely to become as EM friendly as in 2002-07

In the wake of the global financial crisis, the majority of economists and investors failed to anticipate the resilience of the US economic and corporate

governance models, which has underpinned the massive outperformance of US equities over the past three years. Whilst we retain a structurally bullish

view on the US economy, the growth cycle will continue to be qualitatively different to the consumer debt driven growth that proved so beneficial for emerging market exports between 2002 and 2007. There has been a further shift of pricing power away from emerging market producers, which is currently being exacerbated by the ongoing depreciation of the yen. The US will become more competitive in industrial goods due to more favourable cost comparisons in energy and labour as well as a technological shift to more distributed manufacturing techniques. Meanwhile the structural slowdown in emerging market economic growth is likely to have a pronounced impact on the commodity intensive exporters which are a much bigger constituent of the emerging market universe.

Micro structural factors threaten EM economies more than Fed taper

Investors are currently fixated on the impact of potential shifts in funds flows

on EM financial assets, through the Fed tapering policy and have a largely onedimensional

view of risk based on the level of current account deficits in the respective GEM economies. We believe that the real risk is that we are starting

to see a greater reluctance by foreign investors to put money to work in EM because they are increasingly focusing on the underlying structural issues, which up to now have been much more obvious at a corporate micro level than in the macro-economic aggregates. The sudden break in correlation between DM and EM equities at the start of 2013 preceded talk of Fed tapering by several months and was the direct result of investors beginning to

discount more favourable structural factors for the US against the bulk of the

EM universe. The biggest risks are in those economies with weak hard budget constraints, often as a result of a dysfunctional relationship between the state

and the corporate sector, as the absence of enforceable exit mechanisms ultimately undermines returns on capital.

BRICs most at risk – beware short FX/long commodities across GEM

On this basis the BRIC markets with the possible exception of India are eventually more liable to a 'classic' emerging type crisis compared to Indonesia, South Africa or Turkey, though we accept that there is a risk with Indonesia in particular, that predictions of a crisis, which lead to a rapid

rundown in FX reserves, could become self-fulfilling. China in particular has become much more dependent on foreign funding to prop up 'acceptable' rates of economic growth against a steady deterioration of the underlying

return on invested capital across much of the listed corporate sector. There is also a risk across all emerging markets that any sustained rally in the dollar will reveal 'hidden' short FX exposure, often linked to exposure to commodity related assets, which were acquired at top of the market prices. Whilst some EM currencies are now cheap, we would expect widespread further weakness against the dollar in 2014 to include the Korean won and possibly the Renminbi. Although Beijing's post-Plenum drive to attract foreign fund flows depends on a stronger currency, it is difficult to think of many emerging economies which have undergone a significant level of structural reforms without the benefits of either an undervalued currency or a devaluation to bring liquidity into the corporate sector – the renminbi is no longer undervalued in our view and is becoming increasingly vulnerable.

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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

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it has appeared to be for most of the past five years. Accordingly, our continued pro-DM stance has become increasingly reliant on what we still see as the very negative fundamental outlook for EM equities and we tentatively forecast that EM will underperform the DM by around 15%.

More volatility and greater dispersion between GEM markets likely in 2014

It might not always have felt that way, but 2013 has been relatively dull in terms of both EM volatility and the level of dispersion between markets (Figure

4 and Figure 5). We believe that both dispersion and volatility are likely to pick

up over 2014 as a whole and make life more interesting for investors, though most likely not in a very positive way for the following reasons.

Figure 4: Histogram of standard deviation (100 = 31 December 2007)

Figure 5: Annual return by EM country – Box plots of range, median and quartiles

Source: Deutsche Bank, Bloomberg Finance LP

Source: Deutsche Bank, Bloomberg Finance LP

1. Chinese economy and companies remain low visibility & high risk; Most of us have strong opinions about China, which is likely to remain the single most important influence on GEM, but the relatively low level of transparency concerning almost every aspect of economic policy and much of the corporate sector means that sentiment towards China, and by implication GEM, is likely to swing wildly once again.

2. No clear trend in liquidity flows; There are likely to be conflicting fund flow influences over 2014 as developed financial markets walk the bubble-taper tightrope (courtesy of DB credit guru Jim Reid). Overall demand for EM equities should be weaker than DM given the massive net buying of EM assets over the past ten years relative to the US by retail – there is also likely to be much more supply across EM relative to market cap. One potential source of funds for EM assets is if Japanese retail investors accelerate their overseas purchases in response to the falling yen, so we will monitor this closely via DB FX strategist and Japan expert James Malcolm.

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Figure 6: Total return of selected emerging market equity indices since 1 May 2013, USD



(1) Correct as at market close on 9 December 2013.

Source: Deutsche Bank, Bloomberg Finance LP

3. Potential for lower oil prices; Will 2014 finally be the year when oil prices, ex-WTI, finally break down through their narrow range to reflect the deterioration in the supply/demand fundamentals which has been apparent for some time? The bearish factors seem to be mounting up, namely continuing upwards revisions of US supply, less unfavourable geopolitical factors including the partial rehabilitation of Iran, less disruption to non-OPEC supply and lower EM demand – on the latter point, senior DB Asian energy analyst David Hurd points out the marked decrease in purchasing power brought about by currency depreciation for Brazil, India and Indonesia, who have collectively accounted for around 25% of the increase in oil demand over recent years.

Figure 7: 2013 versus 2007 – EV/NCI (x) and CROCI (%) for main EM markets



16%

EV/NCI (2007) - LHS EV/NCI (2013) - LHS CROCI (2007) - RHS CROCI (2013) - RHS

Source: Deutsche Bank, Bloomberg Finance LP

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4. Low GEM valuations give some option value; The relatively low level of valuations for some GEM markets and sectors, especially in terms of replacement cost (Figure 7 - EV/NCI is a reasonable proxy for replacement cost), mean that any positive turn in sentiment is likely to produce sharp rallies, albeit in an overall absolute and relative context that remains bearish.

Investors should take long-term structural positions and live with volatility, or

else take shorter term disciplined contrarian approach

We prefer

to

base our recommendations on longer term strategic

considerations rather than the more flow-based tactical calls, which are generally made on a post hoc basis to generate turnover. For those funds who feel the urge to pursue more active strategies however, we have continued to advocate a contrarian approach, which would have worked since early 2009 due largely to the increasing influence of momentum-based investors who focus on anticipated fund flows, which is an ultimately self-defeating strategy

for most participants. The contrarian approach has continued to work well over

2013, both for GEM overall and for most individual markets, including all of the

BRICs with the partial exception of Brazil. The pattern appears set to continue

for the first part of 2014 but could shift if both China and the oil price finally

break down, which should give dedicated investors the opportunity to generate some longer lasting alpha within the asset class.

Figure 8: Net foreign inflows (USD millions)

India

Last 1 week

YTD

2012

2011

2010

2009

2008

2007

2006

2005

2004

315

17,252

24,574

-564

29,338

17,644

12,900

18,558

8,356

10,905

8,642

(1) Correct as at 22 November 2013.

Source: Deutsche Bank, Bloomberg Finance LP

Country weightings unchanged – based on governance, oil and China view

We discuss the outlook for the individual markets at greater length, later in the

report, but our country weightings for GEM remain unchanged and are still driven by the underweight positions which we have found much easier to determine, whilst we continue to find it very difficult to identify compelling

overweights.

Underweight

China; Whilst China appears cheap in aggregate, this is largely due to the dominant financials sector, where investors are discounting major book value impairments from NPLs; Materials stocks also generally have very low valuations whilst Healthcare and Consumer Staples stocks are among the more expensive in the asset class. MSCI China has outperformed our expectations over 2013 and sentiment appears somewhat elevated, which if the past four years is any guide, suggests

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Indonesia

-26

-1,397

1,707

2,950

2,390

1,383

1,732

3,598

1,942

-1,735

2,126

Korea Philippines

80

6,047

15,069

-8,584

19,800

24,659

-36,641

-29,269

-12,659

-3,561

10,134

-32

808

2,548

1,329
1,224
420
-1,135
1,354
720
354
278
Taiwan
-611
7,068
4,916
-9,488
9,241
14,752
-14,719
2,073
17,424
22,212
9,865
Thailand
-210
-4,336
2,504
-167
2,687
1,136
-4,788
1,548
2,067
2,949
103
ASEAN Asia ex-Japan
-268
-484
-4,925
6,759
4,112
6,301
2,938
-4,191
6,500
4,730
1,568
2,507
25,442
51,317
-14,523
64,680
5,993
-68,451

-2,138
17,852
31,123
30,647
Japan
12,924
124,175
27,733
-323
22,926
-6,513
-66,817
32,759
68,885
113,338
95,603

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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.

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聖 Mexico; This remains overweight largely because it is one of the few GEM constituents where governance is clearly moving in a positive direction, in sharp contrast to its Latam peers, Chile and Brazil. Still, whilst reforms to the oil sector and labour market should raise the level of sustainable economic growth over the longer term, the more immediate impact on the margins of many of the listed companies will be negative. Mexican equities are clearly expensive at current levels to an extent which leaves little room for positive absolute returns over the medium term, but in default of any compelling alternatives, we remain overweight.

聖 Poland; Poland is one of the few emerging equity markets to deliver a positive total return in dollar terms over 2013 at the time of writing, despite the partial nationalisation of the pension fund industry which has absorbed the majority of investors' attention over recent months. Poland still appears to be relatively low risk/low reward compared to the rest of GEM given that financial flows from the EU are likely to meet the domestic funding deficit, while the equity market still yields just under 4%. Our main fundamental reservation concerns the potential for the government to meddle further in the management of some of the state-controlled companies which comprise the overwhelming majority of MSCI Poland, but we intend to remain overweight for the time-being.

聖 Turkey; This is by far the least successful of our recommendations for 2013 because both equities and the currency fell precipitously during the taper scare from late May to August, with only a partial recovery since then. We have three reasons for clinging on to our overweight position. First, valuations now look more reasonable, especially in the dominant financial sector. Second, we are sceptical about the extent and the impact of potential tapering, while we believe that the current account could benefit from a decline in the oil price. Finally, the major problems in Turkey are essentially cyclical – while the AKP-led government under PM Erdogan has made some unhelpful statements and the geopolitical situation in the area surrounding Turkey has been noisy to say the least, the private sector has largely been left to get on with business without the same level of state interference or negligence visible in some other emerging economies.

