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The Changing Face of Emerging Markets

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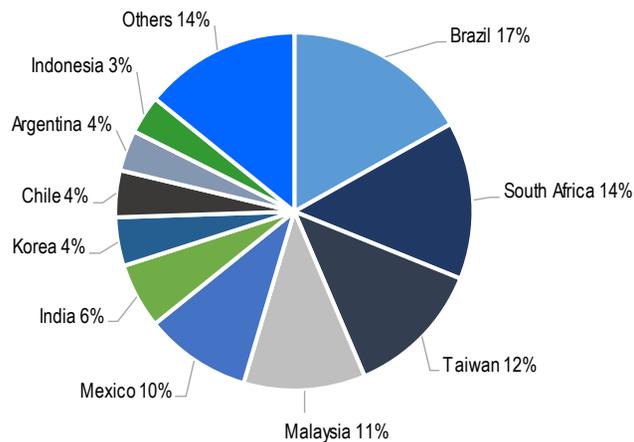
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Change #1: The shifting investment landscape

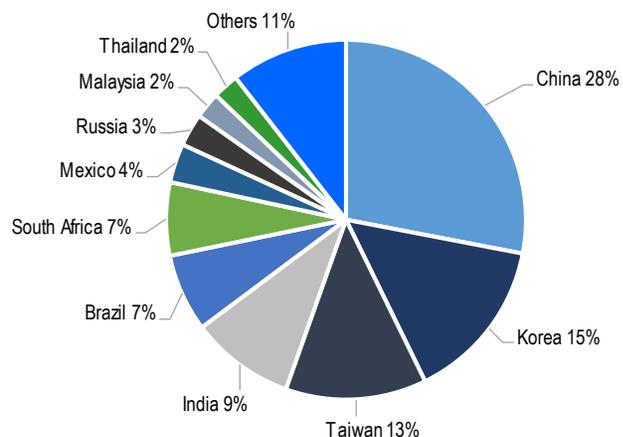


- What are emerging markets? A disparate group of countries and markets with as many differences as similarities. There is a world of difference between Taiwan/Nigeria and Korea/Brazil
- In 1990, Mexico and Malaysia drove performance, now China and India matter most
- Increased corporate multi-nationality – e.g. Samsung and Unilever
- China at 2% of MSCI ACWI is significantly underrepresented

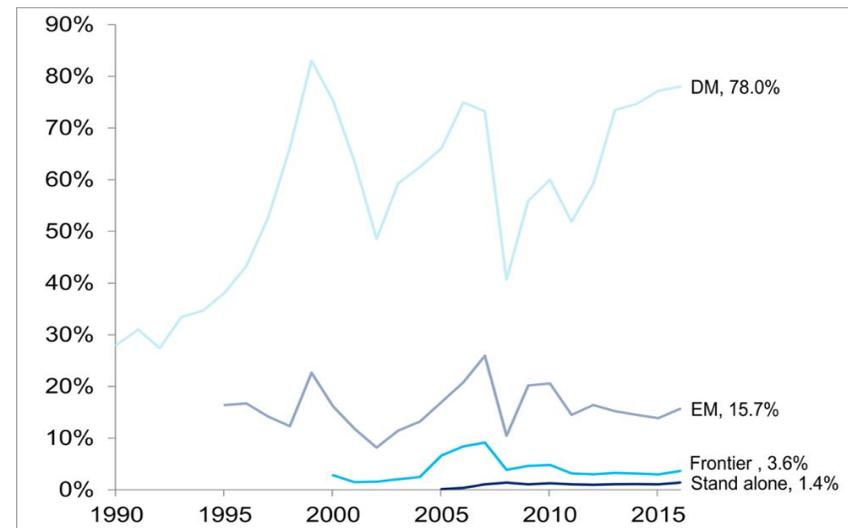
Emerging Markets 1997



Emerging Markets 2017



DM, EM and FM Market Cap to GDP



- Kuwait 28%, but a country with a small rich population is not what most investors think of as a frontier market

Source: CIT, FactSet, Citi, and MSCI. Data as of December 2016. See disclosures on page 2.

