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2002-era valuations do not herald a bull market for GEM equities

Cheap valuations cancelled out by deteriorating fundamentals across BRICS

We compare the situation facing EM investors today with 2002, when GEM was on the verge of a massive bull market in both absolute and relative terms. While valuations appear similar at an aggregate level, the underlying fundamentals are very different. In 2002, following a series of economic and financial crises, there was a positive shift towards capital-friendly economic policies and corporate governance taking place across most of the EM universe, which had gone almost completely unrecognised by investors. By contrast today, the situation has reversed with no visible improvement in corporate governance in privately controlled companies and a pronounced tendency across the BRICS in particular, for increasing levels of state intervention to the detriment of minority investors, with the partial exception of India. The result is a polarisation of valuations within GEM, which is a very bearish indicator, as, unlike 2002, practically all of the cheap sectors and stocks have fundamentals which are visibly deteriorating.

Next big driver likely to be a major downshift in expectation of Chinese growth

The success of the Chinese authorities in sustaining high rates of GDP growth has been at the heart of the bull case for GEM equities as i) China is by far the biggest market within GEM, ii) China has been a major driver of commodity markets and hence of the Russian, South African and Brazilian economies/markets, iii) China's rapid growth, based on their state-led development strategy, has been the major intellectual underpinning of long GEM/short DM. We believe that 2013 will mark the year when economists and investors focus on the underlying imbalances within the Chinese economy, and accordingly reduce their expectations of sustainable growth over the medium term. The deterioration in the perception of China is likely to have a very disruptive effect on GEM equities through both fundamental factors and fund flows, and there are few obvious hiding places within the asset class.

US based asset classes are still the obvious beneficiaries of EM problems

The prospect of lower growth rates in China will initially be to exacerbate the disinflationary pressures in the global economy through cheaper exports and lower commodity prices. The immediate impact in likely to be one final move down in US Treasury yields and a rise in the global equity risk premium. The dollar is likely to experience a sustained rally through most of 2013, sucking liquidity out of EM assets, especially local currency debt, though EM dollar debt is also vulnerable given the massive fund inflows since 2009. Even if the fall in commodity prices is not on the same scale as 2008, the prospects for recovery are also much lower, which should deliver the final *coup de grace* to commodities as an asset class. Lower commodity prices should enhance the appeal of US equities, which we believe are around twenty-seven months into a multi-year bull market against GEM equities, reflecting the superior performance of the US economy and corporate sector coming out of the financial crisis. We tentatively forecast that US equities should end the year with gains of up to 10% compared with a fall of 10-15% for MSCI EMF. Within GEM, we retain our existing country recommendations which are based on our structural scenario, but at this point, would only emphasise our underweight China and overweight cash calls.

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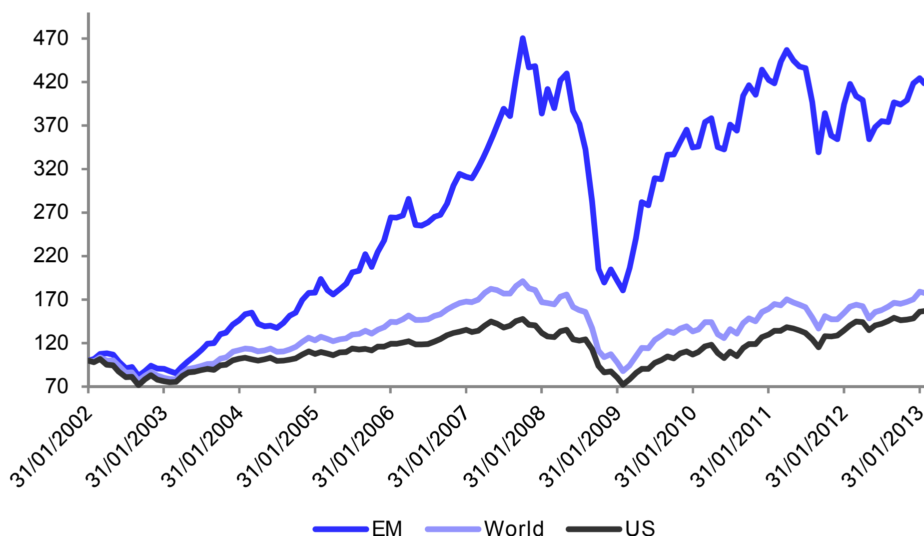
2013 compared with 2002: Superficially more attractive valuations and fund flows, but structural fundamentals more bearish

GEM 2002 – on the cusp of a bull market

We thought that we would look back to 2002 in order to remind ourselves and our clients how emerging markets appeared on the cusp of their phenomenal bull run back from 2003 to 2007 when the MSCI rose by around 450% (see Figure 1). This is not just done with the benefit of hindsight – at the start of 2002, the author of this piece was fortunate enough to be running money in charge of a value-based GEM equity product when the opportunities were very obvious and were fully reflected in the subsequent absolute and relative performance. The most challenging aspect of the job was not managing the money or the very talented team, but persuading potential clients of the almost historic opportunity to make outsize returns, given the propensity of the US pension fund industry in particular to allocate assets on the basis of historic performance.

Today, valuations are very similar to their 2002 levels (see Figure 2), but investor sentiment has been much more bullish towards EMs, in both absolute terms and relative to their developed counterparts, which has been reflected in both retail and institutional allocations. We have compared the background to the two periods and believe that in 2013, GEM equities are about twenty-seven months into a period of multi-year underperformance against US equities and are most likely on the verge of a further decline in absolute terms.

Figure 1: MSCI EM versus MSCI World and MSCI US (31 January 2002 = 100)



Source: Deutsche Bank, Bloomberg Finance LP

Figure 2: EM countries and sectors - Current versus 2002 valuations

Country	P/BV in January 2002 (x)	Current P/BV (x)
EM	1.67	1.67
Brazil	1.08	1.47
Chile	1.36	2.39
Mexico	2.16	3.28
Russia	1.4	0.85
Poland	1.59	1.33
Turkey	3.67	1.90
Hungary	2.32	0.97
China	1.55	1.77
India	2.17	2.76
Korea	1.43	1.15
Taiwan	2.09	1.82
South Africa	1.84	2.59
Indonesia	3.29	3.84
Malaysia	1.82	2.10
Thailand	1.99	2.63

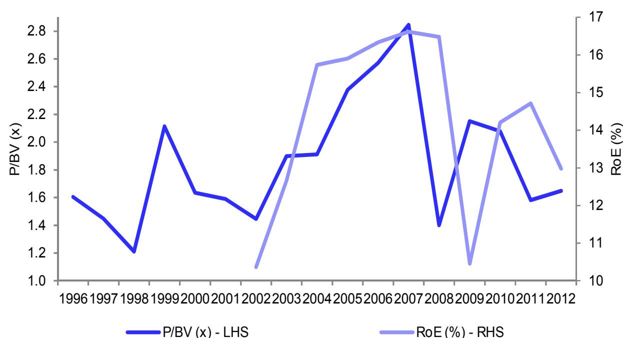
Sector	P/BV in January 2002 (x)	Current P/BV (x)
Energy	1.58	1.04
Materials	1.4	1.54
Industrials	0.97	1.55
Consumer Discretionary	1.72	2.15
Consumer Staples	2.46	4.19
Health Care	3.41	3.77
Financials	1.62	1.59
Information Technology	2.86	2.05
Telcos	2.26	2.37
Utilities	0.66	1.03

Source: Deutsche Bank, Bloomberg Finance LP as at 21 February 2013

Comparison between 2002 and 2013 – backward looking indicators appeared much more negative in 2002 than today, but the direction of marginal change in the economic and corporate fundamentals was generally more positive than is currently the case.

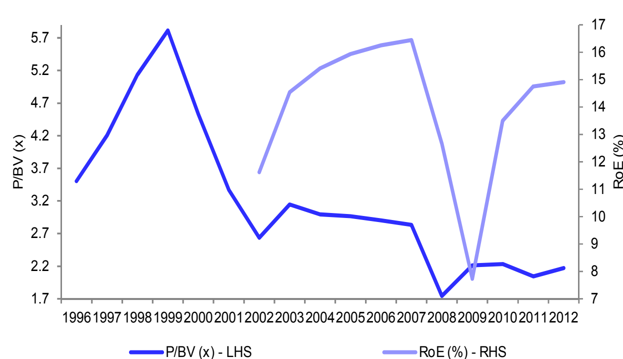
1. **Absolute valuation multiples appear fairly similar while GEM is not as cheap as in 2002 relative to the US**. At the start of 2002 the MSCI EMF was actually trading at the same PBR as it is today at just under 1.67X. Valuations for US equities were undergoing the rapid de-rating which took place after the implosion of the tech bubble from a peak PBR of over 5.7X to the January 2002 level of 3.3X, which compares with 2.3X today. Relative to ROE, both the GEM and US valuations are cheaper today compared with 2002 although the de-rating relative to ROE has been greater for US equities (see Figure 3 and Figure 4).