Neutral/overweight

聖 India; We do not really have a strong view on Indian equities at the current level in front of the nationwide elections in May. Valuations may appear cheap by historical standards, but are probably just fair, given the extent to which growth prospects have deteriorated over the past three years. The election is of course vital not so much in terms of who wins, but more how they win; in other words, will Congress, or more likely the BJP, be able to assemble a coalition which is able to enact and more importantly implement the economic reforms which investors and the policy-making elite alike deem necessary to restore India's growth potential? We suspect that at current levels, a marketfriendly

outcome in May is now partially priced in, whilst the financial situation for a significant part of the corporate sector is likely to deteriorate further over the coming months. Indian equities and the Rupee are likely to be very volatile through 2014 and we would prefer to wait for another period of weakness before adding to positions.

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Figure 9: EM markets - Current P/BV versus its 10-year average

-60%

-40%

-20%

0%

20%

40%

60%

Figure 10: EM markets - Current P/BV relative to EM P/BV, versus 10-year historical average

-60%

-40%

-20%

0%

20%

40%

60%

80%

Source: Deutsche Bank, Bloomberg Finance LP

Source: Deutsche Bank, Bloomberg Finance LP

Figure 11: EM sectors - Current P/BV versus its 10-year average

-50%

-40%

-30%

-20%

-10%

0%

10%

20%

Figure 12: EM sectors - Current P/BV relative to EM P/BV, versus 10-year historical average

-40%

-30%

-20%

-10%

0%

10%

20%

30%

40%

50%

Source: Deutsche Bank, Bloomberg Finance LP

Source: Deutsche Bank, Bloomberg Finance LP

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Consumer Staples

Philippines

Greece
Health Care
Consumer Discretionary
Utilities
Telco
Information Technology
Industrial
Financials
Materials
Russia
Egypt
Energy
Hungary
Thailand
Malaysia
South Africa
Mexico
Taiwan
Indonesia
Turkey
Chile
Poland
Korea
Brazil
India
Czech Republic
China
Consumer Staples
Philippines
Greece
Health Care
Consumer Discretionary
Utilities
Telco
Information Technology
Industrial
Financials
Materials
Russia
Egypt
Energy
Hungary
Thailand
Malaysia
South Africa
Mexico
Taiwan
Indonesia
Turkey
Chile
Poland

Korea
Brazil
India
Czech Republic
China

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Valuations & Margins

Why emerging equities are not as cheap as they appear to be in aggregate

EM equity valuations appear cheap against DM equities

The charts on the following pages illustrate why we believe that emerging market equities in aggregate deserve to trade at a discount to their developed

market peers, which is an argument we first made three years ago (Structural challenges to drive performance, 1 December 2010) when MSCI EM was trading at its highest ever premium to MSCI World.

1) Valuation discount reflects scepticism about EM financials returns.

EM equities appear extremely cheap on a P/BV versus ROE basis (Figure 13 and Figure 14) largely as a result of the Financials sector trading at a massive

discount relative to ROE compared with the DM financial universe (Figure 15 and Figure 16).

Figure 13: EM aggregate – P/BV (x) versus RoE (%)

10
12
14
16
18
%
0
2
4
6
8
0.0
0.5
1.0
1.5
2.0
2.5
3.0
3.5

Figure 14: DM aggregate – P/BV (x) versus RoE (%)

10
12
14
16
18
x
%
0
2
4
6
8

0.0
0.5
1.0
1.5
2.0
2.5
3.0

x

RoE - LHS

P/BV - RHS

Source: Deutsche Bank, Bloomberg Finance LP

RoE - LHS

Source: Deutsche Bank, Bloomberg Finance LP

P/BV - RHS

Figure 15: EM Financials – P/BV (x) versus RoE (%)

Figure 16: DM Financials - P/BV (x) versus RoE (%)

10
12
14
16
18

%

0

2

4

6

8

0.0

0.5

1.0

1.5

2.0

2.5

3.0

3.5

10

12

14

16

18

x

%

-4

-2

0

2

4

6

8

RoE - LHS

Source: Deutsche Bank, Bloomberg Finance LP

P/BV - RHS

RoE - LHS

Source: Deutsche Bank, Bloomberg Finance LP

P/BV - RHS

0.0

0.5

1.0

1.5

2.0

2.5

x

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2) Value spread is more nuanced through the EM non-financial universe. The valuation spread is far more varied across the non-financial sectors (Figure

17). Energy is the most obvious example of a cheap EM sector relative to returns compared with DM, while Consumer Discretionary, IT and Telcos also look better value. In contrast both Healthcare and Consumer Staples look better in DM whilst Industrials and Materials are relatively even, although EM

is a little cheaper in both cases.

Figure 17: EM versus DM by sector – P/BV (x) and RoE (%)

Sector

Financials

Energy

Materials

Consumer Discretionary

Consumer Staples

Industrials

Utilities

Telco

Information Technology

Healthcare

AGGREGATE

EM P/BV (x) EM ROE (%)

1.46

0.94

1.35

2.24

3.82

1.47

1.06

2.39

2.08

3.90

1.59

13.82

12.97

7.64

15.42

14.31

7.33

5.96

16.75

17.17

12.15

12.76

Source: Deutsche Bank, Bloomberg Finance LP

3) DM ROE in non-financials sector is now better than EM as aggregate margins have converged.

A straightforward side-by-side comparison of the DuPont decomposition of the

non-financial sectors in DM and EM reveals that the marginal shift of ROE in favour of DM which has taken place over recent years (Figure 18) is mainly due to the almost continual convergence of margins with EM (Figure 19). Whilst leverage has made an increasing contribution to EM returns (Figure 20), it remains lower than in DM, whilst asset turnover has been volatile on a gently rising trend (Figure 21).

Figure 18: EM vs DM non-financials – ROE (%)

EM Non Financials ROE

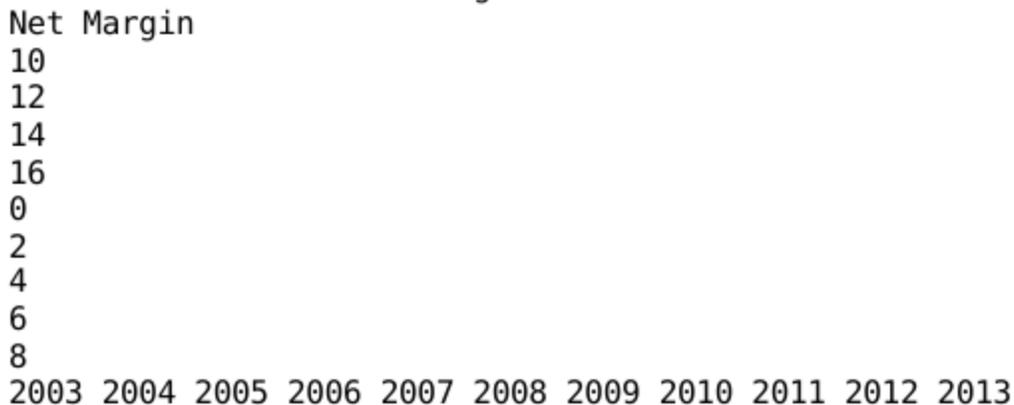


Source: Deutsche Bank, Bloomberg Finance LP

DM Non Financials ROE

Figure 19: EM vs DM non-financials – Net margin (%)

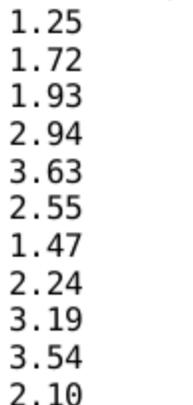
EM Non Financials Net Margin



Source: Deutsche Bank, Bloomberg Finance LP

DM Non Financials Net Margin

DM P/BV (x)



DM ROE (%)

8.16

12.98

9.28

15.46

19.33

13.51

8.05

11.74

17.32

16.84

12.00

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Figure 20: EM vs DM non-financials – Leverage (%)

EM Non Financials Assets/Equity

1.65
1.70
1.75
1.80
1.85
1.90
1.95
2.00
2.05

2003 2004 2005 2006 2007 2008 2009 2010 2011 2012 2013

Source: Deutsche Bank, Bloomberg Finance LP

DM Non Financials Assets/Equity (RHS)

Figure 21: EM vs DM non-financials – Asset turnover (%)

EM Non Financials Sales/Assets

DM Non Financials Sales/Assets

0.0
0.5
1.0
1.5
2.0
2.5
3.0
3.5
4.0
4.5
5.0
0.0
0.1
0.2
0.3
0.4
0.5
0.6
0.7
0.8
0.9

2003 2004 2005 2006 2007 2008 2009 2010 2011 2012 2013

Source: Deutsche Bank, Bloomberg Finance LP

4) EM consumer-related sectors have relatively positive margin performance.

Figure 22: EM vs DM net margins (%) – Consumer

Discretionary

Net Margin (%)

MSCI EM - Consumer Discretionary

10
0
1
2

3
4
5
6
7
8
9

MSCI DM - Consumer Discretionary

Figure 23: EM vs DM net margins (%) – Consumer Staples

MSCI EM - Consumer Staples

Net Margin (%)

10
4
5
6
7
8
9

MSCI DM - Consumer Staples

Source: Deutsche Bank, Bloomberg Finance LP

Source: Deutsche Bank, Bloomberg Finance LP

5) Regulated sectors have fared badly in both EM and DM, but worse in EM; this is especially so in Utilities as governments have reduced returns to capital

to help offset the impact of low growth on living standards.

Figure 24: EM vs DM net margins (%) – Utilities

MSCI EM - Utilities

Net Margin (%)

10
12
14
16
0
2
4
6
8

MSCI DM - Utilities

Figure 25: EM vs DM net margins (%) – Telco

Net Margin (%)

10
12
14
16
18
20
0
2
4
6

8

MSCI EM - Telecommunication Services

MSCI DM - Telecommunication Services

Source: Deutsche Bank, Bloomberg Finance LP

Source: Deutsche Bank, Bloomberg Finance LP

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6) IT and industrials have moved in favour of DM which reflects favourable secular trends, most notably outsourcing from DM to EM companies and the growing importance of DM intellectual capital.

