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**Amundi**  
ASSET MANAGEMENT



INVESTMENT INSIGHTS | MARCH 2018

# Emerging Markets: How to unlock the next wave of returns

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# EMERGING MARKET INVESTING

## No longer only a “superior growth” story

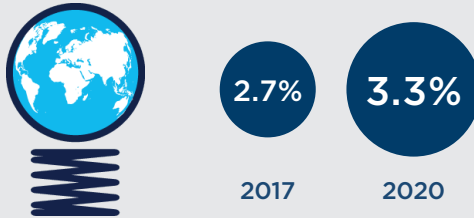
MAR 2018

### CYCLICAL CONDITIONS

#### EM might be the great beneficiary of this synchronized growth phase...

In a world of global synchronized growth, we believe that Emerging Markets (EM) are well positioned to gain an even more relevant role in the global economic landscape. EM can in fact take advantage of strengthening global demand, supportive growth momentum, positive commodities prices dynamics and sustained global trade. As a result, the EM vs DM output growth differential is expected to widen.

#### EM-DM widening growth differential



#### ...but elections in 2018 may drive geopolitical risk divergences

Political instability has historically been a source of concern for EM, in some cases driving economic/financial crisis or, worse, social unrest or civil wars. So, analysing this issue remains crucial to assessing investor sentiment (and flows) towards EM countries. In 2018, EM will see elections in a number of countries, particularly in Latin America (Latam), which could also increase divergence in terms of geopolitical risk among EM.

#### Busy EM electoral calendar in 2018



Brazil, Colombia, Indonesia, Malaysia, Mexico, Russia, Thailand

### STRUCTURAL FACTORS

Vulnerability is lessening compared to the past

EM are moving up in the value chain

Reforms will determine long-term winners and losers



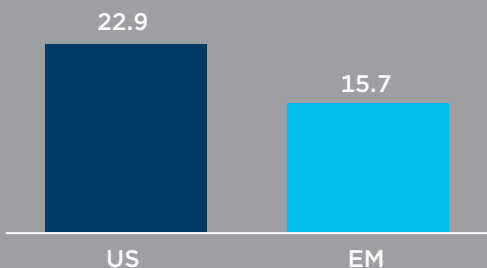
“ An integrated approach, analysing EM through multiple lenses (country, credit and geopolitical risk; macro and micro reform momentum), will in our view be key to understanding a complex and rapidly evolving world. ”

Date of First Use: 31 January 2018. Devised by: Claudia Bertino and Laura Fiorot, Amundi Investment Insights Unit.

### EM Equity

#### 1 Positive fundamentals and supportive valuations

Attractive EM vs US Price to earnings



#### 2 Corporate governance is improving and is a key performance driver



#### 3 Maturing asset class underrepresented in investor portfolios

EM Equity average allocation vs EM market cap (on world market cap)



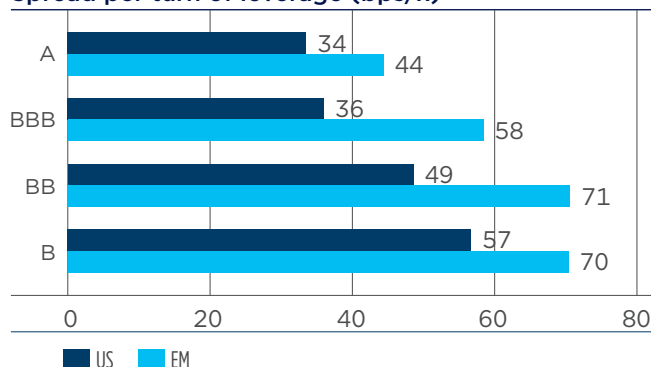
### EM Debt

#### 1 An evolving market, more resilient compared to the past

- ✓ More countries in the Global Bond Index
- ✓ Broader offering in corporate bonds
- ✓ Expansion of the local currency debt market, more resilient to currency depreciation

#### 2 EM bond offers "yield premium" compared to DM

Spread per turn of leverage (bps/x)



#### 3 Wide range of opportunities across countries, sectors and currencies

##### Multiple sources of returns



Source: Amundi Analysis on Bloomberg, BoAML, Mercer European Asset Allocation Survey 2017. Data as of 31 December 2017. MSCI indices for US and EM.

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*“An integrated approach, in which EM are analysed through multiple lenses—country, credit and geopolitical risk; macro and micro reform momentum—will in our view be key to understanding a complex and rapidly evolving world.”*

After years of buoyant market conditions that have driven strong market performance across the board, investors are questioning for **how long this “Goldilocks” regime can last** and which investment areas will continue to offer opportunities in the near future.

In this respect, we believe that Emerging Market (EM) assets still offer potential return opportunities, especially when compared to Developed Market (DM) assets, as **positive cyclical and structural dynamics are at play**. Among the most important of these, we point to the following: the transformation of EM economic models which are gradually becoming more balanced towards internal demand; the structural reforms in process in several countries; the improvement in governance at EM companies; supportive earnings growth dynamics; and the development of new markets and sectors.

All these positive factors signal bullish sentiment towards EM and help drive flows into the asset class, especially to EM debt and, more recently, a renewed focus on equities. However, **as we enter a more mature phase of the global financial cycle and a more uncertain market environment**, with central banks (CB) further tightening monetary conditions, **investors are questioning if this bonanza is set to continue**. The key question is which risks, opportunities and approaches could benefit the most in this new market phase?

In our view, while tightening of monetary policy in DM, especially the US, poses a number of challenges to EM economies and to its leveraged corporate sector, EM are now better equipped to deal with these risks. These economies are generally less vulnerable than in the past and the global economic backdrop is supporting more resilient economic models. For these reasons, **we believe that the next phase for EM will be less a story of “superior growth” and more one of “sustainable growth”**. In this new phase, **strong differences among countries will still persist and determine different development paths** and, as a consequence, areas of risk and opportunity for investors.

Given this backdrop, we think investors should **reassess the role of EM assets in a portfolio**. EM should become more relevant in strategic asset allocation.

Investors should also consider **moving away from an “asset class” perspective regarding EM** and embrace a more selective approach in order to capture country, sector or even company-specific stories and avoid areas of major risk. To do this, investors should develop a solid understanding of the macro backdrop for each country to identify the best investment themes and further exploit how to play them in EM equity and/or bond investing based on a deeper bottom-up analysis. **An integrated approach**, analysing EM **through multiple lenses** (country, credit and geopolitical risk; macro and micro reform momentum), will in our view be key to understanding a complex and rapidly evolving world. Moreover, being able to analyze an investment case looking at **the full capital structure** and bringing together varied expertise (loans, debt, equity, distressed situations) can be a distinctive competitive factor to unlock returns from all the available sources and to enhance opportunities from market dislocation.

