

Summary

- Emerging markets stocks appear to be nearing a bottom, but investors will remain sensitive to Chinese growth and the direction of US rates.
- The equity valuation opportunity is significant; reforms are underway and profits should improve.
- Emerging markets debt may weaken over the short term but should gain in the second half.
- We are excited about the sovereign debt opportunity in Africa, following a recent visit.

Market Overview

During the first quarter, emerging markets were resilient in the face of tensions over Russia's annexation of Crimea and hawkish commentary from new US Federal Reserve Chair Janet Yellen. Developing markets equities ended just 0.4% lower in US dollar terms, as measured by the MSCI Emerging Markets (EM) Index, with this modest result masking a sharp slump in January due to fears about slowing Chinese growth. Worries about emerging markets current account deficits appeared to ease as the quarter progressed. Notably, Indonesian stocks rose 21% during the quarter, while equities in India, South Africa, Turkey, and Brazil rallied in February and March.

Emerging markets equity fund outflows reversed in the last week of March after a long streak of redemptions driven by the fear of rising US interest rates. We have noticed that as shorter-term retail assets have left the market over the past twelve months, longer-term institutional assets have entered, which could result in a stronger base for asset class performance and signal that the market is nearing a bottom.

Bucking the influence of negative market events, local and hard currency emerging markets debt recorded positive returns in March, thus bringing the year-to-date return of the blended 50% J.P. Morgan EMBI Global Diversified/50% J.P. Morgan GBI-EM Global Diversified Index to nearly 3%. More surprising was the outperformance of emerging markets equity and debt versus the developed world in March, reversing a trend that had, for the most part, persisted for over a year.

Emerging Markets Equity

As emerging economies exit a period of China-led growth and cheap credit, attention has turned to the economic imbalances that developed during the boom years. These imbalances and their solutions vary by country. For example, China will probably reduce investment and increase consumption while the reverse is true for Brazil. The announcement and implementation of reforms is a crucial next step, and could result in a strong upside opportunity for emerging equity markets in 2014.

A slow recovery appears to be taking place in the developed markets, which we think is ideal for the performance of emerging equities as it should revive demand for emerging markets goods (and help narrow country deficits), while creating room for policymakers to manage inflationary pressures. Rapid developed markets growth is less desirable from our perspective as it would most likely create a host of inflationary pressures that would detract from the performance of developing markets equities.

The strengthening US economy and tapering of US stimulus, however, has resulted in a rising cost of capital and widening emerging markets current deficits. We expect deficit deterioration for the five most vulnerable economies to slow in 2014 due to policy action and the passthrough effect of higher developed markets demand on emerging markets exports. Fragile Five central banks have also recently reemphasized their commitment to more orthodox monetary policy. In early January, we stated our faith in corrective market mechanisms. In our Indonesia example, we theorized that as credit tightens, consumption should decline, leading to a narrowing in the current account deficit as imports shrink more quickly than exports. There are signs that these mechanisms are working, as the rupiah strengthened in the first quarter.

This is also an election year for many developing countries, including India, Indonesia, Turkey, South Africa, and Brazil. However, we caution against reading too much into election outcomes. As one example, India will go to the polls in May, with hopes riding high on the Bharatiya Janata Party and its reformist leader, Narendra Modi. Realistically, new leadership could mean little for near-term change. Due to India's administrative structure, the federal government lacks the ability to directly implement central policies and must court the support of its twenty-eight states. It is important to keep in mind that reforms in emerging markets are already underway independent of politics. In our India example, stalled projects have been revived and meaningful reform has been passed, including the introduction of a national identification system that should help curb leakages in the distribution of social subsidies.

China continues on its long metamorphosis to a more open, consumer-driven economy. We believe that the market will continue to be sensitive to China's growth path, and recent Chinese Purchasing Managers' Index readings below 50 may add to short-term growth concerns. Premier Li Keqiang set a 7.5% GDP growth target for 2014, a number understood to be somewhat flexible but crucial to meet China's