Figure 26: EM vs DM net margins (%) – Industrials

Net Margin (%)

10
12
14
-2
0
2
4
6
8

Source: Deutsche Bank, Bloomberg Finance LP

MSCI EM - Industrials

MSCI DM - Industrials

Figure 27: EM vs DM net margins (%) – Information

Technology

Net Margin (%)

10
12
14
16
18
0
2
4
6
8

MSCI EM - Information Technology

MSCI DM - Information Technology

Source: Deutsche Bank, Bloomberg Finance LP

7) EMs have fared especially badly in energy and materials primarily due to the

impact of policies based on state capitalism and resource nationalism, which have reduced returns to capital.

Figure 28: EM vs DM net margins (%) – Materials

MSCI EM - Materials

Net Margin (%)

10
15
20
25
0
5

MSCI DM - Materials

Figure 29: EM vs DM net margins (%) – Energy

MSCI EM - Energy

Net Margin (%)

10
12
14
16
18
0
2
4
6
8

MSCI DM - Energy

Source: Deutsche Bank, Bloomberg Finance LP

Source: Deutsche Bank, Bloomberg Finance LP

Conclusion; valuation now ambivalent, but the secular decline of EM profitability relative to DM is likely to continue across most sectors. Whilst the secular strengths of the US model are increasingly factored into valuations (Figure 30 and Figure 31), there is no obvious end to the likely degradation of margins of EM companies in the regulated and resource sectors, relative to their DM peers. Continued DM outperformance in Industrials and IT is also highly likely in our view, given the ongoing secular trends, whilst EM staples stocks appear very expensive relative to their DM counterparts based on their respective return profiles. Financials are a much more difficult call, but given our negative structural view on China, we believe that investors are right to price in a very substantial impairment of assets in China, Brazil and Russia, while India is also problematic. The DM financials sector is still under pressure from increasingly burdensome regulation and litigation relating to the financial crisis, but would appear to be at a better position in the economic cycle than most GEM economies.

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Figure 30: US and EM – Absolute P/BV since 1996 (x)

MSCI US

Figure 31: P/BV of US relative to EM (x)

MSCI EM

1.0

1.5

2.0

2.5

3.0

3.5

4.0

4.5

5.0

5.5

6.0

0.5

1.0

1.5

2.0

2.5

3.0

3.5

4.0

4.5

5.0

Source: Deutsche Bank, Bloomberg Finance LP

Source: Deutsche Bank, Bloomberg Finance LP

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Taper versus governance

BRICs at most risk of 'classic' EM crisis based on

dysfunctional relationship between state and companies

Micro structural factors threaten EM economies more than Fed taper

There is increasing discussion about the possibility of a financial/economic crisis in one or more emerging markets, based on purely macro considerations, namely the impact of tighter Fed policy on those countries with high external financing requirements. We are sceptical for two reasons. First we believe that

the Fed will be extremely cautious in tightening policy, largely because of the

potential impact on emerging economies and financial markets which will then feed back into dampening growth prospects in the US. Second, the taper concerns reveal an excessively one-dimensional focus on a single macroeconomic

aggregate whereas the history of EM shows that more micro related factors around the corporate sector are ultimately the key drivers of EM economies and financial markets. The sudden break in correlation between DM and EM equities at the start of 2013 preceded talk of Fed tapering by several months and was the direct result of investors beginning to discount more favourable structural factors for the US against the bulk of the EM universe. Going forward, the greatest potential for an EM-style financial crisis

resides in those countries with the most dysfunctional relationship between the state and the corporate sector. Our conclusion is that at least three of the

four BRICs economies, with the possible exception of India, are eventually more liable to a 'classic' EM-type crisis compared to Indonesia, South Africa or

Turkey, though we accept that there is a risk with Indonesia in particular that

predictions of a crisis, which lead to a rapid run-down in FX reserves, could become self-fulfilling.

BRIC economies most vulnerable because of failure to implement reforms
Emerging economies and financial markets have historically been highly cyclical and prone to boom-bust cycles largely because the mechanisms to impose a hard budget constraint on enterprises are generally underdeveloped. The result is the accumulation of imbalances that become visible at a micro level some time before they begin to influence the macro-economic statistics. Financial markets are very influential in forcing policy responses, but the history of emerging markets suggests that a crisis or near-crisis situation is

often necessary to force policymakers to implement structural reforms. The current cycle has now shifted from the widespread hubris which was so evident among EM investors and policy makers three years ago, to one of concern at the visible deterioration in growth rates and financial markets across the majority of the EM universe. Unfortunately whilst this concern is manifested in policy rhetoric, there is little evidence of a concerted attempt at

implementation across the BRIC markets in particular.

We write about China at greater length later in the report, but our view postPlenum

is basically unchanged, namely that the mooted reforms fail to address the real driver of the deteriorating rate of productivity in the Chinese economy,

namely the blurred boundaries between the state and private sector, which is the root cause of the widespread misallocation of capital. The result is that it

requires an ever-increasing amount of finance to maintain growth rates of 7% which suggests that both the economy and equity market are extremely

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vulnerable to any deterioration of confidence among the providers of finance who are mostly in China, but with a growing proportion of external funding. The extent of the potential problem is visible in the debt levels for the Industrials and Materials H-share listed sectors which have been rising rapidly

over recent years despite strong sales growth (Figure 34 and Figure 35), which

has itself been boosted by the increase in debt/GDP for the broader economy which Fitch estimates at around 80% over the past five years. Whilst the Renminbi has been extremely strong this year, we continue to think that at some stage China will need to engineer a devaluation of the currency to inject

liquidity into the corporate sector and that the main issue concerns whether this adjustment will, be orderly or disorderly.

In Russia, the increasing state dominance of both the economy and the corporate sector has resulted in an economy which is almost wholly dependent on commodities both in terms of export revenues and support for domestic industry. There has been much discussion of reform but nothing of substance has been achieved so that even if oil prices remain at current levels,

the outlook for the economy remains dismal for 2014 while lower commodity prices could trigger severe economic and political disruption. Russia has very

little in the way of external debt but company indebtedness in some key sectors is rising fast (Figure 67 and Figure 68), which will further increase the

burden on the listed energy and banking sectors to support the broader economy.

There is no obvious respite for shareholders in Brazilian companies from the government-inflicted pressures on both listed companies and the broader economy. As in Russia, a vicious circle has developed whereby lower economic growth leads to more populist policies which undermine private sector confidence in the prospects for the economy thus lowering growth and so it goes. The full impact of expansionary fiscal policies, conducted off balance sheet and also the distortions caused by fuel subsidies is likely to become more visible in 2014, so unless there is a major policy change, which is unlikely before the election(s) late in the year, sentiment towards the Brazilian economy or financial markets is unlikely to improve. Brazil also runs a

current account deficit, much of which is financed by FDI which is likely to decline as the prospects for both commodity prices and the Brazilian economy continue to deteriorate. The result is likely to be an ongoing decline in the value of the Real.

The outlook in India is a little more positive than the other BRICs because the

political elite appears committed to the implementation of structural economic

reforms if the election in May produces a working coalition; India would also benefit from any fall in oil prices from current elevated levels. Also,

India has
along with Brazil been a victim of the taper-related sell-off, but in
India's case
the lower value of the Rupee does appear to be helping the current account.
Nevertheless, the economy will suffer for a considerable time from the
unwinding of a number of state-induced distortions, in particular widespread
subsidies and an overly lenient regime for defining doubtful loans in the
banking system. The state-induced distortions for the listed corporate sector
are less pronounced than in the other BRICs, but we see no real indication
of a
revival in the investment activity which is necessary to revive the very
strong
growth rates in India seen over most of the previous decade.

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Elsewhere, growth/consumption under threat but crises unlikely

The other markets in addition to Brazil and India which have been singled out as especially susceptible to a taper-induced withdrawal of foreign capital flows

do not display structural fault-lines at a micro level to the same extent as Brazil,

Russia and China in our view. There have certainly been well publicized political problems in Turkey over the course of 2013, but for the most part the

corporate sector is able to operate in a relatively autonomous manner. The biggest risk is that investors have little confidence in the central banks unorthodox monetary policies, but a similar type of stand-off was successfully

resolved in 2011, while the current account deficit would be ameliorated by falls in energy prices. South Africa would also benefit from a fall in the price of

oil relative to industrial metals and gold while the integrity of the central bank

and corporate governance means that the economy is almost free of the governance distortions found elsewhere in GEM. Also, the South African rand is largely intervention-free, which means that it tends to adjust very quickly to

changing financial conditions. The relatively positive structural backdrop is why South African assets have performed relatively well during the taper period in our view despite the apparently alarming level of fiscal and current

account deficits. Finally, Indonesia has been singled out by the markets as most vulnerable for a combination of reasons including its history of capital flight, the forthcoming election, and the extent to which the economy has been

operating over capacity during the past couple of years. Whilst there are still

serious questions about sovereign and corporate level governance in Indonesia,

financial vulnerability at a corporate level is much lower than was the case before the financial crisis (Figure 51 and Figure 52). Whilst we do not especially like Indonesian equities, and of all EM countries, the risk of investors

essentially provoking a crisis by the withdrawal of capital is probably highest

there, we would be very surprised if anything approaching a classic EM crisis were to take place in 2014. Ultimately, the biggest risk to all three of these

countries might well come from a liquidation of positions in EM equities due to

poor sentiment emanating from China, rather than the taper.

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Still bearish on China

Positive sentiment overdone given risks of debt trap in corporate sector and local government

Ongoing deterioration in China real ROIC undermines growth prospects

As regular readers will be only too aware, our negative view on both the Chinese economy and equity market derives from a micro-level perspective of the structure and returns of the corporate sector. For the past three years, we

have been using the CROCI data provided by Francesco Curto and his team in which they analyse the real level of cash returns from about 68% of the MSCI non-financial universe as an advance warning of the extent to which productivity is deteriorating throughout the broader economy (Figure 32 and Figure 33). So far this appears to be working – most economists, including DB's own senior Asian economist, Michael Spencer, now acknowledge the extent to which the incremental capital to output ratio (ICOR) has deteriorated

since the financial crisis, as the Chinese authorities have thrown capital at the

economies in a so far successful attempt to maintain growth at what they deem to be an acceptable level. According to rating agency Fitch, the level of

debt to GDP has risen by around eighty percentage points since the middle of 2008.