## No longer only a ‘superior growth story’

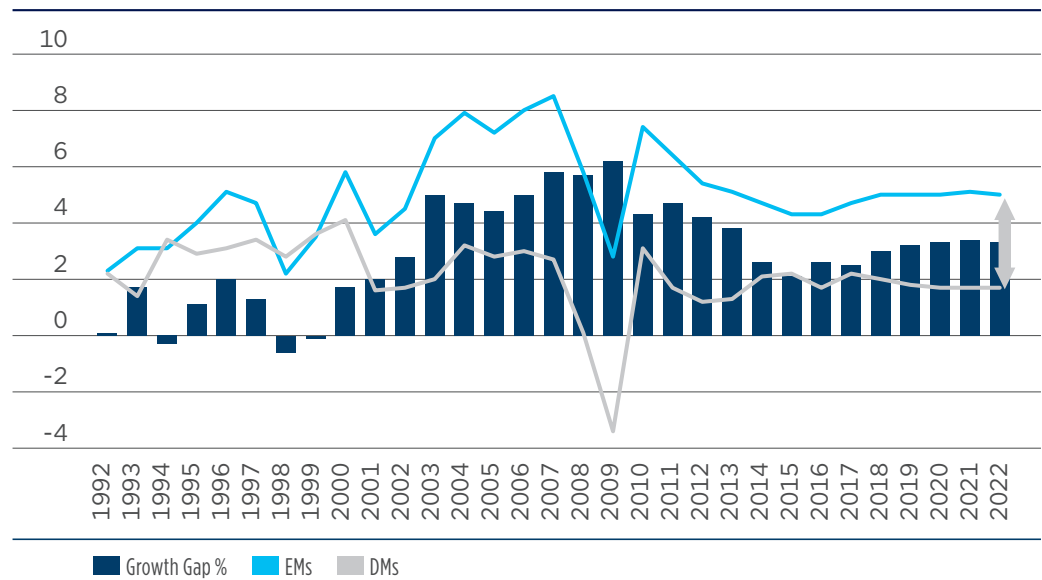
For many years, EM have been a story of superior growth: economies showing strong growth and development. And while many markets still continue to show substantial growth, other important themes are emerging. For this reason, we believe that the next phase for EM will be less a story of superior growth and more one of sustainability of growth. This implies analysing these economies in terms of multiple dimensions: internal and external vulnerability; geopolitical risk; and macro/micro reform momentum. It also means keeping in mind cyclical conditions and structural evolution, which can determine short- and medium-term opportunities for investors.

### 1. Cyclical conditions: EM might be the great beneficiary of this synchronised growth phase

In a world of globally synchronised growth, we believe that emerging economies are well positioned to gain an even more relevant role in the global economic landscape. Emerging economies can in fact take advantage of strengthening global demand and supportive growth momentum. Positive commodity prices dynamics driven by cyclical factors, supply/demand forces, and sustained global trade, could also favour these economies. As a result, the EM vs DM output growth differential is expected to widen.

*EM should continue to grow at the current healthy (or an even stronger) pace while DM will face the challenge of an ageing population.*

**Figure 1: EM vs DM GDP growth\***



Source: Amundi Research and IMF data. Data as at 31 December 2017. \*Amundi estimates for 2017 and 2018, IMF estimates for 2019-22.

EM GDP growth is forecast to maintain the current healthy pace or even improve, while an ageing population and high levels of public debt will continue to undermine the growth potential in the developed world.

The positive aggregate figure, however, masks material regional and country differences in terms of the growth outlook and the position in the cyclical phase. For example, China is now in a more advanced phase of its mini cycle; we still expect some slowdown in the short term, but not disruptive, while we expect Chinese growth to stabilize in the medium term. Russia, India or Brazil emerged from recession in 2017. As we set out below, the analysis of economic conditions which underpins investment opportunities has to go beyond the aggregate level and examine growth by single country to uncover upside potential. In this respect, we believe that Central and Eastern Europe (in particular Czech Republic, Poland) is exposed to the European renaissance story; in Asia, Malaysia, Philippines, Thailand, China could benefit from a domestic demand story, and in Latam Brazil is recording a stronger macroeconomic momentum.

*Mild inflation in EM should drive a neutral attitude from central banks, with less easing required.*

Inflation, the historically big challenge for EM, is mild in most countries, partly thanks to the fading effects of depreciation of local currencies in the past and partly due to negative output gap pressures (Brazil and Russia). Accounting for cross countries differences, we expect inflation mildly picking up while remaining within Central Banks (CB) targets, despite some upside pressure from commodity prices and the narrowing output gap, especially in Asia and Eastern Europe.

In this growth and inflation context, we would expect CB to maintain a generally more neutral attitude going forward, with less easing required amid closing negative output gaps. On the other hand, the still benign global financial environment should prevent excessive tightening by CB.

**Table 1: EM inflation vs CB Targets**

	EM Countries with Inflation Below/Within CB Targets	EM Countries with Inflation Above CB Targets
2017	Brazil, the Czech Republic, Chile, China, Hungary, India, Indonesia, South Korea, Peru, the Philippines, Poland, Russia, South Africa, Thailand, Taiwan	Colombia, Malaysia, Mexico, Turkey
2018	Brazil, the Czech Republic, Chile, China, Colombia, Hungary, India, Indonesia, South Korea, Malaysia, Peru, Poland, Russia, South Africa, Taiwan	Turkey, Mexico, the Philippines

Source: Amundi Research. Data as at 31 December 2017.

## 2. Cyclical conditions: elections in 2018 may drive the political risk, while geopolitical risks remain active

Political instability has historically been another source of concern for EM, in some cases driving economic/financial crisis or, worse, social unrest or civil war. So, analysing this issue remains crucial to assessing investor sentiment (and flows) towards EM countries. In addition to the critical evolution of the Venezuelan crisis<sup>1</sup>, in 2018, EM will see elections in a number of countries, representing half of the EM bond market<sup>2</sup>, particularly in Latin America (Latam), which could also increase divergence in terms of geopolitical risk among EM. In Latam, governments are experiencing very low approval ratings, due to corruption and sluggish growth, so a leftward turn and the re-emergence of populism are possibilities and concerns for investors, who could be alarmed by an absence of commitment to market-friendly reform.

**Table 2: Key elections scheduled for 2018**

Country	Month	Type of Election
Russia	March	Presidential
Colombia	May	Presidential
Indonesia	June	Local
Mexico	July	General
Malaysia	August (at latest)	General
Brazil	October	General
Thailand	November	General

Source: Bloomberg, data as 29 December 2017.

In **Mexico**, given the very low and declining approval ratings for current President Pena Nieto, this election could bring some change, and possibly a left-wing outcome. This has raised concerns in the market about a more radical stance and the reversal of the country's reform agenda. In **Brazil**, a crucial issue will be whether former president Lula will be able to run for the presidency. While his chances for being eligible have significantly declined as a Brazilian appeals court unanimously upheld the corruption conviction, the legal battle is not over yet. Then the elected president will matter in order

<sup>1</sup>See our report "Venezuela on the edge of the cliff", November 2017.

<sup>2</sup>Referring to the Bloomberg Barclays developing-nation local bond index, 27 December 2017.

*In 2018, we will see a number of elections in EM, particularly in Latin America, which should increase divergence in terms of political risk among EM.*

to prevent the country from falling through a more populist political development and effectively going ahead with a much needed reforms' program.

**Colombia** will have both legislative and presidential elections in 2018. Here, the previously revolutionary paramilitary group (FARC) will run, following a peace agreement with the government. The equilibria are quite fragile, so investors are likely to be concerned about outcomes which could derail the transition process of the country.

We don't see much uncertainty regarding **Russia's** elections: Vladimir Putin is expected to win with not much opposition. In **Malaysia**, the current prime minister is the favourite to win.