Figure 3: MSCI EM - P/BV (x) versus ROE (%)



Source: Deutsche Bank, Bloomberg Finance LP

Figure 4: MSCI US - P/BV (x) versus ROE (%)



Source: Deutsche Bank, Bloomberg Finance LP

2. **Emerging market sovereign debt yields were at extremely high premiums to US Treasuries following the series of EM economic and financial crises, which had occurred since the devaluation of the Thai baht in 1997.** There has been a massive improvement in most of the key macroeconomic ratios, which are used to assess debt sustainability across almost all emerging economies, both in absolute terms and relative to their major DM counterparts. Accordingly, emerging debt yields and spreads with Treasuries, have compressed to an extent almost no-one would have believed possible ten years ago. Needless to say the vast majority of investors have reacted to, rather than anticipated the improvement in fundamentals - emerging debt was ignored by the mainstream in 2002, whereas both retail and institutional investors have been pouring money into the asset class over the past four years.

3. **The direction of change in economic policy was generally much more positive for both bond and equity investors across most key EM economies in 2002.** The ferocity of the EM economic and financial crises, which took place between 1997 and 2001 was a catalyst for a series of economic reforms across all of the bigger emerging economies. These involved a combination of tighter fiscal discipline and in most, though not all cases, a move to freer floating exchange rates (Malaysia and China were significant exceptions). On a more micro level, there was a renewed emphasis on institution building, the strengthening of private sector business, including some restructuring of key industries and the promotion of exports and inwards FDI. Investors were generally very slow to recognise the potential impact of these reforms, which together with the more favourable cyclical backdrop, were the foundations for the huge improvement in macro-economic indicators of financial health, which has taken place in most EMs over the past decade. The global financial crisis, which began in 2007, appears to have been a catalyst for a reversion back to much more state led policies in many of the bigger EMs, with very negative implications for EM financial assets in our view.

4. **There was sufficient underutilised capacity across most EM economies to alleviate inflationary concerns but increasing shortages in some key 'old economy' sectors**. The US corporate sector was emerging from a period of very high investment in the so-called new economy, whereas there had been a dearth of investment into the commodity and related industries which are such an important component of the LATAM and CEMEA universes. Meanwhile, investment across much of non-Japan Asia was still convalescing after the 1997 financial crises. The magnitude of the subsequent earnings and economic recovery in some GEM economies such as Russia and Brazil, may have owed as much to undervalued exchange rates and underutilised capacity as it did to the economic reforms. Now the output gap in domestic and service related sectors tends to be much tighter so the authorities in many EMs are walking a tightrope between the fight against inflation and the need to promote growth via low interest rates and currencies.

5. **China was on the verge of becoming the main driver for the whole asset class in 2002** due partly to the restructuring of a significant part of Chinese industry which took place between 1998 and 2002, but more to catch-up growth on the back of faster urbanisation, adoption of western technology, the very low starting point in terms of GDP per capita and rapidly growing exports. We believe that most of these factors have now played themselves out, but that the structural deterioration in the rate of sustainable growth going forward has been obscured for the time being by the mobilisation of ever increasing financial resources.

6. **There was a discernible trend towards better corporate governance in most EMs in 2002.** The diminution in the role of the state in allocating resources is perhaps best illustrated in the case of Korea, where the c*haebol* were no longer protected by an implicit government guarantee. The situation since the 2007-08 acute phase of the global financial crisis has been very different however, with a move towards the redistribution of resources away from capital to the state and labour across most of the larger emerging markets. The privatisations across all of the BRICs which have taken place since 2002 have in general not lived up to their earlier promise over recent years as the state has remained in control of most of the newly-listed companies. The developments relating to privately controlled companies have also generally been disappointing, and South Africa remains the only emerging market, which has anything resembling an open market for corporate control.

7. **Commodity prices were at extremely depressed levels in 2002** while the use of commodities as a discreet asset class was almost unheard of. This all changed from 2002-07, led by the almost exponential increase in demand for industrial metals driven by rapid urbanisation and infrastructure build-out in China combined with the very low level of investment in commodity extraction, which had taken place throughout the 1990s. Whilst the prices of most industrial metals and oil are now below their 2008 highs, they are still at multiples of the levels pertaining in 2002.

GEM 2013 – low valuations not a sufficient precondition for a bull market

The key point of the comparisons is that low valuations at an aggregate level are a necessary, but not a sole precondition, for a bull market. Both the structural backdrop and the marginal shift in economic and corporate fundamentals have also to be taken into account. In 2002 both bond and equity investors were very slow to recognise the positive changes in the fundamental factors, most notable the direction of economic policy, which helped pave the way for the massive bull market of 2003-07. By contrast, investors today are continuing to pour money into the asset class, long after the fundamental drivers have begun to deteriorate, especially relative to US stocks. The reality test is the difficulty, which we believe most EM managers are currently experiencing, in finding stocks with a combination of low valuations and improving fundamentals, as we highlighted in our 2013 outlook piece ('Recent GEM outperformance not sustainable through 2013', 10 December 2012). This is in contrast to 2002, when for those of us fortunate enough to be managing EM money, there were a massive number of out-of-favour stocks where investors were paid to sit and wait for the inevitable payoff over the medium/long term.

Big picture marginal change across the asset class has become even more negative

The key to most dynamic investment analysis is obviously to try to identify the direction of marginal change by individual economy and market, which we attempt to do for the BRICS later in this report. We believe that the big picture for GEM will continue to deteriorate over the next few months for three main reasons:

- **First**, in contrast to the official DB house view which has been correct so far, we believe that the improvement in the Chinese economic and corporate data, which has become evident since the end of August, is not sustainable. Regular readers will know that we base this conclusion on our structural analysis of the corporate sector and we provide an update on how we see the latest developments later in the report.

- **Second**, there is absolutely no end in sight to the pattern of greater state involvement in some of the major GEM economies, in particular China, Russia, Brazil and South Africa, which has become so pronounced since the global financial crisis, mainly to the detriment of equity returns. The effects are apparent in what are misleadingly described as the privatisation programmes, which are taking place in India and Russia, given that the state generally remains in control after the companies are listed (to be fair the Chinese do not refer to the listing of state controlled companies as privatisations).
- **Finally**, the outlook for most EM currencies has deteriorated given the onset of a further round of competitive devaluations driven by further monetisation in the UK and Japan, where the authorities are desperate to breathe life into their respective moribund domestic economies. The apparent undermining of central bank orthodoxy and, in the case of Japan, independence, may just about be justifiable in the case of the developed economies where inflation is not (yet) a major issue (though we have doubts about the UK), but could become a major issue in some EMs, where capacity constraints are much tighter. We believe that governments across most EMs will put pressure on central banks to favour growth over low inflation, which implies generally lower exchange rates. Already we note a war of words between politicians and central bankers in Hungary, Russia and India, while Dilma's administration in Brazil may yet baulk at the measures that the Brazilian central bank may have to take to restrain inflationary pressures.

Very few obvious buy ideas across GEM equity markets

Having just returned from a visit to South Africa, it was interesting just how many clients agreed with the assertion that one of the main reasons to be bearish about GEM equities is the shortage of obvious buy and hold ideas through the asset class. The situation in South Africa reflects the broader GEM universe, where big infusions of liquidity from overseas have pushed the overwhelming majority of companies with good ROE prospects and corporate governance to what appear to be overvalued levels in absolute terms, primarily in the consumer-related sectors (see Figure 7). Meanwhile, at the other end of the spectrum, there are companies such as the platinum, and more especially, the gold miners, which are languishing on such low valuations relative to assets that they are liable to periodic sharp rallies, but where the marginal shift in the fundamentals appears to be in a continual negative direction. The sophisticated South African investor base is in a good position to appreciate the potentially negative impact of both greater state involvement and a slowdown in the sustainable growth rate in China, on the overall GEM equity asset class.

We anticipate a stronger dollar could suck liquidity out of EM carry trade

At the start of 2013, there was an overwhelming consensus that EM equity would outperform DM, while investors in EM debt would manage to eke out positive returns despite rising treasury yields via the positive carry and a further contraction in spreads. We believe that the underlying strengths of the US economy, compared with most of the major emerging economies are becoming more obvious over time, so we would anticipate a period of pronounced dollar strength over the coming months, which combined with the structural factors we highlight above, will go some way towards undermining the case for EM local currency debt, while some EM currencies could move much lower, including eventually the renminbi. We would also expect the spreads on EM dollar debt to move more in line with the fundamentals of the individual credits, given the weight of retail money now invested in EM debt, which unlike EM equity (which is merely overvalued), appears to us to have characteristics which increasingly resemble an investment bubble.

Commodities and EM equities will also fare badly in this scenario

The 2002-07 cycle culminated in the collapse of the US debt-driven model with the financial crisis which was centred on the US housing market. If our view on China and the dollar proves correct, the next step towards global rebalancing will be a significant fall in commodity prices, thereby bringing about a strong recovery in consumer power across the major developed economies and deferring the day of fiscal reckoning for another few years. The risk premium for global equities would most likely rise for a time in what is likely to be a pretty disruptive scenario, but the US market is well placed to continue to outperform and, barring lasting geopolitical after-effects, should begin to resume its upwards move in absolute terms. By contrast, emerging equities will suffer a major liquidity, and in some cases fundamental shock, though in time even China itself would be a winner from higher US growth leaving Brazil, Russia and South Africa as the obvious losers of the major emerging markets. Much of the adjustment for all of these countries and for China itself would have to come via lower exchange rates, which implies some potentially hefty losses for dollar based investors in EM.