Figure 32: China ex-financials – CROCI

0%
2%
4%
6%
8%
10%
12%
14%
16%
1997 1999 2001 2003 2005 2007 2009 2011 2013E

CROCI ex Goodwill

CROCI cum Goodwill

Source: Deutsche Bank CROCI team

COC

Implied LT CROCI

Figure 33: China ex-financials – CROCI drivers

10%
15%
20%
25%
30%
35%
0%
5%
1997 1999 2001 2003 2005 2007 2009 2011 2013E

CROCI Cash Flow Margin

Sales / Gross Capital Invested (RHS)

Source: Deutsche Bank CROCI team

0.00x

0.10x

0.20x

0.30x

0.40x

0.50x

0.60x

0.70x

0.80x

Dysfunctional relationship between local government & corporate sector

The dysfunctional relationship between local government and the corporate sector is the underlying cause of much of the misallocation of resources in China in our view. As a result of the 1994 fiscal reforms, local government is

chronically underfunded as tax revenues are inadequate to meet social and other expenditure obligations. At the same time, local government has been able to exert a relatively high degree of control over locally-based industrial

enterprises and the local branches of state-controlled banks. One consequence is that wherever possible, local governments have subsidised costs for industry

using household savings or what are nominally centrally controlled resources to maintain high levels of local employment and growth. This has had the effect of dragging down returns across almost all of the industrial and materials sector via overcapacity and diverting resources away from potentially

more productive uses, thus undermining the potential growth rate for the entire economy.

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Debt situation is becoming critical for materials and industrials sectors. The debt levels of the Industrials and Materials sectors reveal how close the entire system is to reaching a tipping point. The balance sheet leverage of both sectors has risen sharply since 2008 (Figure 34 and Figure 35) despite a level of capital expenditure which has generally been falling relative to sales (Figure 36 and Figure 37). The implication is that whilst the listed companies have in general been behaving in a rational manner, the widespread provision of cost subsidies especially to A- or non-listed enterprises creates a level of overcapacity which drives returns far below the real cost of capital for entire industries. The situation is becoming increasingly critical in our view, since these enterprises are leveraging into an economy which is itself increasing leverage by a considerable amount, led by the local government financing vehicles, many of which offer direct support to the enterprise sector. There is no definitive figure for the extent of LGFV debt – the National Audit Office has been conducting an investigation, the results of which were supposedly going to be released in the lead up to the Plenum, but have failed to appear as yet for some reason. Our best guess is that the level is some way ahead of RMB20trn compared with the RMB10trn in 2010, which was the last official estimate.

Figure 34: Chinese Materials – Debt/Equity (%), rolling 12m average

100%
120%
140%
160%
180%
20%
40%
60%
80%
0%

Figure 35: Chinese Industrials – Debt/Equity (%), rolling 12m average

100%
120%
140%
160%
20%
40%
60%
80%
0%

(1) Bottom-up aggregation of relevant stocks in MSCI EM index.

Source: Deutsche Bank, Bloomberg Finance LP

(1) Bottom-up aggregation of relevant stocks in MSCI EM index.

Source: Deutsche Bank, Bloomberg Finance LP

Figure 36: Chinese Materials – Capex/Sales (%), rolling

12m average

0%

5%

10%

15%

20%

25%

30%

35%

40%

45%

Figure 37: Chinese Industrials – Capex/Sales (%), rolling

12m average

0%

2%

4%

6%

8%

10%

12%

14%

(1) Bottom-up aggregation of relevant stocks in MSCI EM index.

Source: Deutsche Bank, Bloomberg Finance LP

(1) Bottom-up aggregation of relevant stocks in MSCI EM index.

Source: Deutsche Bank, Bloomberg Finance LP

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Figure 38: Chinese Materials – FCF/Sales (%), rolling 12m average

-35%
-30%
-25%
-20%
-15%
-10%
-5%
0%
5%
10%
15%

Figure 39: Chinese Industrials – FCF/Sales (%), rolling 12m average

-10%
-8%
-6%
-4%
-2%
0%
2%

(1) Bottom-up aggregation of relevant stocks in MSCI EM index.

Source: Deutsche Bank, Bloomberg Finance LP

(1) Bottom-up aggregation of relevant stocks in MSCI EM index.

Source: Deutsche Bank, Bloomberg Finance LP

No concrete measures in Plenum to deal with debt/fiscal issue

The authorities in Beijing need to completely re-engineer the fiscal system to

address the issue of underfunding of local government in order to deal with the

rapid build-up in debt at the corporate and local government level.

Unfortunately, while the post-Plenum document devoted a lot of space to a discussion of fiscal issues, this appears to have been more a declaration of intent rather than a programme of specific measures for implementation.

Michael Spencer who has a much more bullish view of the prospects for China than we do, believes that significant fiscal reforms will only take place on a

ten-year time horizon; my own view is that this timescale will be far too long

for borrowers and investors alike to keep pumping cash into sectors where the returns are visibly deteriorating.

Blurred boundaries between state and private sector impede financial reforms

The bulls argue that China can grow round the fiscal and debt problems by financial reforms which will help to promote the private sector at the expense

of the state enterprises. Whilst this may appear a coherent strategy from a macro perspective, it breaks down at a micro level in our view because of the blurred boundaries between private and state-controlled companies, which are

the main characteristic of the vast majority of privately-controlled listed Industrials and Materials companies above the SME level. Most firms which are nominally private have close links with central or local government and are

in receipt of subsidised cost inputs which may include cheap loans or power, free or cheap land, and direct cash subsidies (usually booked as operating income). Moreover, the boundaries are even more blurred for many non-listed companies in many industries, as local government officials may derive personal benefit from their links with nominally private companies. The most pure private companies exist at the SME level and it is significant that many of

these companies are currently struggling in operational and financial terms. Risk of a debt trap increasing, which should eventually lead to devaluation. The post-Plenum rhetoric from the authorities in Beijing has been carefully calibrated to maintain the confidence among both corporate and financiers alike that structural reforms will enable China to grow at an acceptable level of

7% plus over the medium term without having to undergo a financial crisis. We believe that this is extremely unlikely given that there is an increasingly

visible risk of a debt trap at the corporate level. Figure 36 and Figure 37 show

listed Industrials and Materials companies cutting back on capex relative to Deutsche Bank AG/London

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Q2 03

Q4 03

Q2 04

Q4 04

Q2 05

Q4 05

Q2 06

Q4 06

Q2 07

Q4 07

Q2 08

Q4 08

Q2 09

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Q2 10

Q4 10

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Q2 11
Q4 11
Q2 12
Q4 12
Q2 13

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sales which is a very rational response to anticipated lower nominal growth by individual companies, but which could trigger a vicious cycle if it becomes a more universal objective by slowing growth in the broader economy which then feeds back to further capex cuts. As nominal growth rates continue to fall, debt levels at both the corporate and local government level are likely to rise unless Beijing is willing to follow through on its tough talk and actually enforce a hard budget constraint on potentially insolvent enterprises against opposition from local government. It is almost impossible in any scenario to envisage a significant level of reforms without the benefit of a currency devaluation to lubricate the process and inject liquidity into the corporate sector; the major question in our minds is whether this will eventually be an orderly or disorderly process.

Sentiment towards China will be volatile in 2014 with big tail risks. The net result of the Plenum has been exactly as the Chinese authorities intended, namely to boost confidence towards the economy, thereby ensuring a continual stream of finance which will support the debt driven growth model while the economic reforms begin to have an impact. The other key element is the extent to which the developed economies, in particular the US will revert back to the sort of import growth which helped the Chinese economy so much between 2002 and 2007. We do not believe that exports will come to the rescue in 2014, but our colleague Michael Spencer anticipates a major acceleration based on the recent pick-up in the US ISM survey and the Euro-area PMIs. In any event, sentiment towards China is likely to swing sharply among economists and investors alike as it has done for each of the past four years. We believe that there is a significant chance of a decisive break in a negative direction in 2014, but we would advise even those investors who are sceptical of our negative view to take a contrarian approach to the prevailing sentiment. At the moment given that the overwhelming majority of buy and sell-siders alike are relatively bullish, now should be a good time to adopt a more negative perspective.

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Country conclusions

ASIA EX-JAPAN

China – corporate sector risks are rising

Chinese equities have held up pretty well over the past three years compared with their BRIC peers. We would attribute their resilience to the superficially

cheap level of valuations and the apparent success of the Chinese authorities in maintaining economic growth at levels which have fallen significantly over the past four years, but which remain the envy of policy-makers in every other

major global economy. We are sceptical on both counts for the same reason, namely that both the rate of economic growth and the level of valuations are increasingly dependent on rising levels of debt (see China section, pages 2124).

Figure 40 shows how the return on equity for MSCI China has fallen steadily over the past ten years, but remains at relatively reasonable levels. The

ROE is, however, increasingly dependent on rising leverage within the corporate sector (Figure 41), in the context of an economy which has itself been leveraging at a relatively rapid rate.

Figure 40: MSCI China – Non-financials ROE (%)

ROE

%

10

11

12

13

14

15

16

17

18

8

9

Jan-03 Jan-04 Jan-05 Jan-06 Jan-07 Jan-08 Jan-09 Jan-10 Jan-11 Jan-12 Jan-13

Source: Deutsche Bank, Bloomberg Finance LP

1.5

1.6

1.7

1.8

1.9

2.0

2.1

2.2

2.3

Jan-03 Jan-04 Jan-05 Jan-06 Jan-07 Jan-08 Jan-09 Jan-10 Jan-11 Jan-12 Jan-13

Source: Deutsche Bank, Bloomberg Finance LP

Whilst the major proportion of debt has been financed internally, there are increasing signs that Chinese corporate and local governments which are

responsible for the widespread misallocation of capital, are running out of domestic sources of finance following the rise in the savings ratio of around ten percentage points of GDP, which has taken place over the past ten years. There is a great deal of debate concerning the extent to which flows of more speculative money have entered the theoretically closed capital account to play the anticipated appreciation of the Renminbi but DB FX strategists James Malcolm and Bilal Hafeez both reckon that the implicit China carry trade runs to at least the mid to high hundreds of billions of dollars. If they are correct,

then China is potentially vulnerable to a vicious cycle whereby the unwind of the carry trade sucks liquidity out of the domestic banking system exerting downward pressure on growth which will in turn undermine confidence in the Deutsche Bank AG/London

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Figure 41: MSCI China – Non-financials leverage

(Assets/Equity, x)

Assets/ Equity

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future prospects for the economy and drive further outflows. Against this backdrop the Chinese authorities will do everything they can to maintain confidence in the value of the Renminbi in order to attract further inflows despite the fact that the currency appears increasingly overvalued from a corporate perspective. The necessity to attract large flows of foreign capital

into China on an ongoing basis also implies that China is not such a safe haven

if foreign inflows into emerging markets begin to dry up in 2014, despite the very comfortable current account and official fiscal ratios.