We think that elections may trigger possible spikes of volatility, especially in Latam, but also may open up opportunities for investors. Thus, they remain important elements to monitor in the short term, driving investor sentiment, and in the medium term to assess the momentum of reforms.

In addition to political changes, geopolitical issues will continue to constitute a source of volatility for EM, with North Korea and the Middle East being the most critical areas, having direct implications for both EM and DM financial markets.

US protectionism remains also an evolving issue, especially linked to Mexico and China. The recent increase of protectionist measures issued by the Trump administration, targeting specific products and sectors, seems so far contained and not aimed at generating deeper trade conflicts, but it is a risk which needs to be closely monitored.

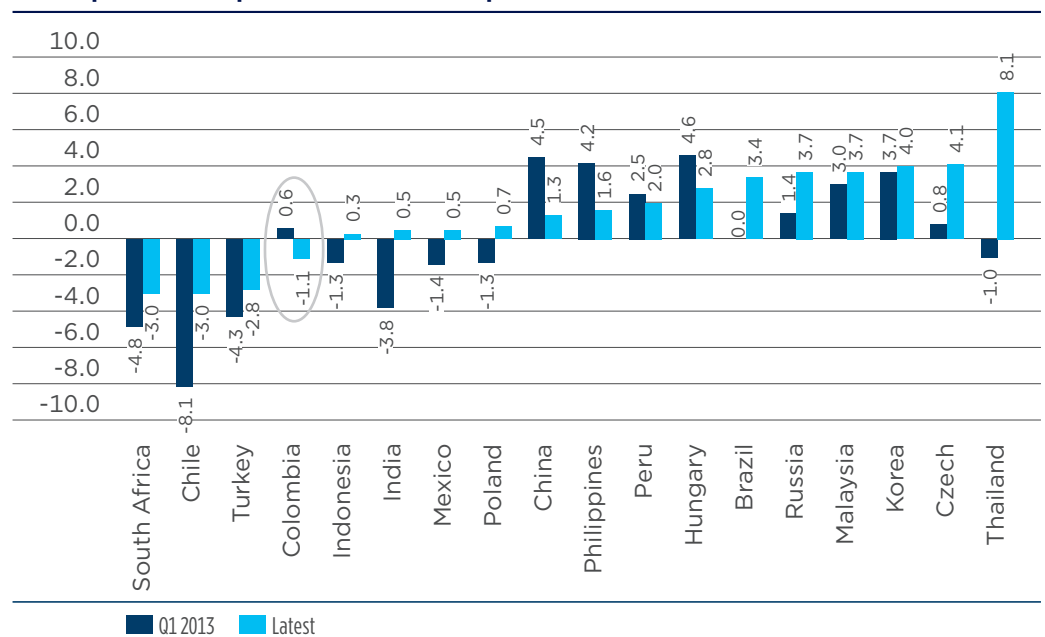
### 3. Structural dynamics: vulnerability is lessening compared to the past

In assessing EM opportunities, besides economic backdrop and geopolitical risk, we believe it will be crucial to look at their vulnerability to external shocks. The highest risks in this respect are, in our opinion, a faster-than-expected Fed tightening (higher rates, and eventually stronger dollar) or harsh protectionist policies.

Since the Great financial crisis, corporate leverage has started to rise. Borrowing by non-financial corporations has grown particularly fast, in all markets, but especially in Asia. This trend now seems to be stabilizing, and in some economies, leverage has started to decline from peak levels, thanks to the rebalancing of economies away from some credit-led industries. Considering that the build-up of debt has been encouraged by the low rate environment, a potential global liquidity tightening poses an obvious financial sustainability challenge for EM.

*With regard to external balances, conditions have improved markedly since the 2013 Taper Tantrum.*

**Figure 2: Basic Balance in EMs (Current Account + Net Direct Foreign Investments) has improved compared to the 2013 Taper Tantrum**



Source: Amundi Research and IMF. Data as at 8 January 2018.

In particular, a faster-than-expected interest rate normalisation in US monetary policy would put pressure on leveraged corporates and on highly indebted countries. The stronger US dollar which would result from a more aggressive tightening could hurt corporates with asset liability mismatches in their balance sheets, as well as countries with high levels of hard currency debt, and could negatively affect the FX reserves needed to protect currencies from an excessive depreciation.

Our analysis shows that as far as external balances are concerned, conditions have improved markedly since the 2013 Taper Tantrum<sup>3</sup> for almost all countries, Colombia being the main exception.

**A 3.5% 10Y US Treasury rate is the critical level to watch for with regard to testing EM stress.**

Even if we cannot exclude periods of market volatility with certainty, we believe that EM should prove more resilient and avoid major disruptions. A 3.5% 10Y US Treasury rate is the critical level to watch for with regard to testing EM stress: if reached aggressively, this could put pressure on the overall EM investment universe and, in particular, on countries with which heavily rely on external borrowing.

Other areas of concern for these economies relate to a possible sharp rise in the oil price (which could occur if equilibria in the Middle East breaks down) and, more broadly, of commodity price shocks. This, in fact, would fuel inflation, negatively affect oil/commodity importers, and damage local currencies, possibly triggering monetary policy tightening. Also in this case, high heterogeneity could persist. China, Brazil, India and Mexico are countries with relatively low commodity import dependencies while, for example, South Korea is in the opposite position<sup>4</sup>.

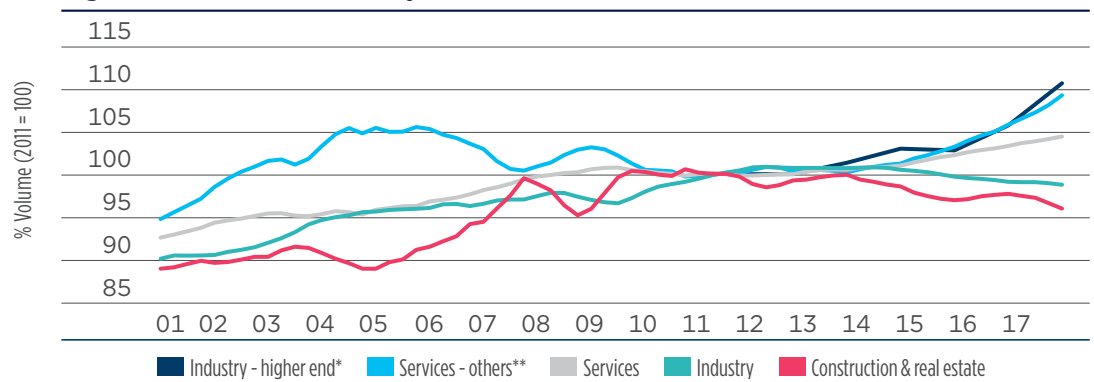
Flexible exchange rates act as an automatic stabiliser for fundamentals in the event of external shocks, like commodity shock, so we could expect currencies to bear the brunt of adjustments in the first place should an external shock occur and mitigate this risk.