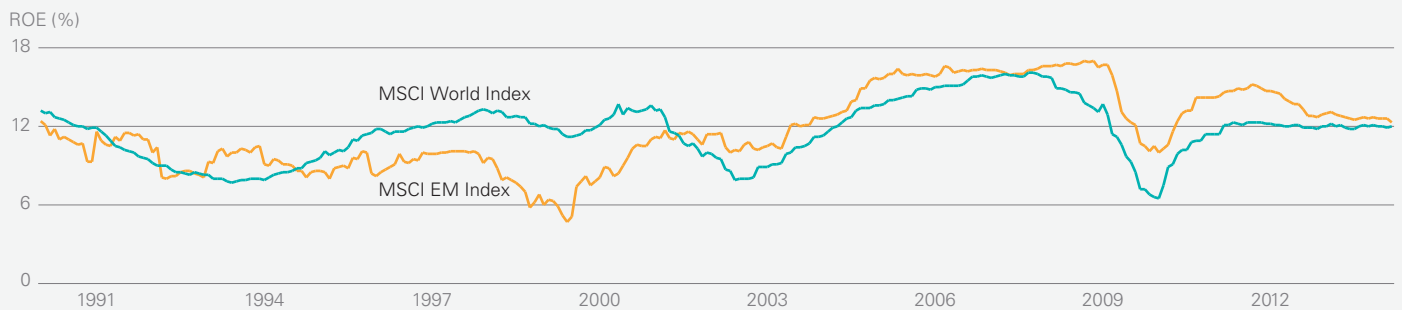
long-term growth targets, which include doubling per capita income by 2020. The recent loosening of the renminbi's managed float to the US dollar moves China closer to establishing its money as a major world currency. Chinese credit growth, which took off in 2008 and 2009, is also an issue as there is currently only a relatively rudimentary framework to handle bad debt. Authorities must decide on the treatment of non-performing loans, whether that means expanding the central government's balance sheet or transferring the burden to its provinces. Chinese stocks have de-rated from relatively expensive levels based on rapid growth to inexpensive based on credit fears, which has presented buying opportunities for our teams. Our relative value team currently holds its largest-ever absolute position in China, albeit still at a lower exposure than the EM index, and our relative growth team is also approaching a maximum position size. China is the largest country exposure in our core portfolio, but it is also the largest country weight in the EM index.

During the quarter, emerging markets small-cap stocks were less volatile than their large-cap peers for a number of reasons, which included their lower exposure to commodities and to countries that were affected by geopolitical events, such as Russia. We continue to find significant value in small caps, but the realization of that value has been somewhat hampered in the short term by emerging markets equity asset class outflows. Over the long term we expect fundamentals to reassert themselves over recent macro influences, and we continue to expect small caps to deliver a differentiated pattern of performance from large caps.

The Russia-Ukraine crisis commanded headlines in February and March, and Russian equities declined 14% over the course of the quarter although the crisis did little to dent the overall performance of emerging markets equities. For our views on this stand-off, please read our recent publication, [Reconciling Crisis and Opportunity in the Emerging Markets](#).

Emerging markets companies remain more profitable than their counterparts in the developed markets and we expect their profitability to improve as a result of industry and company consolidation and better capital management (Exhibit 1). Despite this attractive profile, emerging markets stocks continue to trade at a significant discount to developed markets as well as their own long-term history (Exhibit 2). Financial productivity

Exhibit 1
Profits Remain Higher in the Emerging Markets



As of 31 March 2014
Data shown on a trailing 12-month basis.
Source: UBS, MSCI, Datastream

Exhibit 2
Emerging Markets Stocks Are Trading at a Substantial Discount



As of 31 March 2014
Data shown on a forward 12-month basis.
Forward-looking data are not a promise or guarantee of actual results and are subject to change.
Source: IBES, MSCI, Morgan Stanley Research

has declined in the energy and materials sectors as a result of excess investment during the commodity supercycle, but the pace of these declines is starting to stabilize and our equity teams are seeing value in certain energy- and materials-related companies.

We believe that today's emerging markets equity opportunity has been matched only a handful of times in the past twenty-five years. Our equity teams, guided by their bottom-up approach, are finding and taking advantage of stock mispricings that can result from misunderstood markets. We remain bullish on the outlook for emerging markets equities over the long run, as well as the near term.

Emerging Markets Debt

While emerging markets performance was encouraging, we believe that the strong relative performance of emerging markets debt in March was more a testament to very light positioning by international investors, and less a reflection of a turn in the asset class. At current spread and currency levels, valuations in both external and local emerging markets debt appear to be stretched. As such, we anticipate that yields will move higher and currencies will weaken in the near term.

It is important to note that our view on markets is purely a commentary on valuations, and not a statement on fundamentals. In fact, the general trend of improved balance sheets and flows in emerging markets that began in the third quarter of 2013 has persisted through the first quarter of this year. The majority of emerging markets economies are witnessing improved export growth and better current account balances than last year. Further, most emerging markets central banks have acted to raise overnight rates in order to make local yields more attractive to foreign investors and help control inflation. Yet, we believe that more needs to be done on this front, with further rate hikes in countries as varied as Indonesia, South Africa, Brazil, and Malaysia, in order to stay ahead of market pressure as US Treasury yields resume their rise.