What should investors do in the face of such uncertainty? We would completely disregard the apparent cheapness of the market and would advise GEM investors to take a big underweight position, and non-dedicated investors to avoid Chinese equities entirely wherever possible. We do acknowledge though that this very negative stance will be considered far too extreme by most benchmarked investors in which case we would adopt a dual strategy. First, we do not see a strong case for taking big sector bets within a China portfolio, since post-Plenum, the valuation discrepancy between perceived winners and losers from anticipated shifts in the economy has become increasingly extreme. If our bearish medium term view on the economy plays out, then consumption will suffer along with investment, which will leave the very expensive Healthcare and Staples sectors very exposed. The banks are a black box, just as the developed market financials were going into the 2007-08

crisis; current valuations are obviously discounting a fairly hefty level of impairment, but it is difficult to claim that a worst case scenario is priced in.

Secondly, we would advise a contrarian strategy for those investors who are understandably unwilling to take a strong structural view on China. This has been the right strategy for the past four years as the lack of visibility concerning policy and the underlying state of the economy and financial condition of the corporate sector has driven wild swings in sentiment among investors. At present, both investor surveys and fund flows suggest that weightings have increased markedly along with confidence in economic policy, so now should not be a bad time to scale back exposure.

Finally, there are many reasons why we might be too pessimistic about Chinese equities but there is one sign in particular which might cause us to concede that we are wrong. The increasingly obvious accretion of power and more assertive attitude by the Beijing based authorities has some negative connotations in terms of foreign and social policy, but could be very positive

from an economic perspective if Beijing intends to impose market disciplines on local authorities. We believe that the new administration will back away from the consequences of imposing a hard budget constraint, but if this did start to happen evidenced by meaningful closures of industrial capacity and widespread curtailment of future investment plans, the long term implications would be very positive, although the economy and some key sector would take a short term hit. We will continue to monitor individual industries to try to identify any sectors where there is a clear prospect of individual winners

emerging from a process of consolidation.

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Korea – not as good as overseas investors believe

The Korean market has outperformed the GEM benchmark in a slow but steady manner over 2013, accompanied by relatively low levels of volatility. This mainly reflects sizeable foreign inflows into equities (Figure 42) as Korea

has emerged as probably the biggest overweight within a GEM portfolio over the course of 2013, based on its supposed 'safe haven' status. We are less optimistic than most of our clients and intend to remain underweight Korea for

the following reasons; i) Korea has a relatively high degree of exposure to China, in terms of both final demand and also as a competitor or potential competitor across a broad range of industries, which might become more critical if our Renminbi devaluation scenario were ever to materialise, ii)

We are

not so optimistic about the outlook for the domestic economy due to the increasing burden of heavy household debt; DB economist Juliana Lee points out that the debt servicing burden on households increased from 17.2% in 2012 to 19.5% in 2013, iii) The high level of foreign ownership of Korean equities leaves the market very exposed to any outflows from EM and Asian equity funds or the less likely scenario in our view that investors use

Korea as a

source of funds to increase weightings in one or more of the other larger GEM markets. It may be significant that whilst the majority of investor we meet appear to be overweight Korean equities, they almost universally complain about the difficulty in finding attractive stocks.

Figure 42: Changing foreign investor preference in stocks versus debt

Source: Deutsche Bank (Juliana Lee), CEIC

Whilst Korea is cheap relative to its own history, it is valued in line with the

historical average relative to GEM. The dividend yield is only 1%, which is the

lowest in GEM based on a 15% payout ratio, and the lowest in the asset class next to Russia. There has recently been discussion that some major index constituents, including Samsung Electronics, might increase the payout, but we would be surprised to see any conclusive evidence emerging in 2014.

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Taiwan – defensive merits no longer unappreciated

The Taiwanese equity market has been the best performing major market in GEM at the time of writing due its defensive qualities and its perceived high correlation with the US economy and market through the tech sector. The defensive qualities are still in evidence from a financial and operational perspective with DM-type capex and cash flow characteristics (Figure 43). Taiwan does now however appear less defensive relative to GEM, given the large amount of foreign fund flows into the market over the course of 2013 and the fact that the dividend yield is now under 3%, which is close the GEM average. Other valuation measures show that Taiwan now stands at a premium rating to GEM compared with the average of the past ten years.

Figure 43: TWSE – Capex/Sales (%) and FCF/Sales (%)

Figure 44: Historical trailing dividend yield of Taiwanese equities (%) – Tech versus non-tech

Source: Deutsche Bank (Joelian Tseng and John Chou), Bloomberg Finance LP

Source: Deutsche Bank (Joelian Tseng and John Chou), Bloomberg Finance LP

There is little of interest from a macroeconomic and political perspective – the

recently elected government continues to struggle to make any real impression on the issues that really matter to investors, most notably the Cross-Straits negotiations with China, while Taiwan may suffer on a longer term perspective from the relative paucity of free-trade deals compared with her neighbours.

DB

Taiwan strategist Joelian Tsang reckons that there is about 6% upside for the share index based on consensus expectations of 13% earnings growth for the market in 2014. Within the market Joelian has switched her preference away from the non-tech sectors to tech largely on the back of tech's relative cheapness (Figure 44).

We remain overweight in Taiwan in default of better alternatives, but are increasingly concerned about relative valuations and the extent to which our view has now become consensus.

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India – range bound until post-election outlook clearer

The Indian equity market has rallied strongly since its 2013 nadir in August and

now stands at an all-time high in local currency terms, though MSCI India in US dollars remains some 7% down over the year-to-date, which is worse than the GEM average. Whilst we regard India as the 'least bad' out of all the BRICs, there are still many unresolved structural issues, so we have regarded it

as a range-bound market over the course of 2013, which should be traded on a contrarian basis. We take the same approach going into 2014 in front of the election in May.

As every investor is only too aware, the major issue in India is the pressing need for structural economic reforms to address the linked issues of falling productivity and growth. Many of these changes effectively require a less interventionist stance by the state on both a macro and micro level. The impact

of the failure of the authorities in India to address the major structural issues

has been compounded by the concentrated ownership structure of the majority of listed Indian corporations, which has result in overly pro-cyclical

business strategies, suspiciously close links with parts of the state apparatus,

and sub-optimal balance sheet structures. The potentially toxic outcomes for investors are most noticeable in the infrastructure-linked sectors such as Utilities and Industrials, which have undergone deteriorating cash flow and rising debt levels (Figure 45 to Figure 48). The state-controlled listed banks

have also uncomfortably high exposure to the big privately-controlled conglomerates, though there is little transparency about these links and in terms of how they go about classifying this exposure.

Figure 45: Indian utilities – FCF/Sales, 12m rolling average (%)

10%
20%
-40%
-30%
-20%
-10%
0%

Figure 46: Indian utilities – Debt/Equity, 12m rolling average (%)

100%
120%
140%
20%
40%
60%
80%

0%

Source: Deutsche Bank, Bloomberg Finance LP

Source: Deutsche Bank, Bloomberg Finance LP

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Q4 09

Q2 10

Q4 10

Q2 11

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Q4 12

Q2 13

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Figure 47: Indian industrials – FCF/Sales, 12m rolling average (%)

10%
-40%
-35%
-30%
-25%
-20%
-15%
-10%
-5%
0%
5%

Figure 48: Indian industrials – Debt/Equity, 12m rolling average (%)

100%
150%
200%
250%
50%
0%

Source: Deutsche Bank, Bloomberg Finance LP

Source: Deutsche Bank, Bloomberg Finance LP

For the time being, investors seem happy to focus on two positives. First is the

extent to which the fall in the value of the Rupee has stimulated exports (Figure 49), thereby taking some of the pressure off the current account. Second is the increasingly widespread perception that the BJP will emerge from the election in May as the biggest party and with a clear mandate to undertake reforms with the backing of their regional allies. We do not really have a strong view on the Indian election at this point given that roughly

70% of the electorate is rurally-based and that opinion polls tend not to be so reliable, while the so-called third front also appears to rapidly gaining popularity. We suspect however, that even in the event of the BJP managing to assemble a credible coalition, that the passage and implementation of reform will not be so straightforward, as has been demonstrated with the mixed reception given the new land acquisition law. Meanwhile, some of the structural financial issues will continue to have a negative effect on the economy for some time. The biggest potential for a positive surprise in 2014

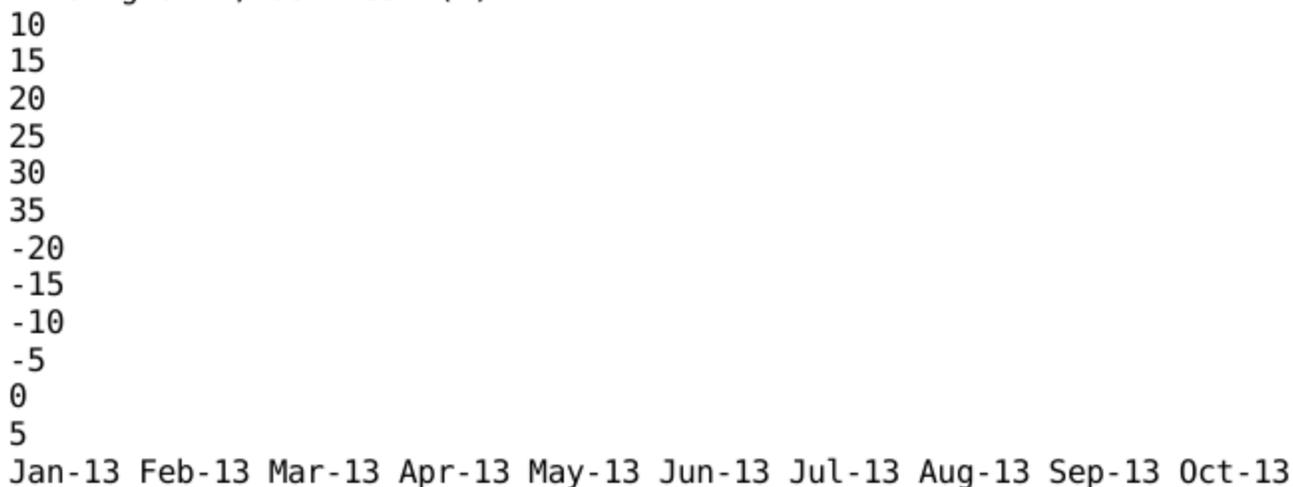
in our view would be a fall in the oil price which is a key variable for both the

Indian economy and equity markets, via the twin fiscal and current account deficits and as a literal and metaphorical lubricant for economic reform (Figure

50).