Change #1: The shifting investment landscape

- Emerging markets is a dynamic, ever-changing asset class
- Not just countries, but also sectors have seen significant change in emerging markets
- A shift from transportation to commodities to technology, and a shift from state monopolies to natural and merit-based winners

MSCI EM Index Holdings Over Time

Top ten as of 12/31/1997	Top ten as of 8/29/2008	Top ten as of 5/30/2016
Centrais Electricas Brasileiras S.A.	Gazprom	Samsung Electronics Co., Ltd.
Telecomunicacoes Brasileiras S.A.	China Mobile Limited	Taiwan Semiconductor Manufacturing Co., Ltd.
Telefonos de Mexico SAB de C.V.	Petroleo Brasileiro S.A.	Tencent Holdings Ltd.
Oil company LUKOIL PJSC	Samsung Electronics Co., Ltd.	China Mobile Limited
Unified Energy System of Russia	Vale S.A.	Naspers Limited
YPF S.A.	America Movil SAB de CV	China Construction Bank Corporation
Petroleo Brasileiro S.A.	Taiwan Semiconductor Manufacturing Co., Ltd.	Alibaba Group Holding Ltd.
Tenaga Nasional Bhd	Teva Pharmaceutical Industries Limited	Industrial and Commercial Bank of China Limited
Wal-Mart de Mexico SAB de CV	Oil company LUKOIL PJSC	Hon Hai Precision Industry Co., Ltd.
Genting Malaysia Bhd.	Sasol Limited	Infosys Limited

Source: FactSet. Data as of December 2016.
See disclosures on page 2.

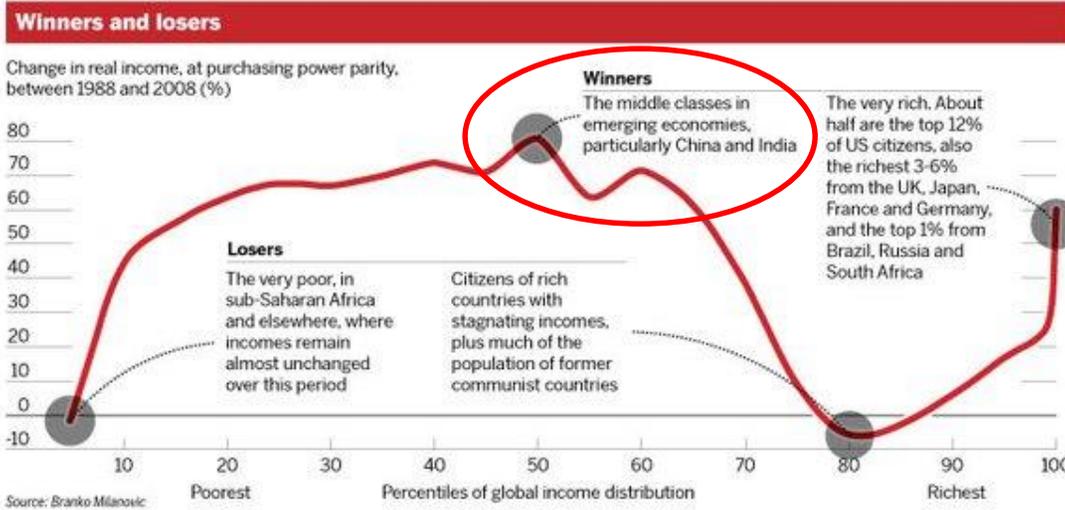
Change #2: Demographics – one change that you can count on

- The inexorable rise of the middle class – from the need for food and shelter to the luxuries of education, entertainment, healthcare, and travel
- Increased importance of domestic demand as an economic driver
- The emerging markets middle class is a big winner from globalization

Stellar growth in EM middle class

	Number (in millions) and share of the global middle class by region							
	2015		2020		2025		2030	
	#	%	#	%	#	%	#	%
North America	335	11	344	9	350	8	354	7
Europe	724	24	736	20	738	16	733	14
Central and South America	285	9	303	8	321	7	335	6
Asia Pacific	1,380	46	2,023	54	2,784	60	3,492	65
Sub-Saharan Africa	114	4	132	4	166	4	212	4
Middle East and North Africa	192	6	228	6	258	6	285	5
World	1,030	100	3,766	100	4,817	100	5,412	100