The next potential shock to global fixed income will likely materialize in the next 30 to 60 days as new US economic data is released, following the weather-related lull of the first quarter. Both the April and May economic and jobs data ought to be bereft of one-time effects, thereby giving investors the first clean picture of the underlying strength of the economic recovery since 2013. Should these numbers beat expectations (as we anticipate they will), both external and local emerging markets debt ought to come under immediate pressure as US rates rise. Given the higher outright level of Treasury yields versus last summer and the market's better understanding of tapering and normalized Federal Reserve policy, we are not anticipating a serious correction in emerging markets debt, rather, a limited one. As such, from a top-down global macro view, we are negative on the asset class in the short term; however, sustained economic improvement across emerging markets ought to result in impressive gains in the second half of the year.

As we have previously discussed, we believe that 2014 and 2015 will offer emerging markets debt managers significant relative value opportunities as return correlations among countries decline. Simply said, we see a greater instance of overvaluations as well as undervaluations in sovereign spreads and currency valuations in emerging markets debt today than we have in the past. One glaring mispricing is in African sovereign debt. Despite the many positive stories among African countries, investors seem to have taken the same brush to the entire continent and have discounted dollar-denominated bonds in this region by more than equivalent bonds in any other region that we follow. This is partly due to the lack of investor due diligence in the region as well as a lack of familiarity with some new issuers of debt in Africa. Nonetheless, having spent half of March traveling through the continent and meeting with policymakers, our investment team is particularly enthused by opportunities in Africa. The largest hard-currency sovereign overweight across our debt strategies for the last three years has been Cote d'Ivoire, which emerged from a civil war and a contested election at the end of 2010. This is a classic case of strong leadership and competent governance propelling an economy out of upheaval and into the mainstream. Cote d'Ivoire was the strongest economy in western Africa for decades before being pulled apart by falling cocoa prices and ethnic tensions. However, as a result of significant foreign aid, debt forgiveness, rising agricultural prices, and massive infrastructure investments, the country is now on track to regain its dominance in Francophone Africa. We were also very impressed with policymakers in Angola, who have initiated a sovereign wealth fund to save the country's windfall profits from increased offshore oil production. The Angolan central bank has taken a deliberately cautious stance on opening up local markets to foreign capital, in order to avoid the types of capital account inflows and outflows that have plagued other developing nations.

While Cote d'Ivoire and Angola have been long-standing positive stories, we believe that two rising stars in Africa will soon gain more investor attention. The first is Rwanda, which issued debt in capital markets for the first time in the second half of 2013 with a small-sized eurobond. While global investors probably know Rwanda as the center of a horrific genocide in the mid-Nineties, the country today is an economic turnaround story. Rwanda, a small country, generated over 7% growth per annum over the last decade, while building out modern transportation and telecommunications systems. Debt remains quite low at 28% of GDP for a country that offers investors nearly 7% yield. We expect that Rwandan debt spreads will contract approximately 50 basis points (bps) in the next 12 months as fiscal and current accounts improve, thus resulting in double-digit total return prospects for investors. The second turnaround story, located in southeastern Africa, is the large country of Mozambique. This country is yet another credit that has been overlooked by international (and emerging markets) investors due to its remote location and new entry into debt markets. Unlike Rwanda, Mozambique has massive new finds in natural resources, specifically coal and natural gas, for which foreign investment has already begun. Over the span of the next five years, Mozambique will likely become the eighth-largest natural gas producer in the world and, along with that, will export not only coal but also electricity to neighboring countries, including those in South Africa. Mozambique

is the poorest country in our coverage universe, as measured by per capita income. We believe that the coal build-out (led by Brazil's Vale) and liquefied natural gas exports (led by the United States's Anadarko) will bring significant prosperity to the country's populace. Today, Mozambique 3-year maturity debt yields over 7.5% on average and, in our view, is nearly 100 bps mispriced.

The aforementioned African sovereigns are just a few examples of multiple idiosyncratic opportunities across emerging markets. These are credits that are likely to rerate, just as their more developed emerging markets predecessors did from 2003 to 2008. From a valuation perspective, these cheap credits are a contrast to the likes of Mexico, Peru, and Philippines; all of which have credit default swaps that trade at approximately 100 bps over US Treasuries, which is very expensive in our view. Thus, while we believe that emerging markets debt as an asset class is valued to perfection, we continue to find diverse opportunities to add alpha.

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