Figure 49: YoY Indian exports growth (%) – Double digit growth for last four consecutive quarters

Figure 50: Total returns of Indian equities versus oil price
– YoY growth, both USD (%)



WTI oil price (1m lag)

MSCI India

Source: Deutsche Bank (Abhay Laijawala and Abhishek Saraf)

Source: Deutsche Bank, Bloomberg Finance LP

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Indonesia – first stress test since 1997; equities expensive

Investor sentiment towards Indonesia has turned around in a dramatic manner since May, as it is the most exposed country to the potential impact of any Fed

taper due to the relatively high current account deficit and low level of FX reserves. We are sceptical about both the extent and the likely impact of tapering on EM equities and would also point out that financial situation of the

major listed Indonesian companies is completely different to the period leading

up to the Asian financial crisis of 1997 at least on the surface. As with most

EMs, we do worry that the relatively easy conditions pertaining over the past decade will have resulted in some hidden 'nasties', mainly momentum-based short FX/long commodity positions, lurking in corporate balance sheets. The risks are compounded in Indonesia by the widespread lack of transparency in terms of corporate ownership and links to financial institutions, notwithstanding the progress which has been made since 1997. Whilst we acknowledge the possibility that a combination of a withdrawal of foreign money and domestic capital flight could prove self-fulfilling, we believe that

the prospects of a full-blown financial crisis are remote, but the system may be

about to be tested for the first time since 1997.

Even if a full-blown crisis remains unlikely, the taper scare has raised important

questions about the failure of Indonesian policy-makers to take sufficient actions to curb what were clearly in hindsight excessive levels of domestic consumption. The Bank Indonesia was slow to tighten monetary policy, whilst the decision to lower fuel subsidies in July has been almost entirely negated by

the decline in the value of the Rupiah, which has raised the cost of importing

oil. This is unlikely to be positive news for an equity market which is heavily

skewed towards domestic consumption plays and which boasts by far the highest book value based valuation in the whole GEM universe. We therefore struggle to make a case for overweighting the market although we suspect that it could outperform nicely in the short term if tapering fears recede. The presidential election is likely to be one of the most important events for the

market in 2014. The favourite to win, and has been for some time, is Joko "Jokowi" Widodo, the very popular incumbent Governor of Jakarta. Although he is not currently affiliated with any party, and cannot run for president until

he is, local press reports suggest that it is only a matter of time until he is

named as the PDI-P's official candidate. The PDI-P is the main opposition party

to the incumbent Democratic Party, meaning the (very likely) election of Jokowi will lead to a political regime change. Despite Jokowi's widespread popularity, mainly from tackling domestic issues such as corruption, he has not yet been tested on international issues so there is uncertainty over whether

he will be able to rebuild foreign investor confidence and how he will deal with

the ongoing currency/ CAD crisis. There is also risk that he will be under pressure to implement policies to appease the PDI-P party when in power, which is headed by former President Sukarno's daughter, Megawati, and has nationalist and leftist tendencies, which could worry some investors.

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Figure 51: Indonesian industry “heavyweights” – Net debt to equity (x)

Figure 52: Other Indonesian stocks – Net debt to equity (%)

Source: Deutsche Bank (Heriyanto Irawan, Raymond Kosasih and Samuel Sentana), Bloomberg

Finance LP

Source: Deutsche Bank (Heriyanto Irawan, Raymond Kosasih and Samuel Sentana), Bloomberg

Finance LP

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Malaysia – low-beta but fundamentally without merit

Malaysia has become widely perceived as the lowest beta market within the GEM universe from both a macroeconomic and a more market-related perspective, although in both cases, this belies some pretty serious structural

flaws. From a macro context, Malaysia runs a hefty current account surplus which obviates any concern about financing despite the steady increase in outgoing FDI flows which has taken place over recent years. Meanwhile the equity market is dominated on both the supply and demand side by state controlled companies and institutions, which as with the macro data, has meant that the level of dependence on foreign financing is extremely low. This

has resulted in Malaysian equities moving to a premium valuation, both in absolute terms and relative to their own history (Figure 53 and Figure 54).

Figure 53: MSCI Malaysia – P/BV (x) since 2000

3.0

x

x

2.5

2.0

1.5

1.0

0

5

MSCI Malaysia P/BV

Average P/BV

Source: Deutsche Bank, Bloomberg Finance LP

-2 s.d.

+ 1 s.d.

-1 s.d.

+ 2 s.d.

MSCI P/E

Source: Deutsche Bank, Bloomberg Finance LP

We believe that this premium valuation is not warranted by the structural fundamentals, in particular rising debt at both the household and government levels. We are also fairly sceptical about the reform programme launched by the recently elected administration. The bulls cite the reduction of fuel subsidies and the introduction of a 6% Goods and Services tax in the recent budget, but the fiscal impact will be partly cancelled out by the new \$3.2bn loan programme for Malays, the Bumiputera Economic Empowerment Scheme, which was introduced in September. Whilst it is difficult to underweight Malaysian equities against an overall bearish backdrop for the asset class, we

would expect a negative return for dollar-based investors over 2014.

Cyclically-adjusted P/E

Figure 54: MSCI Malaysia – P/E (x) and CAPE (x) since

2000

10

15

20
25
30
35
40

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Thailand – tempting only to a tactical contrarian

The Thai equity market has undergone a major correction since May for two main reasons (Figure 55). First, concerns about the taper coincided with some very poor current account data for the second quarter to raise serious concerns

about the foreign financing requirement for the Thai economy. Second, the political outlook has deteriorated to the point where at the time of writing it is

difficult to predict the outcome of the stand-off between the current government led by Yingluck Shinawatra and its mainly Bangkok-based opponents. The result has been a level of foreign selling of equities which, when combined with 2008, has more than cancelled out the cumulative buying since 2006. Unfortunately, notwithstanding this heavy selling activity, the market is only fairly valued relative to its history and remains at a premium rating to GEM relative to its history.

Figure 55: Net foreign buying on SET and bond market (Bt, billion)

Source: Deutsche Bank (Derek Bloomfield), SET, ThaiBMA.co.th

Before we get too gloomy however, there are some mitigating factors. Whilst the economic and political momentum is weak, both the Thai economy and financial markets have a post-Asian crisis history of resilience to politically

driven turbulence. Moreover as Thailand has such a strong manufacturing base, it should benefit from any future recovery in the Japanese economy and could also be one of the main beneficiaries of investment flows out of Japan relative

to the size of its financial markets. The current account is likely to be in surplus

in 2014 while the slowdown in growth has led to very benign inflation so we do not anticipate any prospect of tighter monetary policies at this point in time.

The low weightings of most overseas investors mean that Thailand is probably less exposed to redemptions from GEM funds than any other market, while the inevitable slowdown in consumption next year is probably discounted in the big sell-off in consumer discretionary and property related stocks. Whilst we are not at all optimistic about the prospects for Thai equities over 2014, the

market currently appears tactically oversold relative to its peers and we would

therefore not want to move underweight in a GEM context at current levels.

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Philippines – superior fundamentals more than priced in

The macro fundamentals in the Philippines remain by far the best in Asia in our

view but are more than fully discounted in current valuation levels (Figure 56).

Moreover, there are one or two tentative indications that the market might start to fall victim to the type of hubris which has had such a negative impact

of returns through most of the rest of Asia.

Figure 56: MSCI Philippines – P/BV (x) since 2000

x

0.0

0.5

1.0

1.5

2.0

2.5

3.0

3.5

4.0

MSCI Philippines P/BV

Average P/BV

Source: Deutsche Bank, Bloomberg Finance LP

However, firstly, the good news is the continued superior macroeconomic performance in terms of GDP growth, government debt levels and financial vulnerability, which has been reflected in GDP and credit ratings upgrades over

2013, a unique combination within the GEM universe. Consequently, the Philippines stands out among the ASEAN equity markets as having received consistently high inflows of foreign money over the past two years, a point which is nicely illustrated by the number of investor visits hosted by DB Regis

in 2013 (Figure 57).

Figure 57: Foreign client visits hosted by DB Regis

-2 s.d.

+ 1 s.d.

-1 s.d.

+ 2 s.d.

Source: Deutsche Bank (Rafael Garchitorea)

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Jan-00

Jul-00

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Jul-01

Jan-02

Jul-02

Jan-03

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We cannot downgrade the Philippines to underweight because of the dearth of compelling alternatives. However, we fully share the increasing level of reservations expressed by head of DB Philippines Research and market guru, Rafael Garchitorena, based on the following factors:

☒ The Philippines is standing at a massive premium to its own history and relative to its own history against the GEM benchmark on a P/BV to ROE basis.

☒ There are indications that earnings growth may be starting to slip – Rafa points out that third quarter earnings were extremely

disappointing at the aggregate level – the market is now paying 18 times for around 8% earnings growth.

☒ The supply demand balance for equities may start to deteriorate over 2014. The Philippines is along with Korea the biggest consensus overweight in GEM and so is especially vulnerable to potential redemption of GEM funds by retail and/or institutional investors.

Meanwhile equity raising over 2014 is likely to continue at a similarly high level to 2013's record amount.