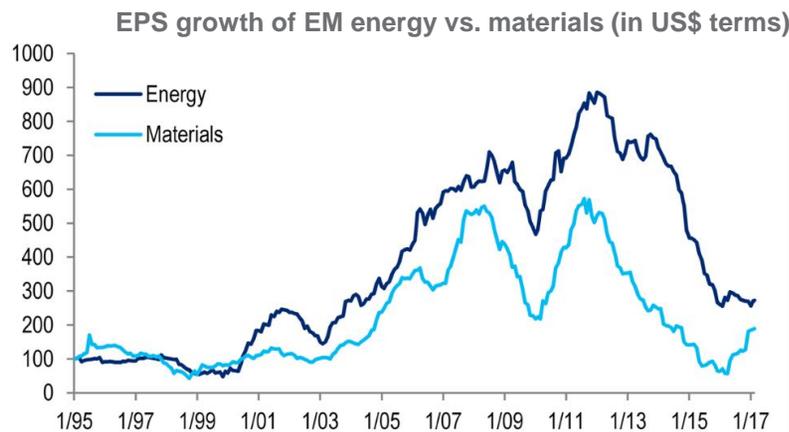
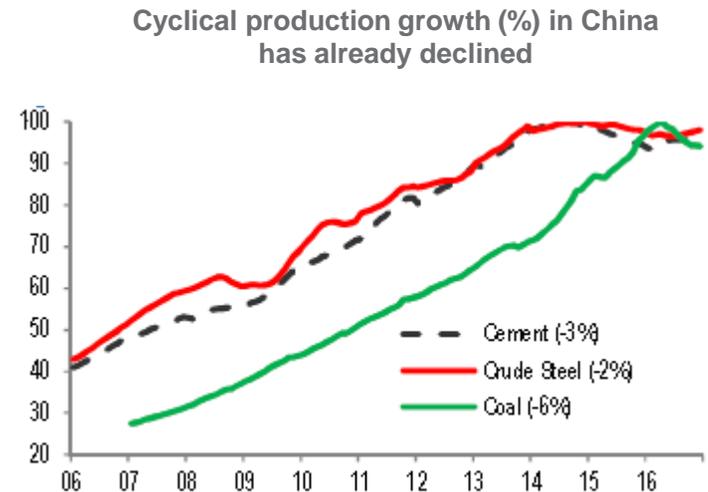
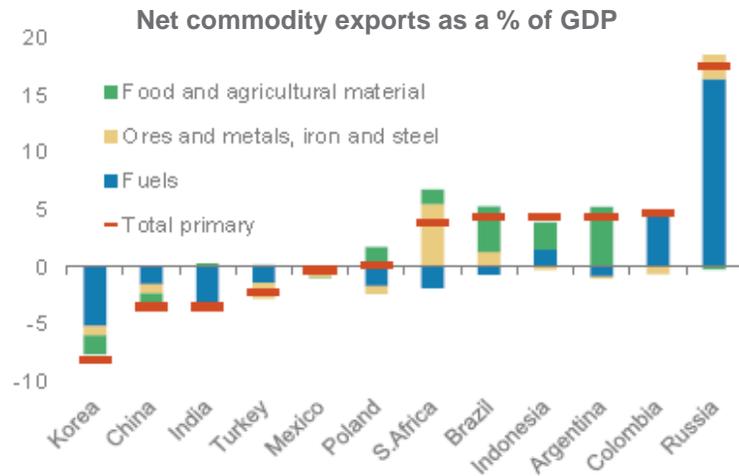
Emerging Markets middle class a big winner



Source: Top: Brookings Institute. Data as of February 2017. Bottom: Branko Milanovic. Data as of December 2016. See disclosures on page 2.

Change #3: The changing business model of emerging markets

- No longer just digging holes in the ground; the importance of commodities in emerging markets is often exaggerated and misunderstood
- Urbanization remains a driver, but the fourth bridge over the river matters less than the first three bridges



Source: Top Left: Bloomberg, IMF. Data as of December 2015. Top Right: JP Morgan. Data as of June 2016. Bottom: Barclays. Data as of December 2016. See disclosures on page 2.