**Emerging economies could take advantage of the positive cyclical backdrop to boost structural growth engines.**

#### 4. Structural dynamics: moving up the value chain

The benign economic backdrop should provide EM with the opportunity to focus on boosting long term growth prospects through quality investments, moving up the value chain from low value-added industries to higher value-added activities. In our view, this is an important condition because it should make these countries less vulnerable to external shocks and could facilitate income distribution and the development of a middle class. In China in particular, the structure of the economy is shifting towards less debt dependent and more efficient sectors. The output share of the industrial sector and the industrial employee share peaked in 2012, and since then, they have declined in favour of services and skilled industrial sectors. The overcapacity cut over the last couple of years in low skilled industrial output could act as an additional boost for the second phase of the reallocation towards service sectors. A higher service share in the economy should help to increase the labour's share of GDP and support household consumption<sup>5</sup>.

**Figure 3: China GDP Share by Sector**



Source: CEIC, Amundi Research. Data as at January 8, 2018. \*Industry - higher end: machinery, auto and electronics. \*\*Services - others: services excluding transport, retail & wholesales, accommodation & catering and financials.

<sup>3</sup>2013 Taper Tantrum refers to the sharp increase in US Treasury bond rates which occurred in 2013 as a consequence of investor reaction to the news of Fed tapering of its liquidity injection into the system.

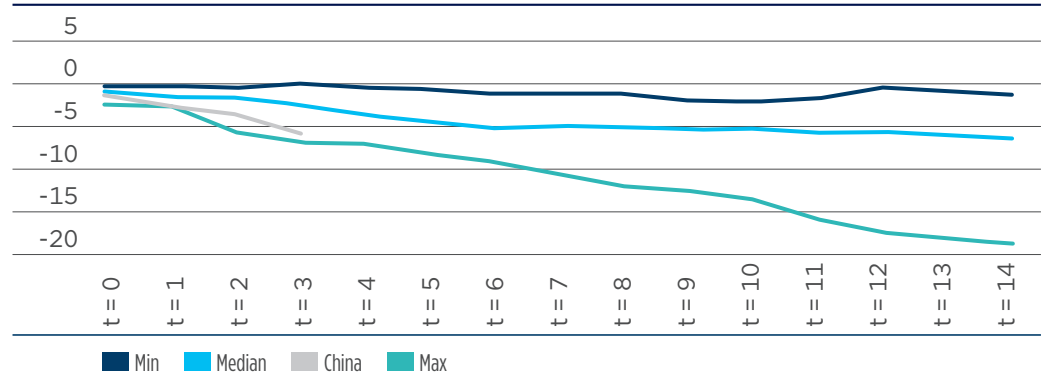
<sup>4</sup>United Nations, Commodity and Development report, 2017.

<sup>5</sup>Source: IMF Working Paper "Rebalancing in China—Progress and Prospects", September 2016.



This transformation has further room to go. If we compare China with other international experiences, we see that this process starts when a country reaches a level of GDP per capita close to USD10,000 (it takes years to be completed). As a term of reference, industrial sectors now account for around 40% of Chinese GDP and this number is just above 20% in developed countries.

**Figure 4: Deindustrialization similar to other countries. Change in nominal industrial share after peak, in % of GDP**



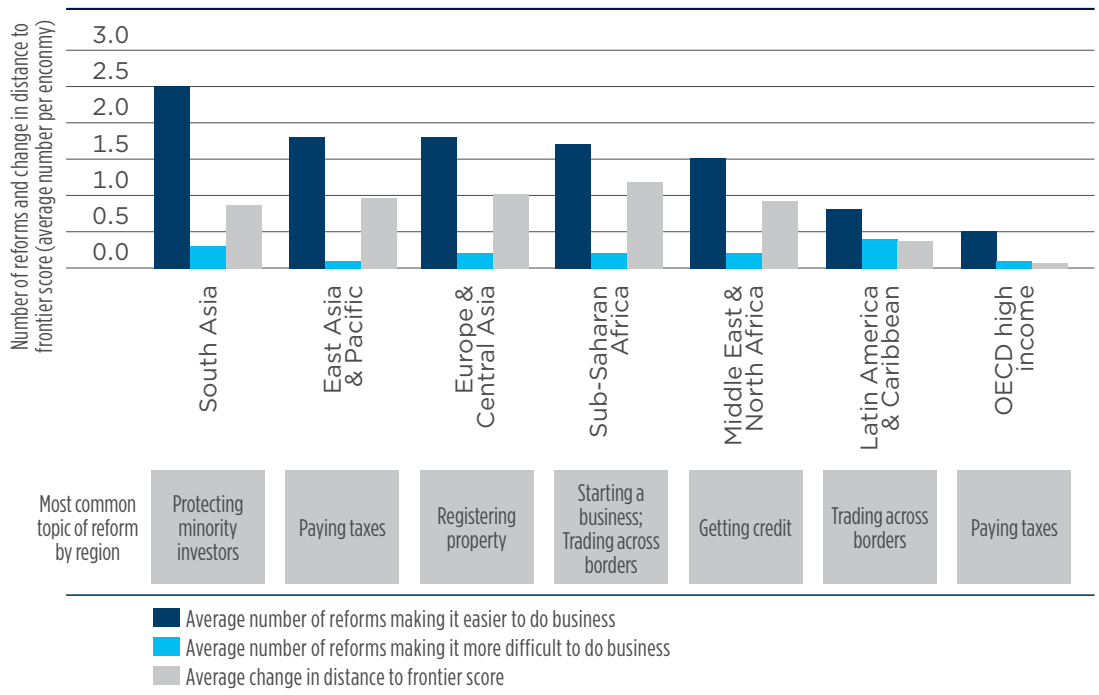
Source: Maddison database, GGDC database, IMF staff calculations. Note T=0 is defined as the year when the nominal share of industrial sector in GDP peaked. Countries in the sample include nine advanced economies.

*Structural reforms are an important area driving heterogeneity in EM, as they are key to assessing why these economies are evolving at different speeds.*

**5. Structural dynamics: reforms will determine long-term winners and losers**

Structural reforms are an important area driving heterogeneity in EM, as they are key to assessing why these economies are evolving at different speeds. The best performing countries, with most successful rates in implementing the structural reforms in multiple areas (social, economic, financial markets), are those with the higher ability to generate a sustainable growth in the medium term and to develop attractive financial markets. As detailed in the graph below, based on 2018 Doing Business rankings, Thailand, India, Zambia and Nigeria have recorded the most notable improvement. South Asia was the most active area in terms of reforms in 2017, with a focus on protecting minority investors.