Weightings within GEM based on view of how this cycle will end

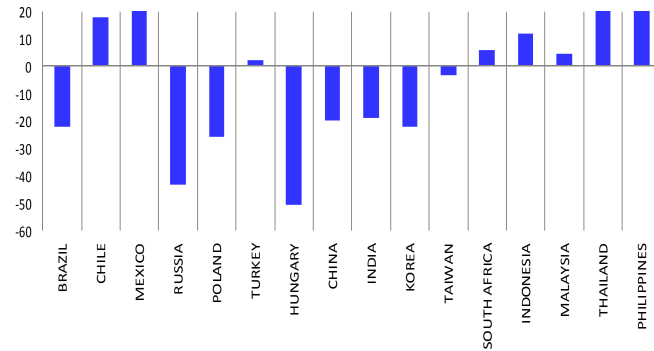
We have been tempted over the past two months to shift our weightings within GEM to upgrade the cheap out-of-favour markets, Brazil and Russia, at the expense of the more expensive Turkey and Mexico, where we have been overweight for two years, or even the ASEAN markets where we have had long-standing neutral positions. As Figure 5 and Figure 6 show, all of these markets appear extremely expensive relative to their history and relative to the rest of GEM, as do the consumer-related sectors and healthcare across the EMF (see Figure 7). In fact, the cracks in the expensive sectors are already starting to show. In December we highlighted the Indian and South African consumer staples sectors as especially egregious examples of overvaluation, since when both Hindustan Lever and Shoprite have experienced significant corrections as if to illustrate the point. Still, we have decided to retain our existing country positions as the structural arguments which we outline later in this report on Brazil, Russia and China remain compelling if our view on the Chinese economy and commodity prices proves correct. We are also underweight in Korean equities, which are also likely to be very vulnerable in this scenario from an exchange rate and export perspective. Our other overweight positions in addition to Mexico and Turkey are Poland and Taiwan and India as a neutral/overweight for those investors who are unable to hold a significant cash position. Still as in December, the only recommendations within GEM, which we feel especially strongly about at this stage are to underweight Chinese equities and to overweight cash.

Faster US economic growth and Chinese reform/residential housing/productivity main reasons we could be too pessimistic

There are of course plenty of reasons why our view could be too pessimistic, not least the possibility that an above consensus recovery in the US economy might drag the more operationally-leveraged GEM universe into more positive territory. Whilst we remain firmly bullish on both the US economy and market over the medium term, we do not think that growth can reach the 3% ‘escape velocity’ until the second half of 2014, given the fiscal drag and the ongoing debate about entitlement reform, which is likely to have an impact on consumer confidence even if no tangible action is taken. The recent rise in gasoline prices is also likely to act as an additional headwind to US growth. Our view on China may also be overly negative if the recovery in the economy proves to be more self-sustaining than we anticipate once the effects of the non-bank stimulus start to decline on a year-on-year basis. This would most likely be through the impact of increased volumes of housing construction and because the extent of overcapacity through much of Chinese industry proves to be much lower than our analysis suggests. We may also have underestimated the possibility that the State Council will begin to initiate serious reforms in such key areas as fiscal policy and changes in the regulations concerning the ownership of land.

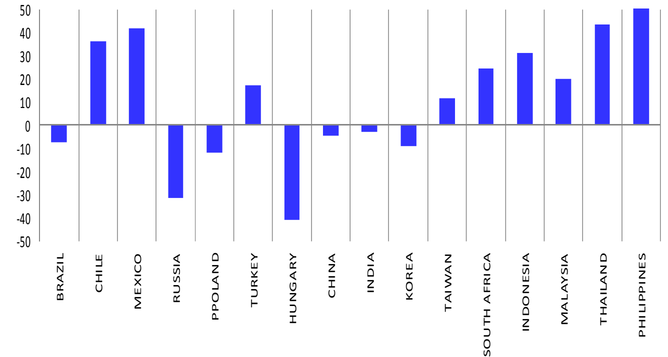
EM country and sector valuation snapshots

Figure 5: Current P/BV of each EM country - Deviation from historical 10-year average (%)



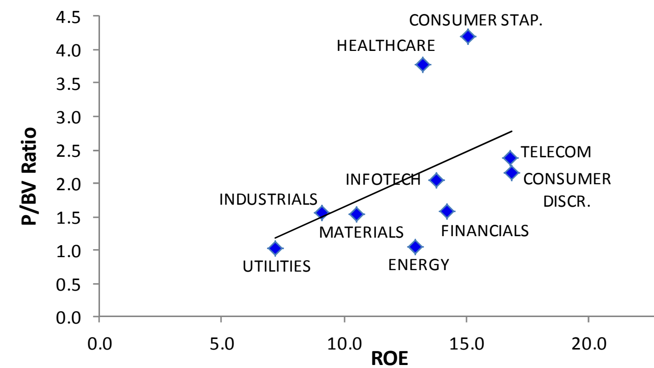
Source: Deutsche Bank, Bloomberg Finance LP

Figure 6: Current P/BV of each EM country relative to P/BV of MSCI EM - Deviation from historical 10-year average (%)



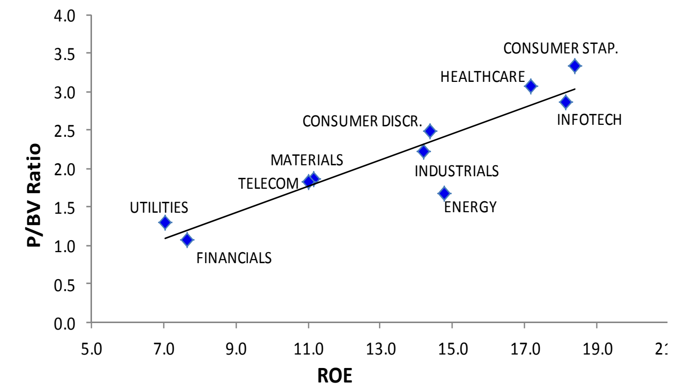
Source: Deutsche Bank, Bloomberg Finance LP

Figure 7: MSCI EM sectors - P/BV versus ROE



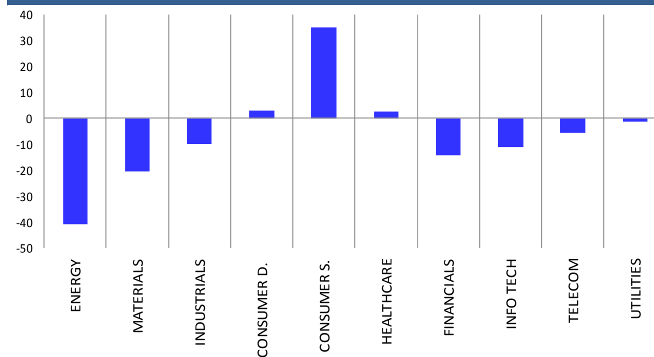
Source: Deutsche Bank, Bloomberg Finance LP

Figure 8: MSCI DM sectors - P/BV versus ROE



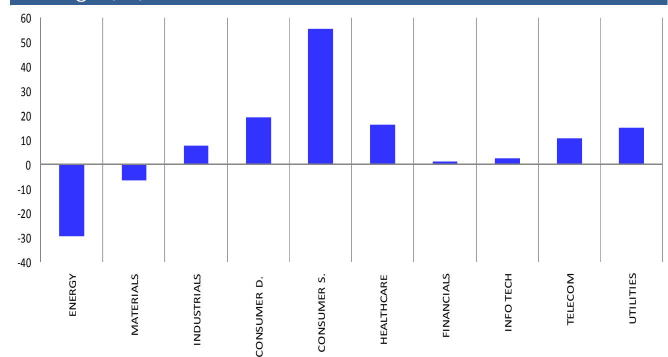
Source: Deutsche Bank, Bloomberg Finance LP

Figure 9: Current P/BV of each EM sector - Deviation from historical 10-year average (%)



Source: Deutsche Bank, Bloomberg Finance LP

Figure 10: Current P/BV of each EM sector relative to P/BV of MSCI EM - Deviation from historical 10-year average (%)



Source: Deutsche Bank, Bloomberg Finance LP

China: economy and market have become addicted to increasing mobilisation of credit – remain underweight

Recovery in economy and market clearly driven by increasing availability of finance

As we highlighted in the outlook for 2013, the recovery in both the Chinese economy and equity market, which has taken place since last August, has been driven by the increasing availability of finance for infrastructure projects and the corporate sector, due to the very rapid expansion in non-bank sources of finance. Since early December, the main developments have been that the magnitude of the financial stimulus has become clearer, while the 'A' share market has started to play catch-up with its 'H' listed counterparts. The extent of the recovery in the Tier-1 residential property market has also become more evident.