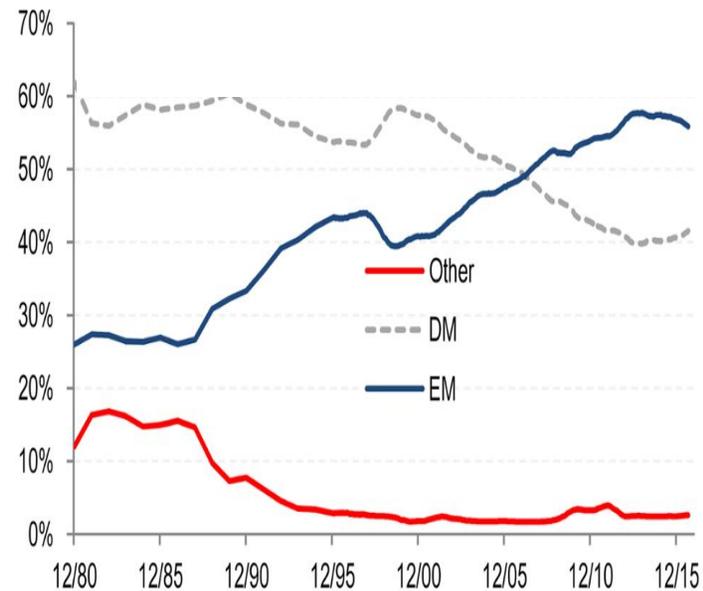
Change #3: The changing business model of emerging markets

- No longer just selling cheap goods to developed markets consumers
- More production designed for internal consumption or for export to other emerging markets

China exports as a % GDP



EM % exports by destination

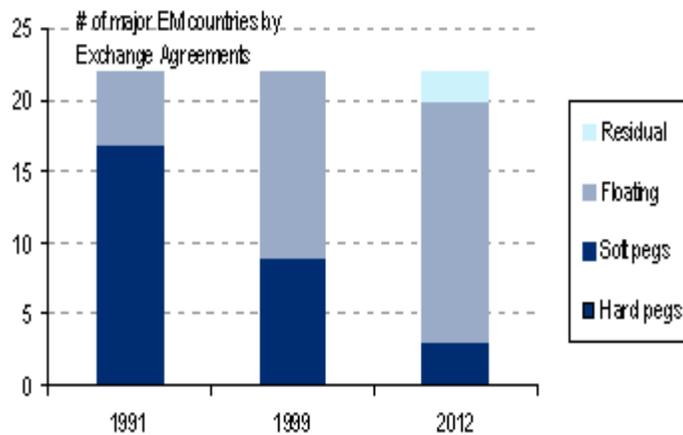


Source: Left: China Banking Corporation, UBS. Right: WorldScope, Citigroup, and Factset. Data as of December 2016.
See disclosures on page 2.

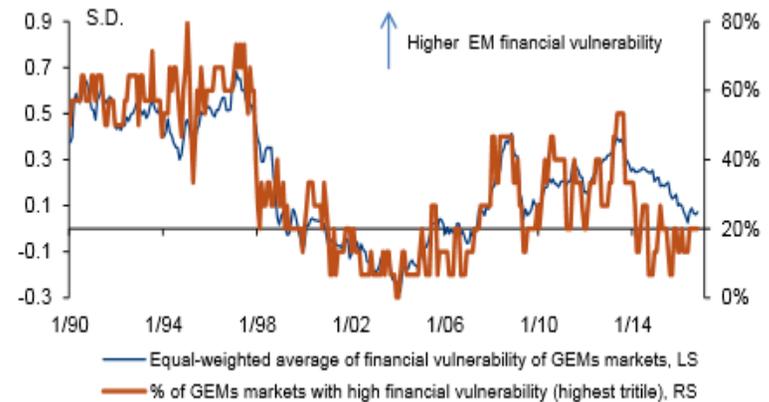
Change #4: Less financial vulnerability

- Most emerging economies (with major exception of the Chinese yuan) have floating currency exchange systems
- Currency flexibility is a natural progression from mercantilism and gives central banks more control over monetary policy
- Emerging economies are less vulnerable today due to major economic and financial reforms in the past decade
- External and fiscal accounts have significantly improved from the “taper tantrum” period