**Figure 5: The average number of reforms per economy is the highest in South Asia, but the average impact is the largest in Sub-Saharan Africa**



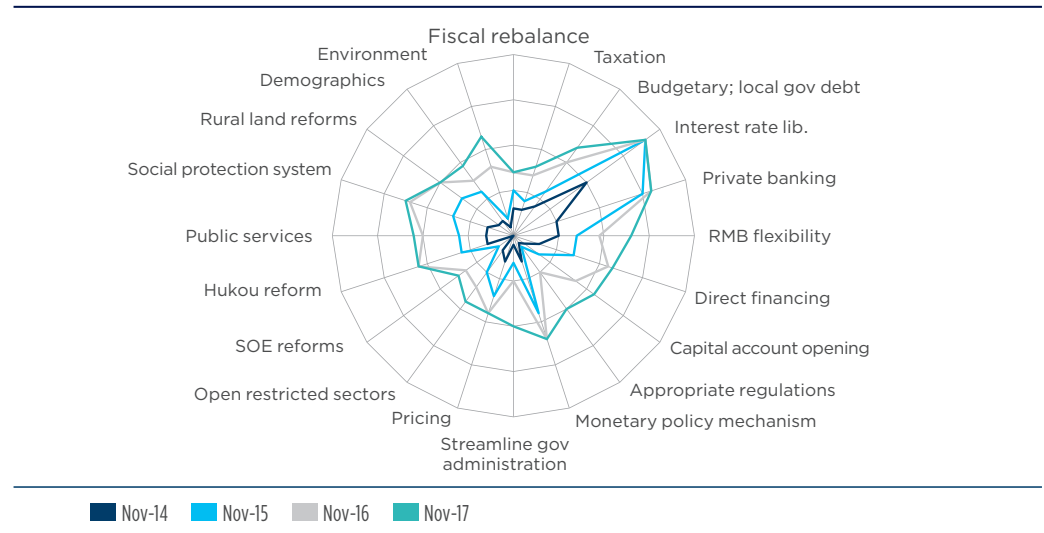
Source: Doing Business database. The average change in the distance to frontier score shows the change between Doing Business 2018 and Doing Business 2017.

*Regarding track record in implementing structural reforms, we believe that China, India and Nigeria are the most attractive countries.*

Also in China, structural reforms are proceeding in the direction of “Quality Growth”, first defined in the Third Plenum in 2013. On the fiscal side, important achievements have been reached, including the replacement of the business tax with a value added tax and the introduction of measures for fiscal rebalancing between central and local governments. Financial reforms are proceeding at good pace, with the interest rates liberalization, the substantial opening of banking and insurance sectors, the ongoing efforts to break RMB pegging, the benchmark inclusion for equity and bond markets. A landmark development is also the draft of regulation guidelines for bringing the broad asset management businesses under a single unified regulatory system. The new regulation will target de facto underlying businesses, also covering, for example, off-balance sheet wealth management products, online funds and various shadow banking, in order to have more unified and proper regulations to prevent new risks from developing. This is a key step in the ongoing strengthening of financial regulations which we believe is one of the key solutions for China’s debt issue, currently the major challenge that could harm EM growth in the future. Much of new debt/leverage/shadow banking in recent years resulted from financial liberalisation and simply required regulations to catch up in order to fill the holes, rather than to bring major disruption. Besides regulation supporting financial stability, we expect that the direction of reforms will continue to include supply side reforms (which have already generated a meaningful reduction in overcapacity in some industries, especially materials) and reforms which will focus on the market role (i.e. Government administration and red tape; mixed ownership for the SoEs, the state owned enterprises). Social reforms (including income shifting, demographics, environmental) and political (anticorruption) are also already happening and we see their impacts starting to pass through, for example in the household savings preference, which is dropping amidst the better social security net created by the reformed social protection system.

Regarding the track record in implementing structural reforms, we believe that China, India and Nigeria are the most attractive countries.

**Figure 6: Amundi’s China reforms tracker**



Source: Amundi Research. Data as at January 22, 2018.

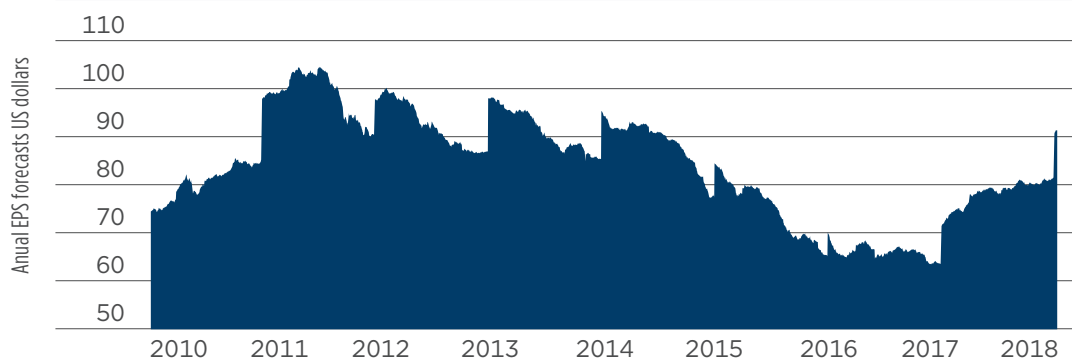
## 2. Supporting factors for EM equity investing

*EM earnings growth, attractive valuation vs DM, and strong cash flow generation should further support positive returns in EM equities.*

### 1. Positive fundamentals and supportive valuations

We expect positive equity market returns to be driven by improved earnings growth. After a period of declining EPS, EM are finally showing some earnings growth, a situation that we expect to remain in place in 2018 considering the supportive macro framework and the still favourable financing conditions.

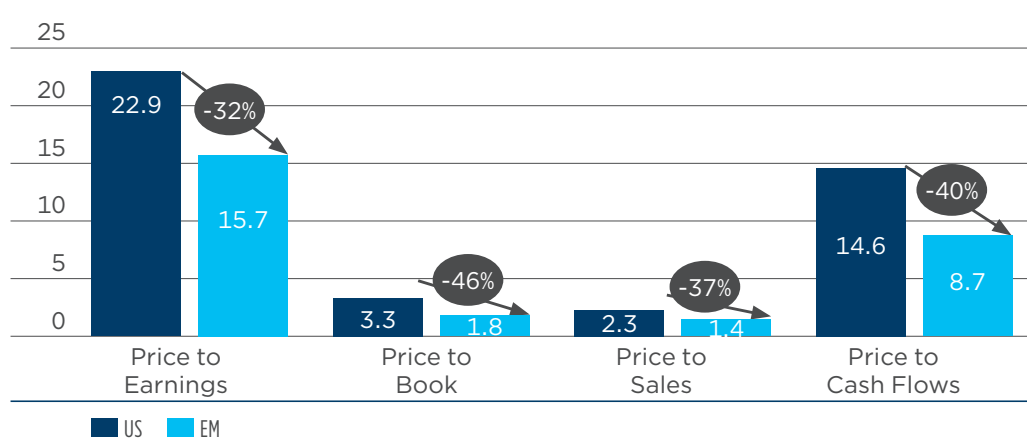
**Figure 7: Forecasts for corporate earnings on the MSCI Emerging Markets index have been raised for the first time since 2010**



Source: Amundi analysis on Bloomberg data as at January 8, 2018.

The pickup in growth and the synchronized global recovery should continue to support industrial sector earnings, with benefits from operating leverage seen as well. A positive commodity outlook should favour material/energy sectors (i.e., improvement in commodity prices led by supply/demand rebalancing). But EPS growth should also be experienced by IT consumer-facing stocks, which are still experiencing fast growth. And from a valuation perspective, EM still look attractive especially vs DM, with value/traditional economy sectors offering the best upside (i.e., financials, industrials) in countries such as China and Brazil. Finally, we also note that stripping out IT/consumer stocks, valuations are even more compelling.

**Figure 8: EM valuation metrics more attractive vs DM**



Source: Amundi analysis on Bloomberg data as at 29 December 2017. Index MSCI USA for US and MSCI EM for emerging markets. Price/earnings is the ratio of a market's current share price compared to its estimated per share earnings for the current year. Price/book value is the ratio of market price of a company's shares (share price) over its book value of equity. Price/sales is the ratio of a market's price to its revenue per share for the trailing 12 months. Price/cash flow compares a market's price to its level of annual cash flow.