But there are indications that Beijing is becoming increasingly concerned

The pace of increase in total credit over the final quarter of 2012 on a year-on-year basis is almost comparable with the early stages of the 2008-09 stimulus, although the mechanics are somewhat different given that the earlier effort was powered by lending from the big state-controlled banks. Beijing originally envisaged that the stimulus which was launched in the wake of the liquidation of Lehman Brothers, would total about 12.5% of GDP, but the final total was in excess of 27% of GDP as various levels of local government co-opted the banks to fund their own pet projects – something which most of the authorities in Beijing now recognise was a major policy error. There are indications that the central administration is becoming alarmed by comparisons between the situation now and in 2008-09, especially the role played by local governments. For example, in the week before Chinese New Year, Finance Minister Xie Xuren called for much stricter monitoring of local government debts with the aim of enforcing a much higher level of compliance with financing regulations. The CBRC has re-emphasised the requirement to separate loans made at a local level from those made by nationwide lenders and has also set a three month deadline to enforce the policy drawn up in 2011 to prevent banks pooling money from different WMPs.

Central government is walking a tightrope – is the economy now self-sustaining?

The very obvious difficulty for Beijing lies in having to strike a balance between low growth and over-stimulating the economy to the extent which could lead to further NPLs and higher inflation. We believe that the very magnitude of the increase in TSF which has taken place over the past few months, reflects the dire situation confronting the economy by late summer of last year, when there were clear signs of a cash crunch developing through a significant part of the corporate sector. The key question in the first half of 2013 is the extent to which a slowing in the year-on-year rate of growth in TSF will be transmitted to the real economy. China bulls will point to the pronounced recovery in parts of the residential property market and the renewed emphasis on infrastructure which is aimed at facilitating the process of urbanisation, as evidence that the recovery should become increasingly self-sustaining. By contrast, those of us with a more bearish perspective, would cite annualised credit growth of around 22% relative to 12% nominal GDP growth as evidence that the inevitable decline in credit growth will feed through to the real economy almost immediately- if our central assumption that the return on invested capital is continually falling through most of the economy, then the authorities will be faced with some very unenviable choices. We believe that 2013 will probably be the year when it becomes very apparent that the sustainable rate of growth in China is much lower than is generally believed.

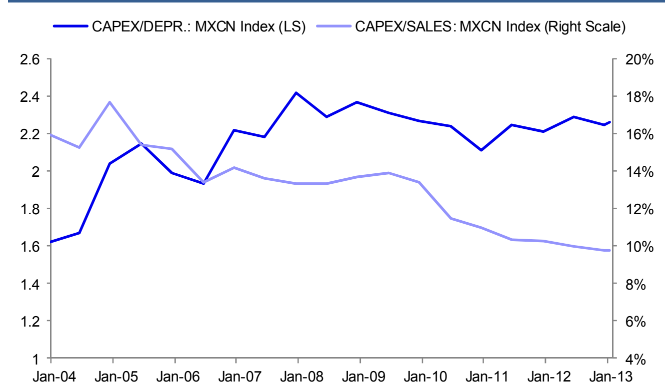
We are sceptical about the likely extent of real structural reform

DB China economist and strategist, Dr Jun Ma, has consistently said that the reform agenda will not take shape until the formation of the new State Council in March. Nevertheless, he has expressed scepticism that the new leadership will be able to implement much in the way of real change in such important areas as SOE reform and the relationship between Beijing and local governments. We believe that two very important areas to watch are rural land reform and fiscal reform in order to optimise the economic impact of further urbanisation, and to promote a more rapid rebalancing of the economy away from excessive levels of fixed asset investment towards consumer spending. Both of these reforms would require a Herculean effort to overcome vested interests and ideological obstacles as DB senior analyst Michael Spencer pointed out in a recent report. The most likely scenario is for a series of piecemeal measures, which in our view are unlikely to suffice to head off the structural problems, which threaten to bring the future rate of growth much lower. We are similarly pessimistic about the so-called anti-corruption campaign, which appears to be addressing relatively superficial issues such as the number of courses in official dinners, rather than the blurred boundaries between the state and private sectors, which are the real cause of rent-seeking and the inefficient allocation of resources in our view. It is probably significant that there has been a very high degree of opposition to measures to introduce a property tax, much of it reportedly from government officials with multiple properties.

Overcapacity still evident across many listed industrial sectors

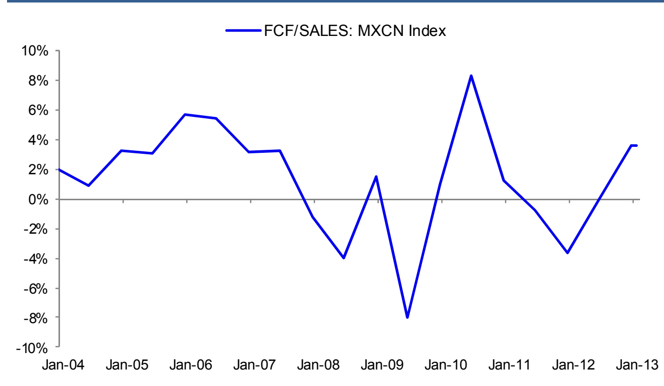
Regular readers will know that we try to pay particular attention to investment and cash flow trends across the listed corporate universe in China and have been especially concerned about the extent of overcapacity which we believe exists across most of the leading industrial sectors, which are not strictly controlled by Beijing. Superficially, the situation appears to have improved a great deal from the cash shortages which were becoming increasingly evident during the summer across many industries (see Figure 11 to Figure 14). Dr Jun Ma has rightly identified a number of sectors such as textiles, apparel and electronics where the capacity adjustment appears largely complete, but as he points out most of these are in 'true' private sector which is dominated by SMEs and FDI-driven companies. For the big listed companies, the shift appears to be very slow and in general driven by reactive cutbacks in capex growth, rather than by more proactive restructuring programmes. Even the DB Asian steel team led by James Khan, who recently upgraded their view of the steel sector, acknowledge that compared with previous cycles, the magnitude of the improvement is relatively low, reflecting the fairly weak pick-up in final demand which is evident across many sectors.

Figure 11: MSCI China index - Capex/ Depreciation and Capex/ Sales



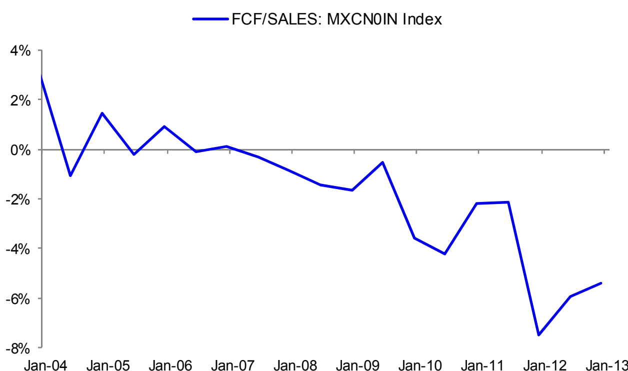
Source: Deutsche Bank, Bloomberg Finance LP

Figure 12: MSCI China index - FCF/ Sales



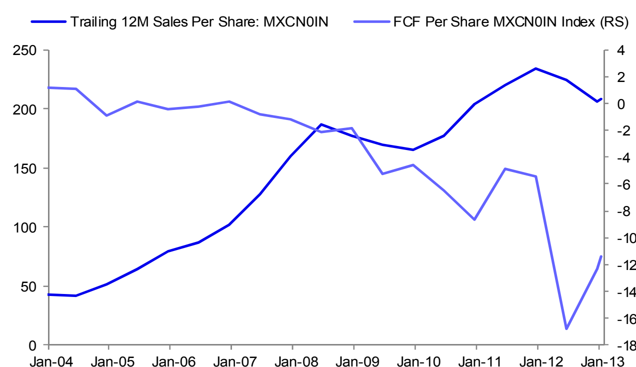
Source: Deutsche Bank, Bloomberg Finance LP

Figure 13: Chinese industrials - FCF/ Sales



Source: Deutsche Bank, Bloomberg Finance LP

Figure 14: Chinese industrials - Trailing 12-month sales per share and FCF per share



Source: Deutsche Bank, Bloomberg Finance LP

The corporate sector remains a geared play on the domestic economy

The share prices of many industrial companies have risen very sharply since the market lows towards the end of August, which we believe is more a reflection of sentiment and liquidity, including no small amount of short covering, than of any longer lasting improvement in fundamentals. We would interpret Caterpillar's action in writing off around three quarters of the acquisition value of one of their Chinese acquisitions due to 'revenue impairment', as potentially symptomatic of the type of problems which are likely to be lurking in the balance sheets of the Chinese banks, but which have been obscured by the very high rates of economic growth. These type of issues combined with massive overinvestment should lead to a very rapid deterioration in corporate profits and cash flow, once the pace of increase in credit begins to slow by a meaningful amount and reveals the amount of latent overcapacity across much of Chinese industry. Just like in other state-dominated markets such as Brazil and Russia, the gearing of much of the listed corporate sector to the real economy on the downside, is increased by the primary function of many companies as vehicles to enable the state to implement a social and sometimes political agenda, a tendency which becomes more pronounced when the economy is relatively weak.