Number of EM countries by exchange agreements



Financial Vulnerability in EM

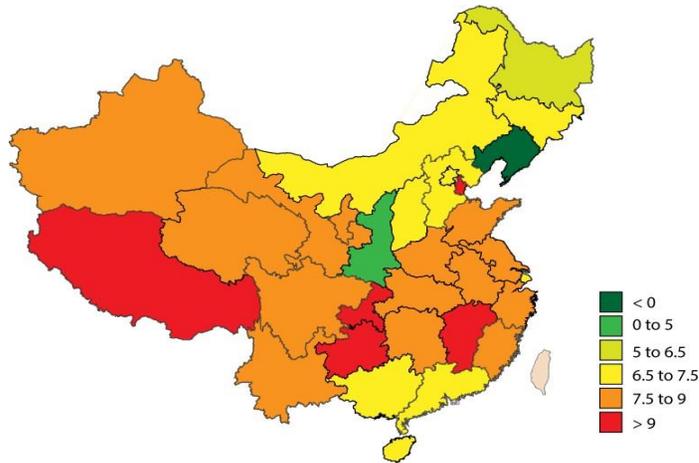


Source: Left: UBS. Right: Merrill Lynch. Top Right: Data as of December of 2016.
See disclosures on page 2.

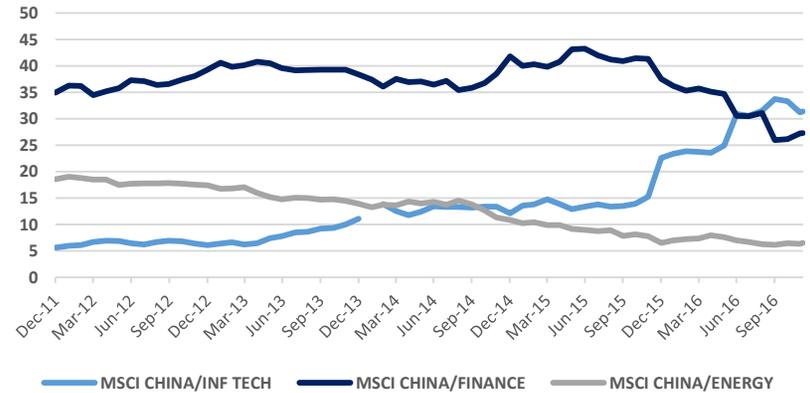
Change #5: Intra-country changes – China

- Significant sectoral and ownership changes – state ownership diminishes
- Not one economy – “The mountains are high and the emperor is far away”
- Cheap labor still relevant, but the growth of robotics is remarkable – what type of jobs do they create?

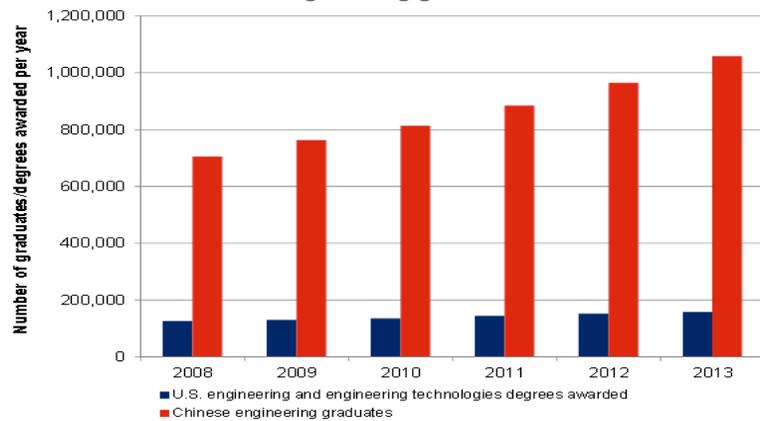
Economic growth by province 2015



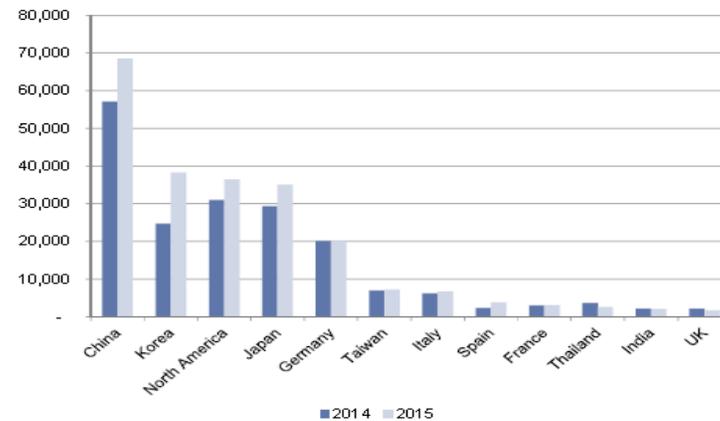
The changing face of China
Sector weights (%) over time in MSCI China