*Not just 'quantity': quality of earnings has also materially improved.*

We do expect EM equities to benefit more and more from improvement in micro-economic conditions. In particular, there has been a visible improvement in the quality of earnings in EM, where earnings growth has been backed by strong free cash flow (FCF) generation, with the FCF yield rising in EM Asia compared to the US for the first time in a decade. Consequently, we view EPS growth and the improvement in its quality to be key return drivers in absolute and relative terms.

**Figure 9: Strong Free Cash Flow generation in EMs**



Source: Bloomberg. Data as at December 29, 2017.

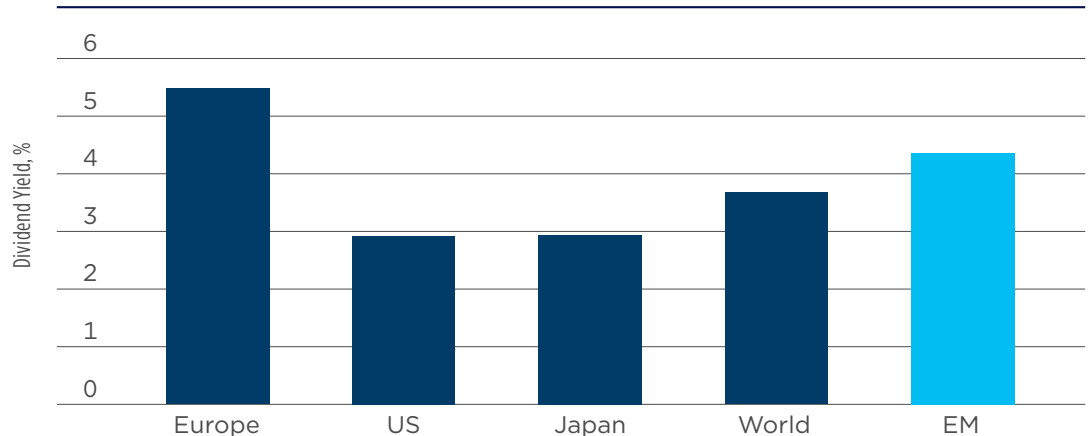
*Improvements in corporate governance are also helping to build the case for EM equity and driving outperformance for those companies leading in terms of ESG standards.*

## 2. Better Corporate Governance

The improvement in quality of earnings is occurring in a context of stronger corporate governance which has been ongoing for the last two decades at both firm and country levels, even if with large differences among countries.

The improved corporate governance translates in an attractive dividend payout of EM companies compared to some major developed economies, which signals, in our view, the willingness of these companies to reward investors and make them attractive for investors in search for income opportunities.

**Figure 10: EM High Dividend Stocks offer attractive income**

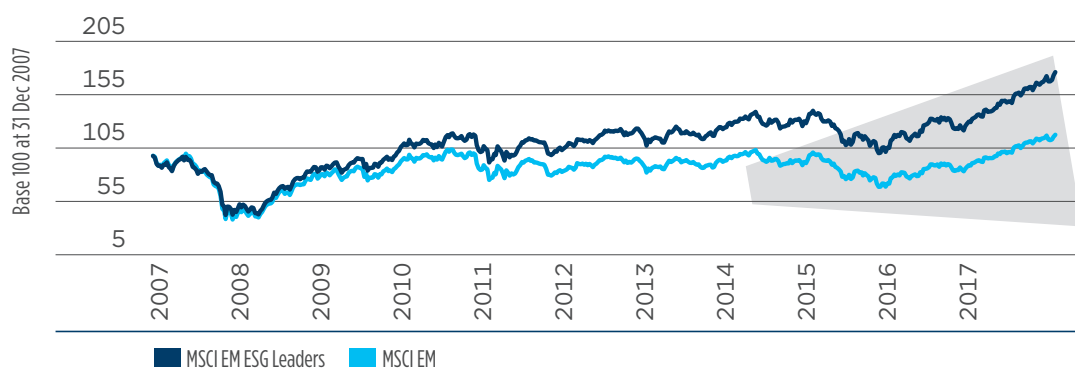


Source: Bloomberg. Data refers to MSCI High Dividend indexes for the different areas. Data as at December 29, 2017.

Strong corporate governance and the presence of investor protection frameworks ensure that whoever provides finance to corporations receives a return from those investments – thus, it is crucial for attracting capital inflows. Strong corporate governance fosters resilience to financial shocks, as, in the crisis phases, investors tend to dump the most opaque companies first.

In addition, strong corporate governance usually results in more robust balance sheets, providing access to longer-term financing, which generally protects firms from financial instability, thus enhancing attractiveness to investors<sup>6</sup> In EM, where there is still room for improvement in governance and Corporate Social Responsibility (CSR) disclosure, a focus on selection based on ESG (Environmental Social Governance) criteria, and in particular on governance, has been a key determinant for outperformance (see Figure 11) and this should continue, in our view, to be a key selection criteria in the search for opportunities in the future.

**Figure 11: ESG matters in EM equity**



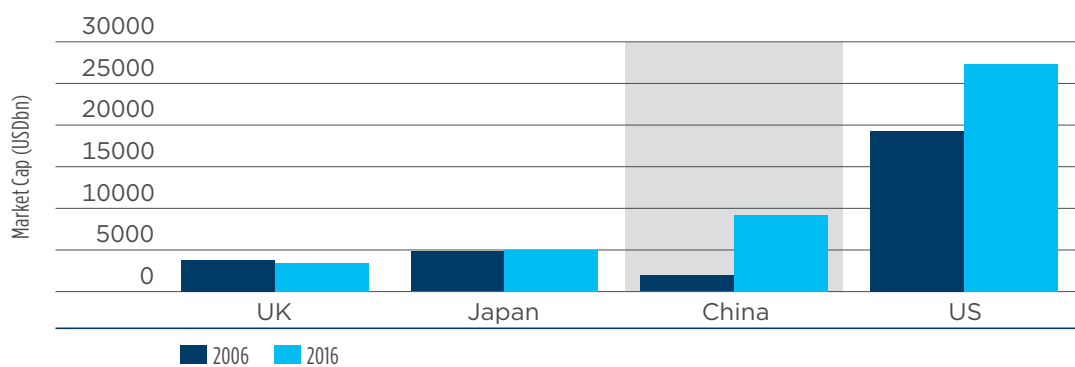
Source: Bloomberg. Data as at December 31, 2017.

*EM and China in particular currently make up an increasing part of the global equity universe. Sector composition is also more balanced compared to the past. With investors still under-invested in this asset class, we believe EM equity has room to attract a greater role in asset allocation.*

**3. Maturing asset class still underrepresented in investor portfolios**

While still representing a limited share of the whole investible space, EM indexes are becoming more diversified. At its inception in 1998, MSCI EM included just 10 countries representing less than 1% of world market capitalization. Today, it consists of 24 countries representing around 11% of world market capitalization<sup>7</sup>. As an example since the establishment of the Shanghai & Shenzhen stock exchanges, the Chinese equity market has continued to rise, the number of listed companies has increased from eight in 1990 to 3,000 today, and the market capitalization is now about USD7tn, second only to the US.