In any event, like most of GEM, relatively few obvious buy ideas – remain underweight

We moved to underweight Chinese equities in a GEM context because of what we perceived as the negative underlying economic and corporate factors, almost exactly a year ago when the MSCI China was trading at a very similar level to where it now stands, in contrast to a small fall for the MSCI EMF index. Given that most of our other underweight recommendations have been relatively poor performers against the GEM benchmark, in particular Brazil and Russia, together with the relatively high level of complacency which now prevails among most managers towards Chinese equities, underweight China is now our major country call in a GEM context. DB sector analysts have a wide variety of views on their industries, but we derive some comfort from the relatively high degree of caution towards some of the larger sectors such as telcos, large parts of the consumer sector, coal, aluminium shipbuilding, healthcare and to a lesser extent, energy and banks where Tracy Yu has upgraded her recommendations, but acknowledges the potentially high level of systemic risk.

Russia: top-down outlook appears to be positive but equity investors face more complex reality – remain underweight

Easy to make top-down bull case for Russian equities

There is a long list of reasons why investors might want to be overweight in Russia from a top-down perspective.

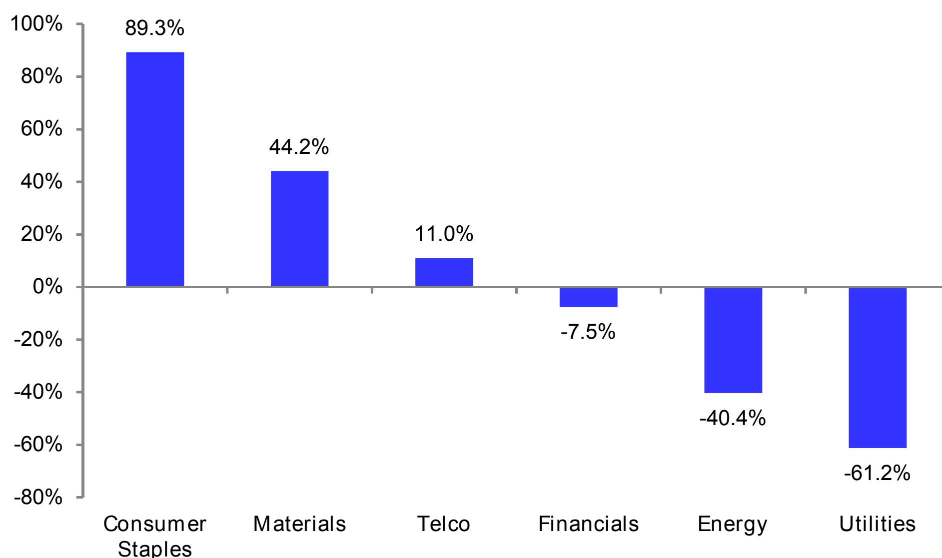
- **The economy may be low growth, but appears very stable**. The macroeconomic situation appears extremely stable with negligible levels of government debt, a relatively balanced fiscal situation so long as the oil price remains above $100 and falling rates of inflation. Moreover, the central bank is moving towards an inflation-targeting regime which has increased confidence among international investors in the rouble and Russian fixed income instruments.
- **The direction of policy appears to be pro-reform.** In addition to the shift at the central bank there are other apparently pro-reform initiatives in progress. The most immediate for investors are the very real, if belated, improvements in market infrastructure for both equities and fixed income instruments, most notably Euroclear and the central depository. The main economic initiative is Putin's own '100 Steps' project which aims to improve the environment for business within Russia by the use of specific ranking targets based on the World's Bank's "Doing Business" scorecard. Alongside this effort, Putin is trying to promote the 'de-offshorisation' of the economy through the so-called anti-corruption campaign, which has already claimed some fairly prominent victims.
- **The equity market is extremely cheap.** As we highlighted in our outlook for 2013, Russia is the main outlier within the GEM universe in terms of valuation on both a PER and PBR basis. Russia is also extremely cheap relative to its own history and relative to its own history relative to the other GEM markets (see Figure 5 and Figure 6).

But the reality for equity investors is not nearly so straightforward

As usual in Russia, the situation confronting investors from a micro perspective is not nearly so straightforward – in most sectors and companies, we believe that the interests of minority investors remain below those of controlling shareholders and are also in many cases subordinate to social and political considerations.

While valuations might appear cheap, the aggregations for the market conceal as much as they reveal. Much of the apparent cheapness is due to the dominance of relatively cyclical sectors, in particular materials and energy which have specifically Russian issues to contend with, as well as the customary cyclical discount. The market, in particular the MSCI-listed stocks, is relatively narrow compared with its BRIC counterparts. There is a paucity of straightforward consumer plays, with the obvious candidate, Magnit, much more highly rated than the majority of its GEM peers (see Figure 15).

Figure 15: P/BV of Russian sectors above or below P/BV of EM sector counterparts (%)



Source: Deutsche Bank, Bloomberg Finance LP

Both the oil and gas sectors face huge regulatory and tax-related issues – the oil companies can live with the current tax regime, but it is far from being settled on a permanent basis. Government policies also steer the integrated oil companies towards excessive amounts of investment in downstream assets in our view. The acquisition of TNK/BP by Rosneft which has consolidated the dominance of the state over the oil industry will bring in external managerial and FDI expertise, but no one appears quite sure where portfolio investors fit in to the equation - the position of minority investors in TNK/BP remains the subject of considerable uncertainty. Gazprom's business model has come under pressure across a wide variety of fronts – pricing, pipeline export, regulation – while the situation regarding gas supply to the Ukraine illustrates the extent to which the company remains an instrument for the state's social and geopolitical agenda.

Meanwhile, like China, throughout much of the listed sector the boundaries of many of the supposedly privately-controlled companies with the state sector can become extremely blurred. This has become apparent in the ongoing struggles for control in a number of companies such as Norilsk Nickel, where the Kremlin appears to have brokered a settlement without any apparent regard for the longer term interests of minority shareholders. It is especially unsettling for investors to observe the very public struggles over the nature of recent and forthcoming privatisations, in particular between the privately-controlled Summa group and state-controlled Transneft. The influence of the state is pervasive into many industries and companies which are prima facie predominantly privately-controlled – many of the listed metals and mining stocks are experiencing difficulty in restructuring their domestic operations if this involves major lay-offs – social obligations will continue to come before the interests of minority shareholders in what remains a relatively undiversified economy with low levels of state-provided social protection.

All of these issues add up to a major stock selection problem for investors, as a result of which Sberbank has become the default play for investors bullish on the Russian market. The stock has enjoyed an extremely good run, in both absolute and relative terms, and while it does not appear expensive, we believe that investors may be underestimating the potential vulnerability to structural and cyclical issues in the broader economy. Our biggest underlying concern about the Russian economy is the

relative lack of restructuring which has taken place during the years of high commodity prices. The EBRD recently published a very informative report which highlighted these issues, in particular the continued dependence of many towns and cities in Russia on a single employer, mainly in the metallurgical industry (see "Diversifying Russia: Harnessing regional diversity", 13 December 2012) - we worry that the exposure of the state-controlled banks to the manufacturing sector could result in major contingent liabilities in a downturn.

We are also not so confident about the big picture issues

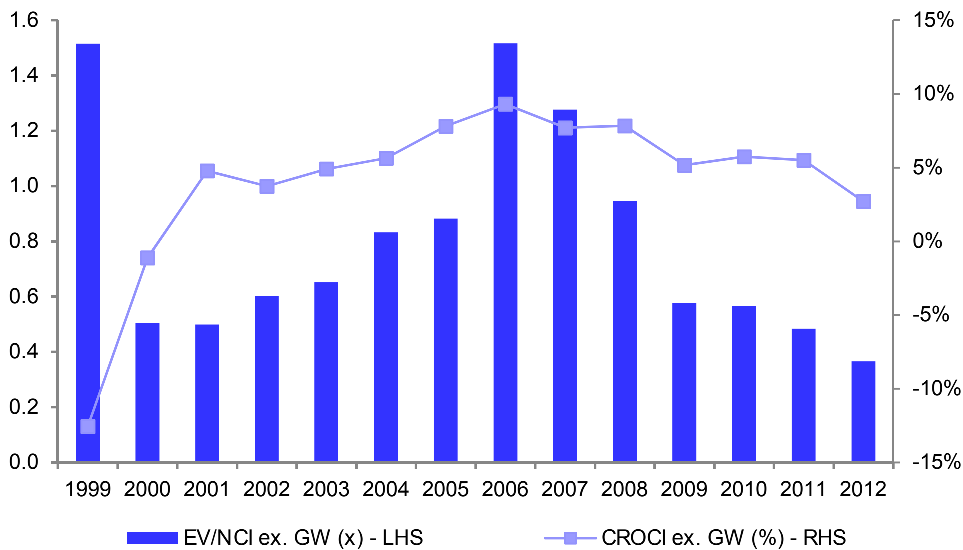
We might just be prepared to overlook some of these factors if we did not have some very real concerns about the big picture, which fall into three categories:

- **First**, the recent war of words between the government and central bank over the pace of monetary easing is a reminder that if growth slows further, the CBR is likely to come under pressure to engineer, or at least not stand in the way of, a rouble devaluation, even at the expense of a sharp increase in inflation.
- **Second**, it is not totally clear that investors should take the anti-corruption or 'de-offshorisation' campaign at face value. Whilst the campaign has claimed some prominent victims, there have been suggestions that the Kremlin is using it as pretext to discredit some prominent opponents of the current administration. The real issue underlying corruption is the absence of clear rules and the blurred boundaries between the state and private sectors. The long term solution therefore depends far more on the successful implementation of Putin's 2018 agenda rather than on a few headline-grabbing anti-corruption cases, although we are intrigued by the mooted investigation of procurement practices at Gazprom by the Audit Chamber, under the supervision of former PM Sergei Stepashin.
- **Finally**, our longstanding bearish view towards the Chinese economy does make it hard for us to be especially bullish towards an economy which remains so dependent on commodity prices.