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LATIN AMERICA

Brazil – cheap but fundamentals continue to deteriorate

Brazil has been by far the worst performing major emerging market over the past three years, mainly because of the dramatic policy shift towards state capitalism, which has taken place since the financial crisis. The propensity of

the government to intervene in the corporate sector is reflected in the ongoing

de-rating of the state-controlled listed companies in both absolute terms and relative to their private sector peers (Figure 58). The outstanding company specific issue at present is the extent to which Petrobras is forced to subsidise

the rest of the economy via both product prices which impose losses on the company, and also through a very demanding local content requirement for equipment suppliers. The recent decision to grant the company relatively small

price increases, but without an automatic price adjustment mechanism, indicates that shareholders in Petrobras will have to foot part of the bill for the

PT's efforts to win the election(s) in October.

Figure 58: Average P/BV ratio of non-state versus state-owned companies

Brazil-NonState

10.0

12.0

14.0

0.0

2.0

4.0

6.0

8.0

Apr-04 Mar-05 Feb-06 Jan-07 Dec-07 Nov-08 Oct-09 Sep-10 Aug-11 Jul-12 Jun-13

Source: Deutsche Bank, Bloomberg Finance LP

Brazil-State Owned

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Figure 59: Brazilian non-financials - FCF/Sales (%), Rolling 12m average
()

g

-10%

-5%

0%

5%

10%

15%

20%

Source: Deutsche Bank, Bloomberg Finance LP

The negative impact of government policies on the economy is likely to continue to emerge on both a micro and a macro basis in 2014. DB economist Jose Carlos de Faria expects lower growth, mainly due to the continuing reluctance of the private sector to invest as the impact of heterodox state-

led policies has undermined business confidence and created distortions which cannot be easily unwound. The full fiscal impact of the big expansion in lending and market share by the three big state controlled banks will only become fully apparent over the medium term. Meanwhile, we would expect consumption to come under pressure in 2014 and for employment levels to finally begin to rise in a meaningful manner. If slower growth in China puts further pressure on commodity prices, as we expect, the multiplier effect on Brazil could be significant in terms of fiscal revenues and future FDI inflows to

finance the current account deficit. Against this backdrop, the Real is likely to

further depreciate against the US dollar.

Notwithstanding the very poor fundamentals, we need to beware of a repeat of what has happened to equities in Argentina over the course of 2013 where a rise of nearly 50% in US dollar terms has occurred despite the further deterioration in the immediate political and economic situation. As with Argentina or Russia, the asset valuations of the more cyclical and state controlled companies are very low which makes them an option-like play on any improvement in risk appetite. We believe that such a scenario is unlikely to

happen in Brazil in 2014, because there is no real indication of an inflection

point in government policies as yet, although the market could experience very

sudden sharp upwards moves if the opinion poll ratings of the PT and Rousseff deteriorate – the World Cup may have a part to play depending on Brazil's performance as host and the performance of the national team on the pitch.

For the time being though, we remain underweight in Brazil as we expect both the domestic and the external environment to remain unhelpful, a view which is reinforced by the difficulty in finding stocks which combine attractive fundamentals with reasonable levels of valuation.

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Mexico – expensive but still better than the alternatives

Figure 60: Mexican non-financials - FCF/Sales (%), Rolling 12m average

10%

12%

14%

16%

0%

2%

4%

6%

8%

Source: Deutsche Bank, Bloomberg Finance LP

Figure 61: Total return of Mexico versus Brazil (rebased at February 2011)

MSCI Mexico

100

110

120

130

50

60

70

80

90

Feb-11 Jun-11 Oct-11 Feb-12 Jun-12 Oct-12 Feb-13 Jun-13 Oct-13

Source: Deutsche Bank, Bloomberg Finance LP

We have been overweight in Mexico for almost three years now for two reasons. First, the dearth of regional or GEM alternatives – unfortunately the

best reason to overweight Mexico is that it is not Brazil - Mexican equities have

eked out small positive returns in dollar terms in sharp contrast to their peers

in Brazil and Chile. The other factor has been that policy-makers in Mexico are

almost alone in a GEM context in that they are pursuing a relatively coherent agenda towards structural reforms in four key areas, namely fiscal, energy, competition and the financial sector. The overall aim is to liberalise the supply

side of the Mexican economy by removing some of the major obstacles to investment, thereby raising the potential growth rate.

Whilst the benefits of the reform process will emerge over the medium and longer term, there are two issues for Mexican financial assets in the meantime.

The first is that the reforms are all to a greater or lesser extent contentious in

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MSCI Brazil

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particular the pivotal energy reforms, which involves a fundamental overhaul of the state energy monopoly Pemex, which is the sacred cow of the Mexican left. Our impression is that whilst the process has been very noisy over 2013,

overall progress has been somewhat better than we had anticipated. The second issue is the extent to which the reforms will have a negative impact on

the listed corporate sector before the benefits come through in terms of stronger growth rates. The tax changes will raise the effective rate of tax for

the majority of companies, whilst the moves against oligopolistic practices in

the telecom and media sector constitute both threats and opportunities to the listed companies. The changes to both the tax system and competition

regulations are occurring against a backdrop of deteriorating free cash flow (Figure 60) which if it continues will undermine one of the most attractive features of the Mexican market in the current financial environment. Mexican equities are valued in line with their history on a P/BV to ROE basis, but are

very expensive relative to history, against the GEM benchmark, but we intend to remain overweight as a function of our overall bearish view on GEM.

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Chile – continued breakdown of the neo-liberal model

Figure 62: MSCI Chile – P/BV (x) since 2000

x

0.0

0.5

1.0

1.5

2.0

2.5

3.0

3.5

x

10

15

20

25

30

35

40

45

50

0

5

MSCI Chile P/BV

Average P/BV

Source: Deutsche Bank, Bloomberg Finance LP

-2 s.d.

+ 1 s.d.

-1 s.d.

+ 2 s.d.

MSCI P/E

Source: Deutsche Bank, Bloomberg Finance LP

Chile has been the worst performing emerging equity market over 2013 for two main reasons. First is the continued bearish outlook for the copper price,

which is the most important external driver for the Chilean economy and has been highly correlated with the historical performance of Chilean equities, despite the absence of direct plays on the metal. Second, the equilibrium between capital and the state, which had survived twenty years of government by the leftist Concertacion, has been disturbed by the widespread popular agitation against the current education system and other policies which are deemed by much of the electorate to favour business and the top 10% of Chilean society. The almost inevitable (re)-election of Michelle Bachelet is quite

certain to be accompanied by a much more leftist agenda, which will redistribute resources away from capital to the state and labour.

The most important question for investors is the extent to which these two factors are discounted in the current level of the equity market. There has been

a big de-rating over the past eighteen months (Figure 62 and Figure 63), which probably discounts the changes to the corporate tax system which are almost certain to take place in the early stages of a new Bachelet-led administration. Nevertheless, the overall level of valuations both in absolute terms and relative to GEM is still not cheap, and neither a further big deterioration in the demand for copper, nor the potential inability of the new administration to withstand further pressure for even more redistributive policies, are priced in to the market.

Cyclically-adjusted P/E

Figure 63: MSCI Chile – P/E (x) and CAPE (x) since 2000

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Jul-00

Jan-01

Jul-01

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Jul-02

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Jul-06

Jan-07

Jul-07

Jan-08

Jul-08

Jan-09

Jul-09

Jan-10

Jul-10

Jan-11

Jul-11

Jan-12

Jul-12

Jan-13

Jul-13

Jun-00

Dec-00

Jun-01

Dec-01

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CEEMEA

South Africa – cheap currency but expensive equities

The South African equity market is comfortably up in local currency terms over

the year-to-date, but has fallen sharply in US dollars. The poor performance of

the rand is mainly due to the twin fiscal and current account deficits and has

taken the currency into deeply undervalued territory on any sort of PPP analysis; the problem though is that in contrast to some other weak currency countries, most notably India, the performance of exports has been deeply unimpressive. Next year could be somewhat problematic for the economy, especially if the independent central bank, the SARB, decides it has to raise interest rates to head off inflationary pressures. The best hope is probably that

the external environment becomes more supportive with stronger growth, including China supporting metals prices, but with weaker oil. We believe that

the oil price will weaken along with metals prices as growth in China slows, which would still be mildly supportive for South Africa. The election may generate some noise, but given that the outcome is as close to a foregone conclusion as it is possible to get in a democracy, the real interest will be in the

composition of the post-election ANC cabinet, possibly with Cyril Ramaphosa as Deputy President, in which case the government may begin to implement the more market-friendly parts of the National Development Plan.

We still do not have an especially strong view about the equity market going into 2014. The good news is that in contrast to this time last year, relative sector valuations appear to have become somewhat more rational following the underperformance of the Consumer Staples sector (Figure 64). The market though, despite this year's underperformance, still trades at a fairly hefty premium against its history relative to GEM on a price-to-book versus ROE basis. This premium rating reflects the superior governance and capital allocation for South African companies over the GEM average as well as the presence of a sizeable and sophisticated domestic money management industry. We are however somewhat concerned that the improvement in underlying returns as measured by CROCI relative to the rest of GEM has now clearly started to level out (Figure 65), which may reflect the cumulative rise in

the costs of doing business in South Africa.

Figure 64: South African equities – P/BV (x) versus ROE

(%)

0
1
2
3
4
5
6

7

5

Consumer Stap.

Healthcare

Consumer Discr.

Telecom

Industrials

Energy

Financials

Materials

Figure 65: Relative EV/NCI and CROCI of South Africa
versus GEM (calculated as SA value/GEM value)

10152025

ROE (%)

Source: Deutsche Bank, Bloomberg Finance LP

30

-0.2

0.0

0.2

0.4

0.6

0.8

1.0

1.2

1.4

1.6

Relative CROCI

Source: Deutsche Bank CROCI team

Relative EV/NCI

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P/BV (x)

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Russia – cheap but fundamentals remain very negative

We remain underweight in Russian equities despite the very cheap level of valuations for the same reasons as when we initiated the position almost three

years ago. First, the Russian state is continuing to exercise a tight grip over

much of the listed the corporate sector, including many of those companies which it does not control directly. Second, the rate of sustainable economic growth has deteriorated in the absence of any real attempt at economic reform. The basic model for running both the economy and the corporate sector which has become known as Putin's sistema, has not changed over recent years, in fact the state is becoming more dominant in the energy industry as a result of the expansion of Rosneft, which is likely to continue in

2014. Finally we retain a bearish view on commodity prices which bodes ill for

both the overall Russian economy and much of the listed corporate universe. There have been a number of incidents which have taken place over the course of 2013 that should serve to remind investors of the almost total disregard for

minority shareholders on the part of the Russian state and other controlling shareholders of listed companies; these range from the dispute over the status

of minority shareholders rights at TNK/BP, through the buy-out of Pharamstand and the tariff freeze which was imposed on the utility sector. Going forward, there are major risks for the big state owned banks and Gazprom if the economy continues to deteriorate, since these companies will be under an obligation to help the state fulfil its social obligations, regardless of whether

this is in the commercial interests of the companies concerned. The situation is

similar in terms of the Russian state's geopolitical agenda, as has become increasingly clear in the current dispute over the status of the Ukraine where

the state controlled banks and Gazprom have a significant level of exposure.