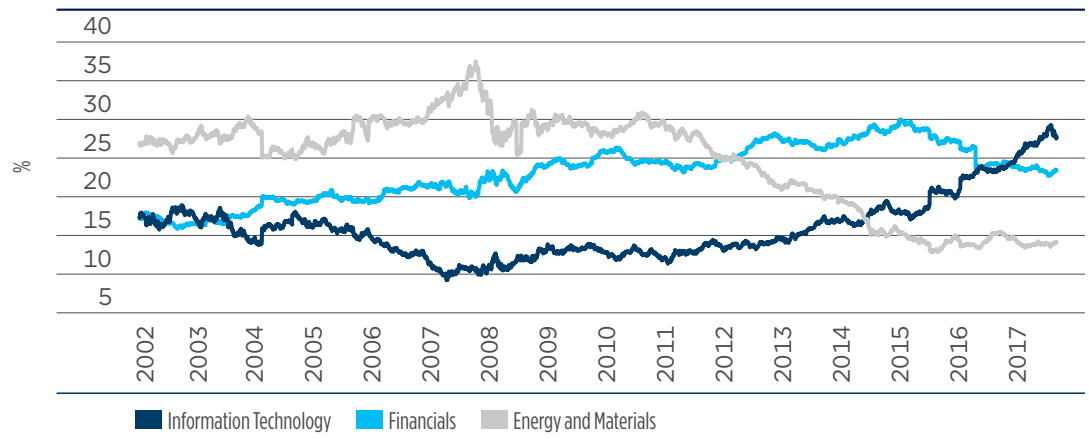
**Figure 12: Chinese equity market now second by market capitalization**



Source: WFE, FTSE. China = Shanghai & Shenzhen Stock Exchanges Listed and Hong Kong Listed China H-Shares. US = NYSE; Nasdaq, UK=LSE). Data as at December 31, 2016.

The sector composition of the equity index has also evolved, mirroring the evolution of EM economies. Information technology in particular has been a rising star in EM and now accounts for 25% of the index (34% in the Asian EM index) while energy and materials have constantly diminished. In fact, their share in the index has fallen from a peak of 36% in 2008 to just 14% in 2017.

<sup>6</sup>IMF, Financial Stability Report, Chapter 3, October 2016  
<sup>7</sup>Source: MSCI, <https://www.msci.com/emerging-markets>

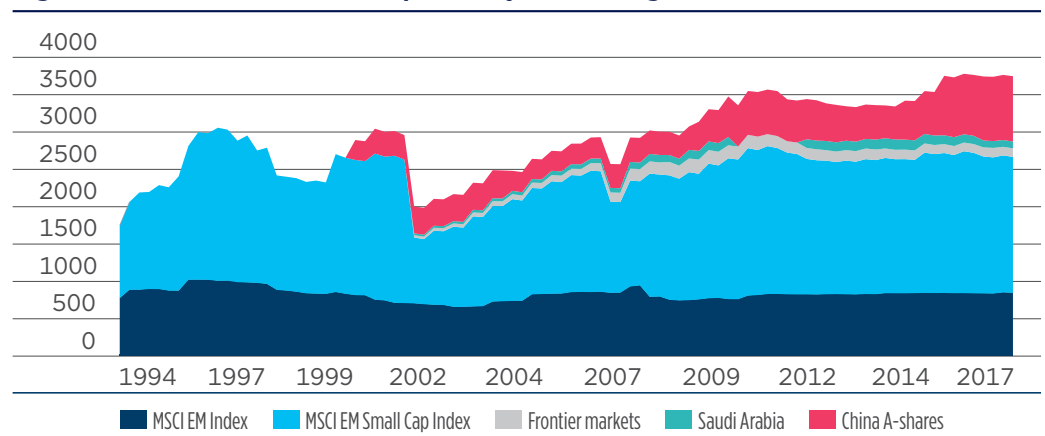
**Figure 13: Evolution of sector weights in the EM index**

Source: Amundi, Factset. Data as at January 8, 2018.

*EM benchmark indexes still do not keep the pace with the rapid and radical changes experienced by these economies: active investors can add quality and good growth potential beyond the benchmarks in “niches” of the markets.*

Despite this evolution, EM benchmark indexes still do not keep the pace with the rapid and radical changes experienced by these economies and, consequently, they often result in only partial representations of the EM investable universe, with a tilt towards some particular sectors or domination by big players.

This means that active investors can benefit from an enormous opportunity to add quality and good growth potential beyond the benchmark (MSCI EM Index) by enlarging the investment universe (see Figure 14) to include in market “niches” that also tend to be more sheltered in phases of high volatility (e.g., some small and medium cap equities). Exploiting these opportunities, however, requires deep and direct knowledge of industries and dedicated fundamental research coverage. Here, familiarity with the ESG principles – governance in particular – is key to avoiding areas of risk.

**Figure 14: Number of listed companies by market segment**

Source: Amundi, Factset. Data as at January 8, 2018.

While EM stocks are becoming relevant in terms of capitalization and sector opportunities evolve, investors globally remain underinvested in this asset class. For example, when looking at US-domiciled fund managers, they still have just 5% of assets under management allocated to EM equities, a much lower level than their global peers, and a very low proportion compared to the share of MSCI EM on the world index in terms of market capitalization<sup>9</sup>.

**In conclusion,** supportive fundamentals, better corporate governance and structural under-allocation, combined with the positive macro backdrop described in the previous pages, in our view provide fertile ground for investors in search of growth opportunities with a medium-term horizon. As the underlying dynamics are very heterogeneous both at the macro (vulnerability, reforms, phase of the cycle) and micro (governance, sector appeal, market structure) levels, we believe investors should consider a flexible and selective approach to better take advantage of EM equity opportunities.

<sup>9</sup>According to data of research firm Evestment.

### 3. Supporting factors for EM bond investing

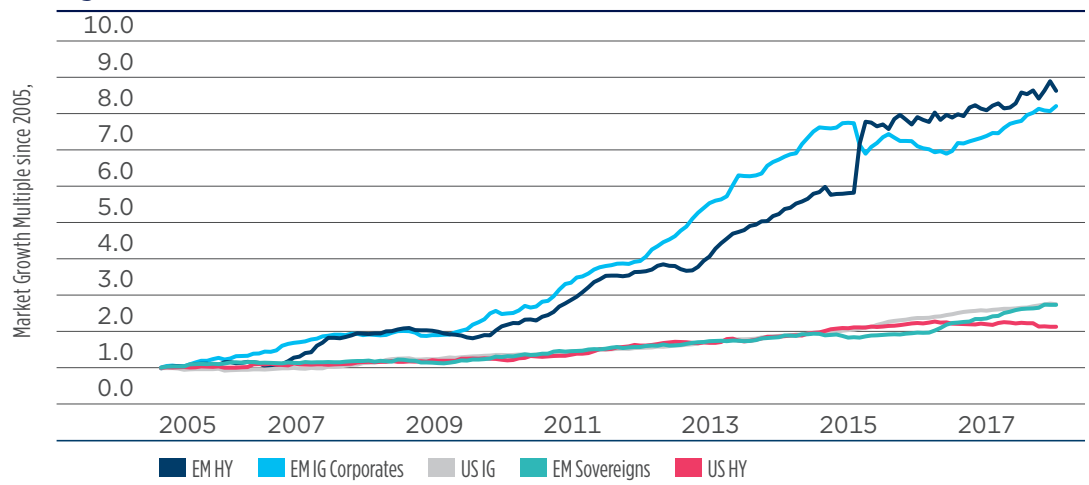
While allocation to EM equity is still very low compared to their capitalisation in global equity markets, EM bond investing has attracted more flows in recent years as a consequence of the increased search for income brought on by the low yield environment and issuance has also accelerated. We believe that investor appetite for this asset class will remain, as multiple trends will be at play. However, due to recent market performance, EM bonds will be more and more a carry trade story, while the potential for additional spread tightening is limited.