Conclusion – remain underweight; Russia is a value trap for the time being

In some respects, Russia does appear to be a value investor's dream, in particular the very low level of valuations relative to replacement cost across a range of major industries (see Figure 16). From early 1999, this, along with the positive inflection of economic policy and corporate governance was enough to persuade us in a previous life that Russian equities were a compelling long term proposition. This positive structural story began to unravel with the dismemberment of Yukos which began in late 2003, marking the start of a greatly increased state role in the corporate sector. Today we see no sign of a reversal in this trend, while the Russian authorities have not yet figured out an appropriate role for minority investors in Russian corporations, other than to provide cash for 'privatisations' which leave the state firmly in control. It is unsurprising, given the authorities ambivalent attitude towards portfolio investors, that the government and private companies are more comfortable with having sovereign wealth funds as major investors given their supposedly longer term orientation and the ancillary political and economic benefits that might result from such deals.

Figure 16: Russian equities - EV/NCI (replacement cost proxy) versus CROCI



Source: Deutsche Bank CROCI team

Our more general reservations are reflected in the difficulty we have in identifying compelling individual stock ideas, which is illustrated by the recent decision of the DB oil and gas team to downgrade the energy behemoth Rosneft from buy to hold. We therefore remain underweight in Russian equities, albeit with the caveat that the very low valuations of parts of the market, can lead to very sharp rallies.

India: some positive reform momentum but very low political, economic and corporate visibility - neutral/overweight in default of better alternatives, but still prefer cash

Strong market run since June due to reform drive and Eurozone liquidity

We upgraded the Indian market back in June of last year, just before the Congress led administration's re-launch of its economic reform agenda, but with the caveat that we did not expect much in the way of absolute returns. In hindsight we were much too cautious as the MSCI India has appreciated by over 20% since then, although the market seems to have run out of steam this year. The renewed emphasis on reforms also coincided almost exactly with the provision of sufficient monetary support for the eurozone, which sparked a rally in global risk assets. Regardless of whether the eurozone or the Indian government was the real catalyst, it would appear that many overseas investors share the optimistic view of the DB India strategy team led by Abhay Laijawala, that the situation now is analogous to the start of the liberalisation of the Indian economy in 1991 Accordingly, emerging market fund weightings in India have risen as foreign investors have poured an estimated $33bn into the Indian equity market since the start of 2012.

Very low visibility in terms of where the reform agenda and economy are headed

At this point, it is difficult to see where the reform agenda is headed and what impact it has had on the economy so far. There are some positive indicators. First, the government has succeeded in passing some important bills through parliament after an agreement between the ruling UPA coalition and the main opposition BJP. Second, many of the Indian states, which in aggregate are becoming an increasing force in Indian politics at the expense of the national parties, have been forced to concede a greater role to market forces out of economic necessity – the best example of the effect of this pressure is in the power price increases which have taken place to a greater or lesser extent across most of the country, though these are still nothing like sufficient to provide a basis for further investment. There are however a number of potentially negative factors:

- First, as always in India, implementation will be the major issue. One of the key reforms is to fast track the approval of important projects – it is unclear whether the establishment of the Cabinet Committee on Investment will be able to issue clearances or whether the real power still resides with the individual ministries. There are also major obstacles at the state level, for example against measures for coal price pooling which have been approved at cabinet level.
- Second, there will inevitably be measures to offset at least some of the costs to the losers from these changes. If these measures are purely transitional in nature, then that is unlikely to be a problem, but this is not necessarily the case. DB India economist Tamur Baig, has highlighted the potential benefits of the new cash transfer plan, the Direct Benefits Transfer, but these will take years yield substantial benefits. There has been a lot of positive attention given to the reduction in fuel subsidies, but the Food Security Bill could potentially increase the food subsidy bill by around 0.4% of GDP, which would more than offset the increase in diesel prices.
- Finally, there is an ongoing problem with the near paralysis which exists in parts of the civil service following the corruption scandals, which gripped the country through much of 2011 revealing the extent of the blurred boundaries between some of the larger Indian conglomerates and the public sector. The reaction from parts of the administration has been a marked reluctance to recommend or approve any sizeable projects, for fear of being accused of favouritism.

Meanwhile the underlying economy continues to deteriorate

The situation in the real economy continues to deteriorate both in terms of the quantity and quality of economic growth. The fundamental problem, which is the slowdown in investment spending in the private sector, is now being compounded by the government's efforts to achieve their fiscal targets in order to stave off downgrades from the ratings agencies. Given that there is a national election in 2014, the coalition government's efforts on containing expenditure appear to have been focused on fixed investment. Meanwhile private sector investment remains constrained by infrastructure bottlenecks and the relatively high levels of leverage across much of the corporate sector, while both private companies and state-controlled banks have difficulty in raising equity because of the reluctance of controlling shareholders to dilute their stakes. Unless the government's reforms can kick-start confidence, the Indian economy risks being drawn into a vicious circle.

There are two additional macro-economic problems, namely inflation and the current account deficit. Inflation has fallen back a little over recent months but remains far too high to justify much in the way of monetary easing. The RBI is caught in something of a dilemma. On the one hand, much of the domestic inflationary pressure is due to infrastructure and related bottlenecks, which have relatively little sensitivity to monetary policy – indeed, one might even argue that over time, easier money might even help to push down inflation through the positive effect on the investment climate. On the other hand, India's current account is increasingly dependent upon foreign portfolio flows as opposed to FDI to compensate for low domestic savings – the RBI therefore wants to maintain confidence in the rupee, and in its commitment to fight inflation. What overseas investors do not want to see is the central bank coming under pressure from members of the government, since this will soon undermine that confidence.

The equity market is a reflection of the underlying economy

The relatively low visibility and somewhat schizophrenic nature of the Indian economy are fully reflected in the equity market, which is very polarised even by GEM standards. On the one hand there is a very highly rated group of companies which are almost all privately controlled, some of them by overseas-based parents; a disproportionate number of the Indian-based companies in this group have a relatively narrow-based focus and are not part of larger conglomerates. Financial leverage among these companies is at extremely low levels – the majority have net cash. The other major group consists of much more lowly rated companies which tend to be either controlled by the state, or are part of much larger conglomerates whose main business lines are often intertwined with government, such as telecoms, power and infrastructure. The leverage levels among this latter group, which is much larger weighted by market cap, are far higher and in many cases give some cause for alarm – they highlight both the extent of the blurred boundaries between state and private and the flawed nature of much of India's corporate governance, which effectively precludes many companies from raising equity for fear of diluting the controlling shareholders. Many investors have also expressed reservations about the government's privatisation programme, which has tended so far to leave significant shareholdings in the hands of state-friendly domestic investment institutions and appears to have done little to change the way the enterprises concerned are managed.

We remain neutral/overweight India on back of commodities fall & reform agenda

By now readers may be wondering just why we are neutral/overweight in Indian equities? There are two main reasons. First, we still believe that India will be the main beneficiary along with Turkey in the GEM universe from lower commodity prices on the back of a slowdown in China – still, the initial impact is unlikely to be positive in absolute terms as the rise in risk aversion may reverse the portfolio flows from overseas on which India increasingly depends. Second, the marginal change in the direction of government policy does appear to be positive which is we believe in sharp contrast to the other four BRICS. We do however acknowledge the extreme difficulty in finding good buy ideas, as well as the risk of a sharp decline in the rupee and do not expect positive returns from Indian equities for dollar-based investors, over the next few months.

Brazil: utterly unloved on the back of state intervention and deteriorating economy, but poor sentiment is not a sufficient reason to upgrade – remain underweight

The Brazilian economy appears to be on the road to nowhere

We remain very pessimistic about the Brazilian economy over the medium and long term based upon the impact of what we see as the administration's flawed strategy of increased state intervention and import substitution on the efficient allocation of resources and private sector confidence. The consensus expectation for growth in 2013 has now fallen from over 3% to somewhere between 2% and 2.5%, largely on the back of the decline in private investment, while public investment in infrastructure remains far too slow to begin to overcome the bottlenecks, which, along with the tight labour laws, have pushed up inflation. The only potentially positive news over recent weeks is the apparent stabilisation of the real between 1.90 and 2.10 on the back of clearer indications that Dilma's administration will not stand in the way of a rate hike if the central bank deems one to be necessary to curb inflation. Whilst this might appear to be bearish, any clear indication that the central bank retains significant operational autonomy is likely to reassure the overseas investors Brazil needs to attract to fund the current account deficit.