We remain very concerned about the financial prospects of much of the corporate sector. At present the Russian corporate sector in aggregate generates a very high rate of free cash flow (Figure 66), which has long been our preferred metric in GEM. The problems is that debt levels are now starting

to rise quite sharply (Figure 67) due to increasing capex requirements in the energy sector, while there is an increasing level of financial distress in evident

in parts of the metallurgical sector (Figure 68). We have been consistently more negative than the market about the prospects for the two big listed statecontrolled

banks due to concern about their potential exposure to both the Ukraine and to the metals sector (Figure 69) while any decline in oil prices would also likely to trigger problems in both consumer loans and service

based
businesses.

The low level of asset valuations means that periodic sharp rallies in Russian equities are almost inevitable –for some strange reason they seem to happen in the lead up to the sale of state controlled companies – but dedicated investors should remain underweight and non-dedicated avoid the market completely in our view.

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Figure 66: MSCI Russia – FCF/ Sales, rolling 12-month average (%)

20%
15%
10%
5%
0%
-5%

Figure 67: MSCI Russia – Leverage (Total debt/Equity), rolling 12-month average (%)

10%
15%
20%
25%
30%
35%
40%
45%
0%
5%

Source: Deutsche Bank, Bloomberg Finance LP

Source: Deutsche Bank, Bloomberg Finance LP

Figure 68: Russian sectors – Net debt/ EBITDA (x)
2008

Oil and gas
Metals and mining
Telecom
Retail and industrials
Utilities

TOTAL

0.45

1.25

1.44

1.46

0.26

0.73

2009

0.79

3.05

1.52

1.55

0.52

1.16

2010

0.43

1.49

1.35

1.45

0.35

0.77

Source: Deutsche Bank (Bob Kommers and Olga Gaydamakina), Company data

2011

0.31

1.74

2.17

2.1

0.45

0.85

2012

0.39

2.34

2.18

2.13

1.05

0.99

2013E

0.87

3.25

1.87

1.83

1.56

1.35

Figure 69: Debt of, and state banks' exposure to, individual companies (USD billions)

Company

Rusal

Sector

Mechel

Evrast

PIK

Metals & mining

Metals & mining

Metals & mining

Construction

Net debt/EBITDA

11.7

10.3

4.3

1.8

Source: Deutsche Bank (Bob Kommers and Olga Gaydamakina), Company data

Total debt

12

10.2

8.1

1.2

Sberbank

5.6

0.8

1.2

0.9

VTB
0.4
1.8
1.0
0.1
GZPB
0.6
0.8
2.3
NA
Total
6.5
3.3
4.5
1.0
% of total debt
55%
32%
56%
81%

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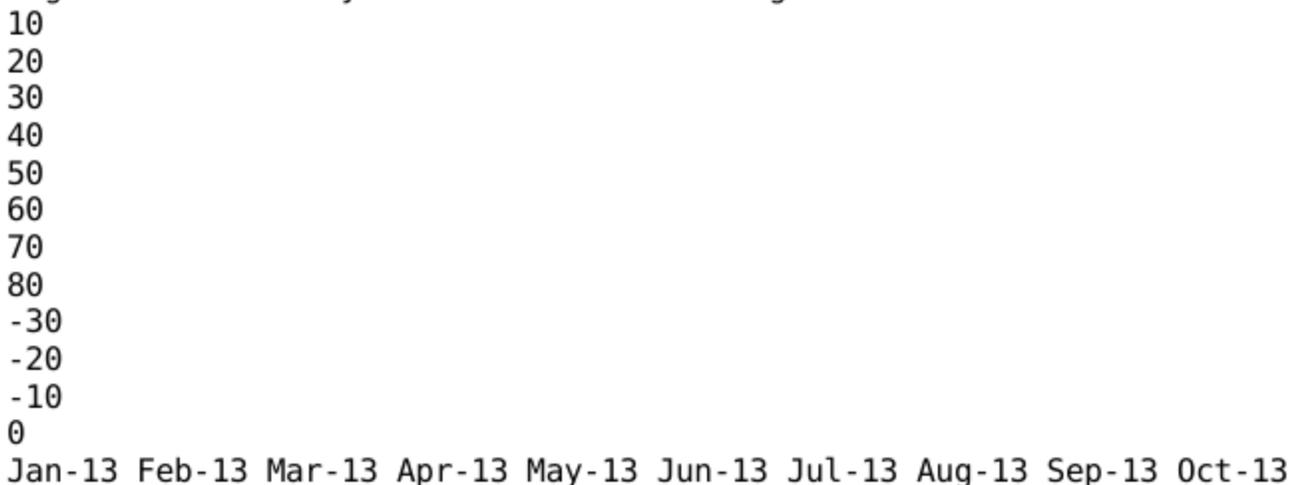
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Turkey - risk reward has improved at current levels

Figure 70: Currency valuation of the "fragile five"



WTI oil price (1m lag)

MSCI Turkey

Figure 71: Total returns of Turkish equities versus oil price – YoY growth, both USD (%)

Source: Deutsche Bank (Marc Balston, Robert Burgess, Drausio Giacomelli, Gustavo Canonero, Taimur

Baig), Haver Analytics

Source: Deutsche Bank, Bloomberg Finance LP

Our long-standing overweight position on Turkish equities has been by far the least successful of our recommendations for 2013, as both equities and the currency fell precipitously during the taper scare from late May to August, with

only a partial recovery since then. Our preference for Turkey in common with all of our country overweights is largely driven by the 'less ugly' factors, but

there is at least some prospect for positive absolute returns following the taper-induced sell-off.

Investors are focusing almost entirely on the current account deficit at the present time and the associated belief that the central bank is behind the curve

in tackling excessive levels of domestic consumption. DB economist Robert Burgess has been very cautious about the prospects for the Turkish economy over recent months, but now believes that the current account deficit should narrow to 6.5% of GDP due to lower gold and cheaper oil imports. The drop in the value of the lira which has taken place over the past few months has also taken the currency into overshoot territory in terms of its deviation from a theoretical fair value, in common with the other big current account deficit economies (Figure 70). Turkey along with India has the highest sensitivity to lower oil prices of any of the global equity markets in our view (Figure 71), so if

Brent does finally move to a lower level in 2014, that would provide additional

justification to overweight the market.

Political factors have clearly exerted a negative influence on Turkish

financial

assets in 2013, both domestically and in the surrounding areas, most notably Syria. The political calendar for 2014 should provide an equally noisy backdrop

starting with municipal elections in March, presidential elections in late-July or

August and then parliamentary elections the following year. The presidential election is probably the most important event given the potential for a clash between Prime Minister Erdogan and the current president, Gul. Investors would generally prefer Gul or one of his supporters, given their more emollient

tone towards the corporate sector, but in reality the conduct of economic policy is unlikely to change very much regardless of who wins. Indeed one of the reasons why we prefer Turkish equities to many of the alternatives within Deutsche Bank AG/London

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GEM is that political rhetoric notwithstanding, the private sector is pretty much

left to get on with conducting its business with a relatively low level of state

interference.

The major risks for Turkish equities this year are probably from the effects of

tighter monetary policy which will weigh on consumption, although the weaker lira and any further pick-up in economic activity in Europe will sustain

exports. The financial sector which dominates the index will also be impacted by regulatory measures to restrict consumer indebtedness but bank stocks have performed very poorly over 2013 and are now pricing in most of the negatives in our view.

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Poland – still defensive in GEM context

Figure 72: Pension funds – Balance of flow assuming that 25% of participants will decide to stay

Figure 73: Pension funds' net equity purchases – Primary versus secondary market

Source: Deutsche Bank (Tomasz Krukowski, Marcin Jablczynski, Tatiana Kapustina, Igor Semenov, Natalia Smirnova), KNF

Source: Deutsche Bank (Tomasz Krukowski, Marcin Jablczynski, Tatiana Kapustina, Igor Semenov, Natalia Smirnova), KNF

Poland has been one of the few emerging equity markets to deliver a positive total return in dollar terms over 2013 at the time of writing, despite the partial

nationalisation of the pension fund industry, which has absorbed the majority of investors' attention over recent months.

DB analysts Tomasz Krukowski and Marcin Jablczynski, believe that changes in pension fund regulations will have a more visible impact over the longer term,

but not necessarily in 2014 as both pension fund members and managers weigh up what policy to adopt towards the domestic equity market.

Meanwhile, retail flows into domestic equity mutual funds have picked up by a significant amount over the course of 2013 (Figure 72 and Figure 73).

Poland still appears to be relatively low risk, low reward compared to the rest

of GEM, given that financial flows from the EU are likely to meet the domestic

funding deficit, while the equity market still yields just below 4%. Our main fundamental reservation concerns the potential for the government to meddle further in the management of some of the state controlled companies which comprise the overwhelming majority of MSCI Poland, as was the case recently with utility PGE.

We remain overweight in Polish equities on the back of our continued caution towards GEM as a whole, but would anticipate single digit positive absolute returns at best. The major macro risk is political, namely that if by the end of

the year Civic Platform is still trailing Law and Justice in the opinion polls,

investors will begin to worry about the imposition of Hungarian type policies after the parliamentary elections in mid-2015.

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Appendix 1

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Equity rating dispersion and banking relationships

1000

1200

1400

1600

200

400

600

800

0

Buy
Hold
Sell
Companies Covered Cos. w/ Banking Relationship
Global Universe
45 %
40 %
48 %
34 %
6 %
22 %
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