Number of engineering graduates in China and the US



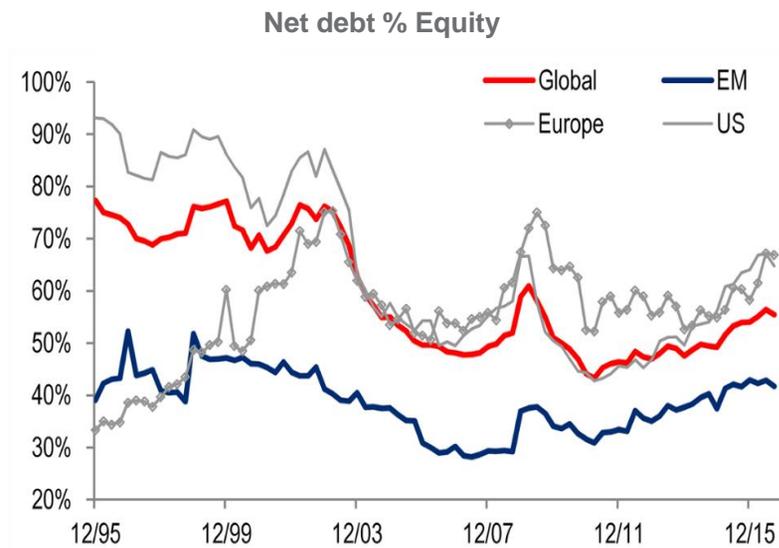
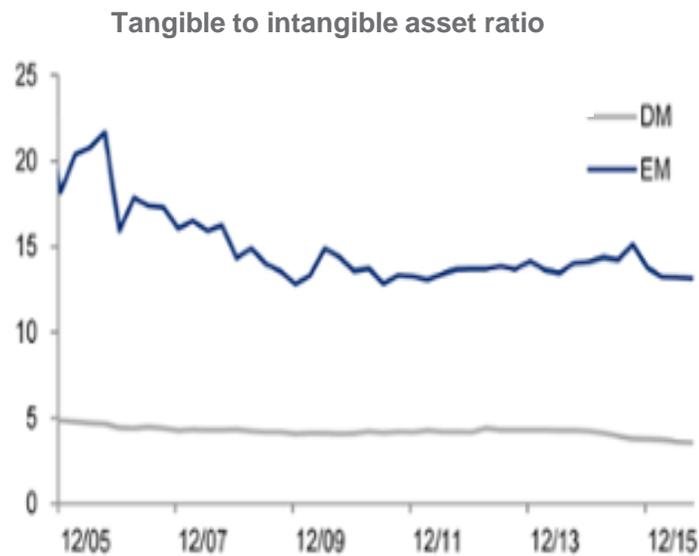
Robot demand by country



Source: Top Left: CEIC, National Bureau of Statistics. Top Right: MSCI, Factset. Bottom Left: National Bureau of Statistics, National Center of Education Statistics, Goldman Sachs. Bottom Right: International Federation of Robotics, Goldman Sachs. Top Right: Data of December 2016. See disclosures on page 2.

Change #6: Micro changes – Free cash flow

- Emerging markets are generally more capex heavy than developed markets
- Capex to sales is rapidly decreasing, leading to a significant increase in free cash flow, and in the context of under leveraged balance sheets
- A combination of return to shareholders, corporate activity or perhaps a pick-up in capex again – all have positive implications



Source: Left: BAML, Worldscope. Right: Citigroup, Worldscope. Data as of December of 2015.
See disclosures on page 2.

Change ... that's the problem with traditional passive in EM

- Yesterday's emerging markets will be different from those of tomorrow
- Big companies often there because of systematic advantages, not merit
- But, passive is a "self-fulfilling prophecy" while flows continue



Source: BAML, Haver, Bloomberg. Data as of December 2016.
See disclosures on page 2.