No change likely in interventionist stance

One of the more admirable aspects of what is happening in Brazil is that the government has been very clear about its intentions. On 4th December, finance minister Guido Mantega was quoted by Bloomberg in an interview in Brasilia as saying 'it's not true that we are interventionists, but we have done reforms. Some of them hurt and would go against minority interests'. Some market commentators and economists have started to become a little bit more optimistic that the influence of the governor of the central bank, Alexander Tombini, is increasing at Mantega's expense, but we are sceptical that the administration's industrial strategy is likely to change in any way. The same consistency, by the way, can be observed in the implementation of the anti-corruption agenda which has claimed some very prominent victims, closely associated with the current government – unlike China and Russia, this campaign appears to do exactly what it says on the tin.

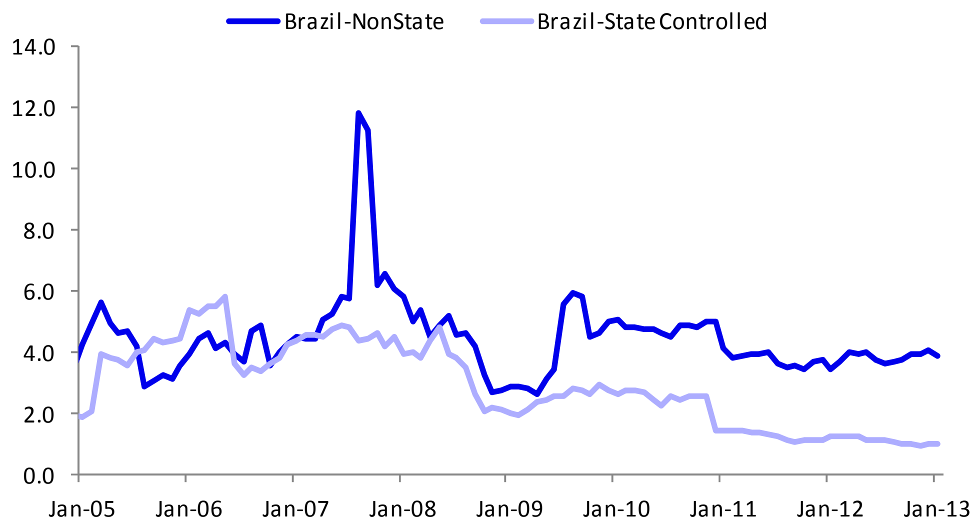
Key milestones this year are the infrastructure agenda and new mining code

The government's plans to launch a part privately funded infrastructure programme across the entire transportation sector should get underway over 2013, via a series of concession auctions. Investors will be watching the terms on offer very closely, particularly given the very adverse impact of the conditions imposed on the utility sector last autumn. The government has already announced more favourable terms for the highway concessions which are scheduled to kick the whole process off and more of these types of measures should begin to improve confidence in the private sector. The new mining code is likely to be of more direct relevance to investors in the equity market. The indications here are not so good, as it appears almost inevitable that both the rules and tax/royalty rates governing the sector will be tightened by a considerable amount. A more difficult question is the extent to which an adverse outcome has been priced in given the pronounced underperformance of Vale relative to other iron ore plays such as Rio's over the past year. If we are correct that commodity prices fall by a significant amount, then both Vale and Petrobras will be left relatively exposed, as the government preoccupation with social and political objectives over commercial considerations, will most likely preclude the sort of restructuring which many developed market based mining companies are currently undergoing.

Everyone now seems to be bearish – is it time to upgrade?

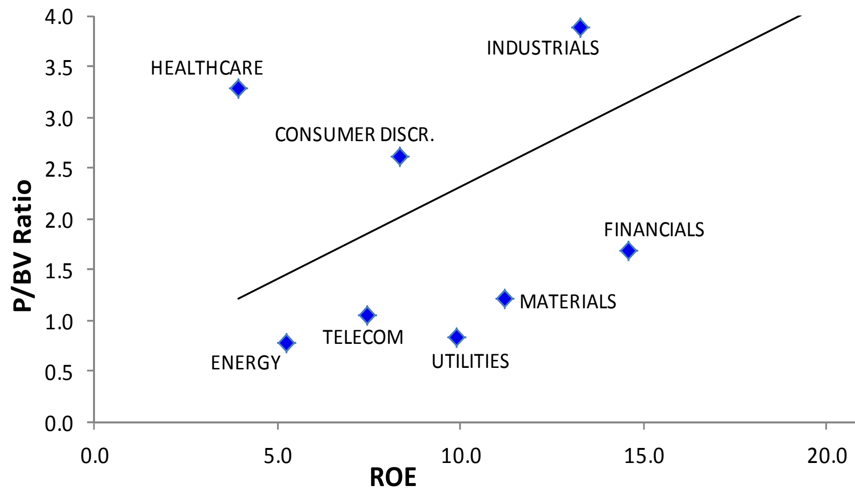
DB Brazilian economist Jose de Faria recently reported back that he had never seen his clients so bearish about the prospects for Brazil, which naturally poses the question as to whether it might be time to upgrade, after having been underweight in Brazil for two years, during which time the market has been the worst performer in the whole of GEM. We are sorely tempted, especially as we are struggling to find any other emerging markets that we really like, but we intend to remain underweight for two reasons. First, if we are correct about China and the ensuing impact on commodity prices, then Brazil stands out as one of the main casualties both in economic and stock market terms; whilst the direct exposure to lower commodity prices may not appear that high in terms of GDP, we believe that the associated multiplier effects on FDI flows and fiscal revenues could be very damaging. The currency would most likely come under severe pressure while the government's tendency to a more interventionist stance would if anything be exacerbated in our view. The other reason for caution is one which Brazil has in common with other EMs, namely that there are very few compelling buy ideas which combine reasonable valuations and improving fundamentals. In fact, even by current EM standards, the dichotomy in Brazilian valuations appears to be somewhat extreme. Figure 17 shows the extent to which privately-controlled companies have outperformed their state-controlled counterparts. Consequently, those sectors which are perceived to be relatively free of government intervention are standing at massive valuation premiums to the rest of the markets (see Figure 18); we would be very wary of much of the Brazilian consumer sector in particular.

Figure 17: P/BV of Brazilian state-& non-state controlled stocks since January 2005 (x)



Source: Deutsche Bank, Bloomberg Finance LP

Figure 18: Brazilian sectors - P/BV versus ROE



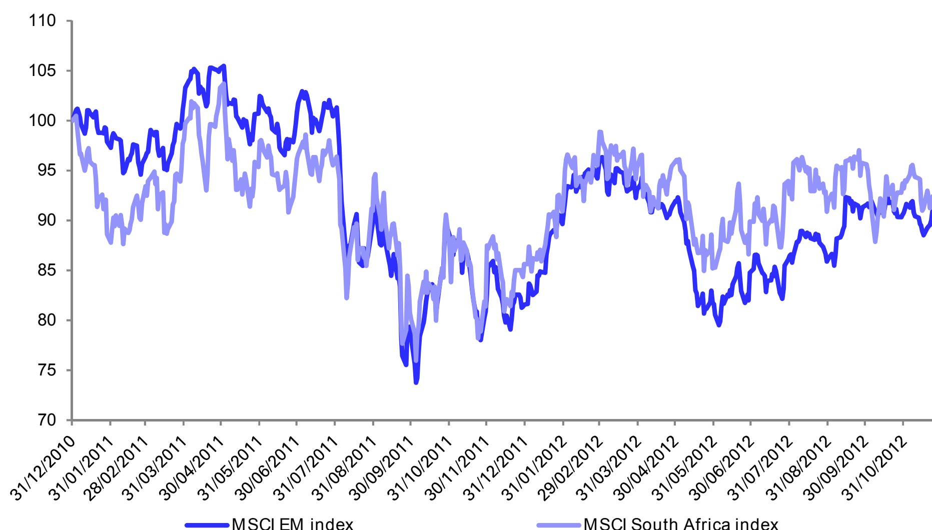
Source: Deutsche Bank, Bloomberg Finance LP

South Africa: vulnerable to China slowdown and reduced foreign portfolio flows, but strength of institutions and corporate governance should provide some downside protection – neutral

Structural shortfall in growth has resulted in weak currency over time

Every EM investor is familiar with the main problem which confronts South Africa, namely the inability of the government to engineer a growth rate which is anything like adequate to begin to absorb the large amount of surplus labour that exists within the country. There are many contributory causes, including the lingering effects of the industrial structure which became established under the apartheid-based regime, but the relationship between the ANC and the unions, which favours those inside the system at the expense of the unemployed, has also been an important factor. The most visible result, and the reason that we have always had a 'neutral' recommendation on South African equities in a GEM context, is the almost continual downward pressure on the Rand, so what excess return a dollar investor might make on South African equities is generally lost to currency depreciation. Over time, this has resulted in South Africa as a relatively low beta play on the asset class (see Figure 19).

Figure 19: MSCI SA versus MSCI EM - Total return since DB GEM Equity Strategy initiation on 1 December 2010, rebased at 100



Source: Deutsche Bank, Bloomberg Finance LP

Recent fall in Rand gives some cushion but there are major downside risks

Having been relatively bearish on the currency we are encouraged by the large number of rand forecasts being marked to market, but there are three main risks ahead which could spell further downside for what increasingly appears to be an undervalued currency.

- **First**, the relatively high liquidity and absence of restrictions on trading the rand makes it the currency vehicle of choice for many EM traders who use it as a proxy for the asset class. If our bearish view on EM debt proves correct, the market may have to absorb some fairly high selling volumes over the coming months.

- **Second**, the current account deficit is largely financed by bond flows from overseas and by exports of raw materials. Falling commodity prices combined with rising risk aversion could prove a toxic combination for the rand especially as it would be difficult for the SARB to tighten monetary policy against a backdrop of rapidly slowing growth and potential social unrest.
- **Finally**, many investors are concerned about the possibility of political disruption in South Africa head of the 2014 election. We are frankly not so concerned, because we see much of the political coverage as elevating noise over substance – our concerns are much more structural such as the impact of the increasingly blurred line between the state and parts of the private sector in promoting rent-seeking behaviour in areas such as government procurement.

We are not overly concerned about politics ahead of the 2014 election

The coverage of the political scene in South Africa in the overseas press tends to present a series of binary outcomes concerning issues such as labour unrest and nationalisation. The truth is that the real relationship between the ANC and the business establishment is complex and not at all transparent. A lot of the statements by both government and business are in our view 'playing to the gallery', especially ahead of next year's elections for the Presidency and National Assembly. While the bellicose statements of government ministers about the mining industry might appeal to much of their natural constituency, investors should pay more attention to the comprehensive defeat of Julius Malema and his nationalisation agenda, and the election of the business-friendly former anti-apartheid activist Cyril Ramaphosa, as Deputy President. Equity investors should be much more concerned with the mechanics and possible dilution caused by the process of Black Economic Empowerment, about which there is little quantitative publically available information, than with dramatic headlines about nationalisation in our view.

Corporate sector remains an exemplar of good governance by GEM standards

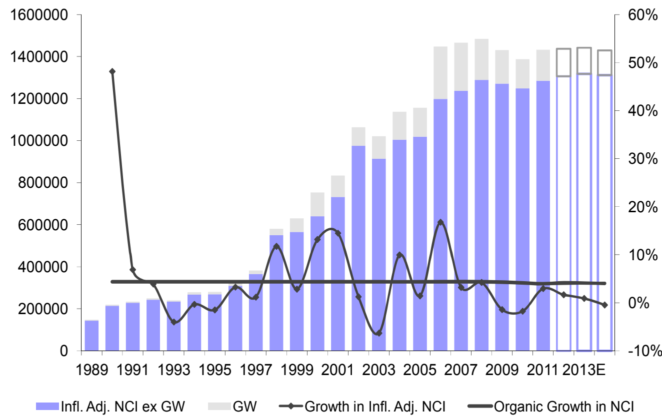
On the margin, the state has had a significant and increasing influence on the corporate sector. Nevertheless, our impression is that for the listed universe of companies, the main effect has been an indirect one, which is as DB SA head of equity research, Mike Gresty, has pointed out, to increase the costs of doing business through regulation and the indirect influence of the ANC on the outcome of wage negotiations. There has also been an increased tax burden for the mining sector through the system of royalty payments, but its difficult to think of almost any significant mining jurisdiction where there has not been some redistribution of the rents, including some developed economies such as Australia. The listed corporate sector has remained an exemplar of good corporate governance by the standards of the rest of GEM. The state has very little direct ownership in any of the big listed corporations, although the Public Investment Commission (PIC) which includes the government Employees Pension Fund is one of the larger shareholders in most of the listed companies, but operates very much in the established institutional investors framework, which is one of the key differentiators between South Africa and the rest of GEM. South Africa remains the only market in the GEM universe where there is an open market for corporate control.

State role in economy clearly increasing but in a relatively consistent way

Going forward, the ANC has endorsed Trevor Manuel's seemingly moderate and very comprehensive National Development Plan, the main thrust of which is to increase the amount of investment in the overall economy, which is rightly the government's most pressing concern. Indeed, it is possible to see this plan as partially a response to the reluctance or inability of the private sector to invest at a rate commensurate with the needs of the real economy; as DB's CROCI team's work shows, the amount of real capital invested has been declining over time, which stands in complete contrast to the rest of GEM (**see** Figure 20). Still, this has enabled the South African CROCI universe to

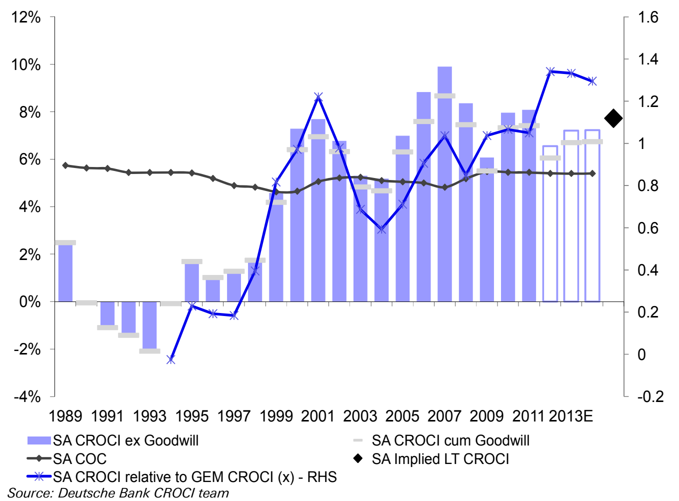
outperform its GEMs peers over time (see Figure 21). This backs up our claim that while there is much coverage over the apparent confrontation between the state and private sector, the real relationship is much less adversarial. One key test will be the ability of the mining to sector to respond to a further decline in metals prices – we do not think that the government-led moratorium of the planed redundancies at Amplats marks a significant turning point, but we will be monitoring the situation closely.

Figure 20: South African equities - Net capital invested



Source: Deutsche Bank CROCI team

Figure 21: South African equities - CROCI



Source: Deutsche Bank CROCI team

SA has a similar valuation problem to the rest of GEM

The South African investors with whom I had the pleasure of meeting during a recent visit were generally very sympathetic to the idea that one of the main reasons to be bearish towards GEM is that it is difficult to identify compelling buy ideas. My impression is that possibly the majority share our view that the emerging equity asset class has received inflows which have forced valuations above long term fair values, because they can see the effect on the high ROE stocks in their own market; my sense is that their relative reluctance to be overweight in the perceived quality plays cost much of the domestic investor base significant performance over most of 2012, but may now be staring to deliver alpha. On the other hand, our relative caution towards commodity prices does not make the miners a compelling buy either, though a weaker rand should help. Overall, I think that South African equity market will decline over 2013 in dollar terms, but in the absence of compelling overweights, I retain a neutral recommendation in a GEM context.

Appendix 1

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The views expressed in this report accurately reflect the personal views of the undersigned lead analyst(s). In addition, the undersigned lead analyst(s) has not and will not receive any compensation for providing a specific recommendation or view in this report. John-Paul Smith

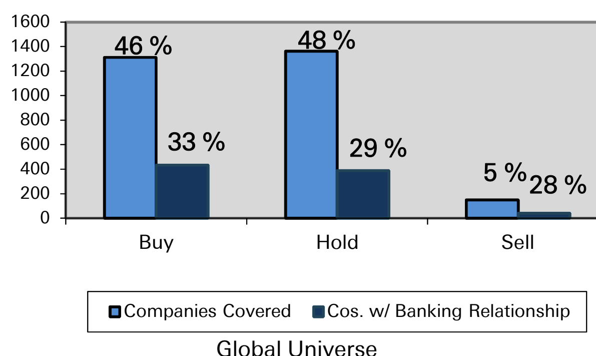
Equity rating key

Buy: Based on a current 12- month view of total share-holder return (TSR = percentage change in share price from current price to projected target price plus pro-jected dividend yield) , we recommend that investors buy the stock.
Sell: Based on a current 12-month view of total share-holder return, we recommend that investors sell the stock
Hold: We take a neutral view on the stock 12-months out and, based on this time horizon, do not recommend either a Buy or Sell.
Notes:

1. Newly issued research recommendations and target prices always supersede previously published research.
2. Ratings definitions prior to 27 January, 2007 were:

    Buy: Expected total return (including dividends) of 10% or more over a 12-month period
    Hold: Expected total return (including dividends) between -10% and 10% over a 12-month period
    Sell: Expected total return (including dividends) of -10% or worse over a 12-month period

Equity rating dispersion and banking relationships



Global Universe

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