*EM bond universe has grown significantly over the last decade, in particular in the corporate segment. The expansion of local debt markets is also positive, as it makes EM more resilient to currency depreciation.*

#### 1. An evolving market, more resilient compared to the past

The EM debt universe has grown significantly over the last decade, in particular thanks to the impressive development of the EM corporate segments, both investment grade and high yield.

**Figure 15: Growth in EM bonds**



Source: BofA Merrill Lynch. Data as at December 31, 2017.

With the development of the investment universe, the EM debt indexes have also evolved, with the JPMorgan EMBI Global Diversified covering 66 countries today compared to a mere 26 in 2000<sup>9</sup>.

Noticeable in the past few years has been the increase in the share of local currency debt in the EM fixed income universe. For example, the share of outstanding government debt in local currency rose from 68% in 2001 to 86% at the end of 2016<sup>10</sup>. This trend is further supporting the case for EM resiliency, as the debt in hard currency represents a risk in case of local currency depreciation. Moreover, the expansion of local debt is helping to build more complete local yield curves based on more liquid instruments and more reliable pricing.

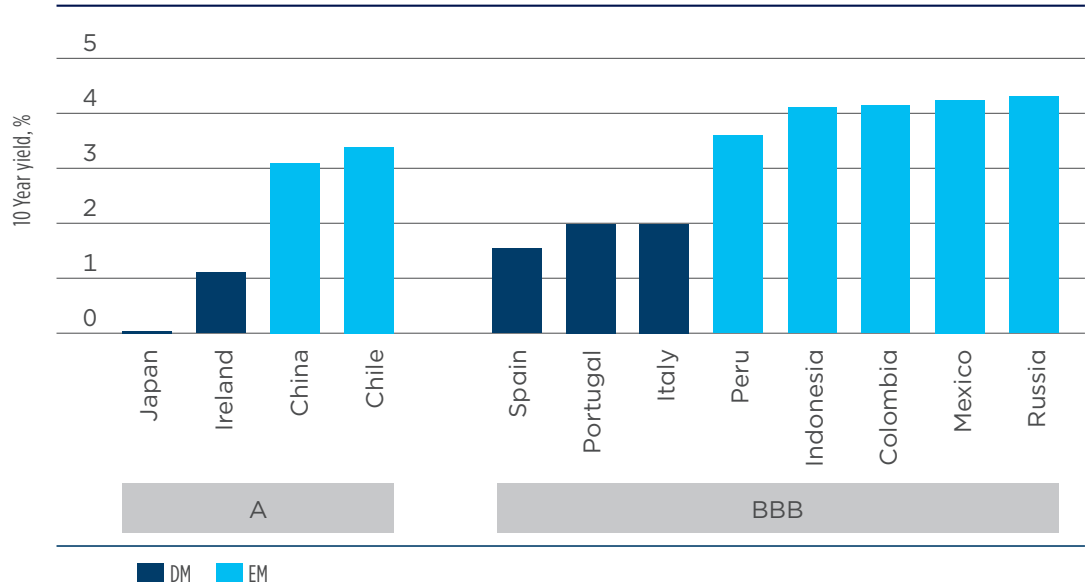
#### 2. EM bond “yield premium” compared to DM

Even accounting for heterogeneity and for higher risks due to multiple factors (geopolitical, vulnerability in some areas), valuations of EM sovereign debt appear interesting, especially if compared to developed market bonds, where yields even on 10Y securities remain very compressed.

<sup>9</sup>Source: JPMorgan. Data as at 31 December 2017 vs 31 December 2000.

<sup>10</sup>Source: Bank of International Settlement (BIS). BIS Quarterly Review, September 2017.

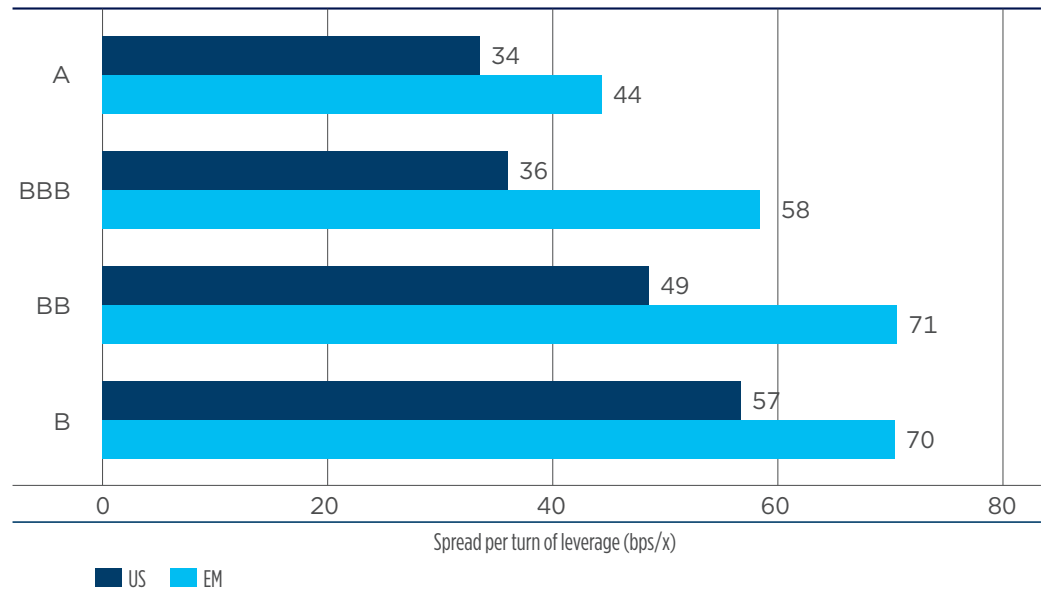
**Figure 16: Yields on 10-year sovereign bonds**



Source: Amundi, Bloomberg. Data as at March 29, 2018. Data in local currency. S&P Ratings. AAA-AA includes AAA, AA+, AA; A includes A+, A, A-; BBB includes BBB+, BBB, BBB-.

Fundamentals are also favourable for corporate markets, which are showing a moderate decline in leverage and lower default rates thanks to the global recovery and the positive commodity cycle. Credit spreads have tightened significantly, but we believe that EM corporates are still interesting compared to DM, as spreads per turn of leverage<sup>11</sup> remain attractive compared to US corporates.

**Figure 17: Spread per turn of leverage (bps/x)**



Source: Amundi, BofA Merrill Lynch Emerging Markets Chartbook. Data as at February 28, 2018.

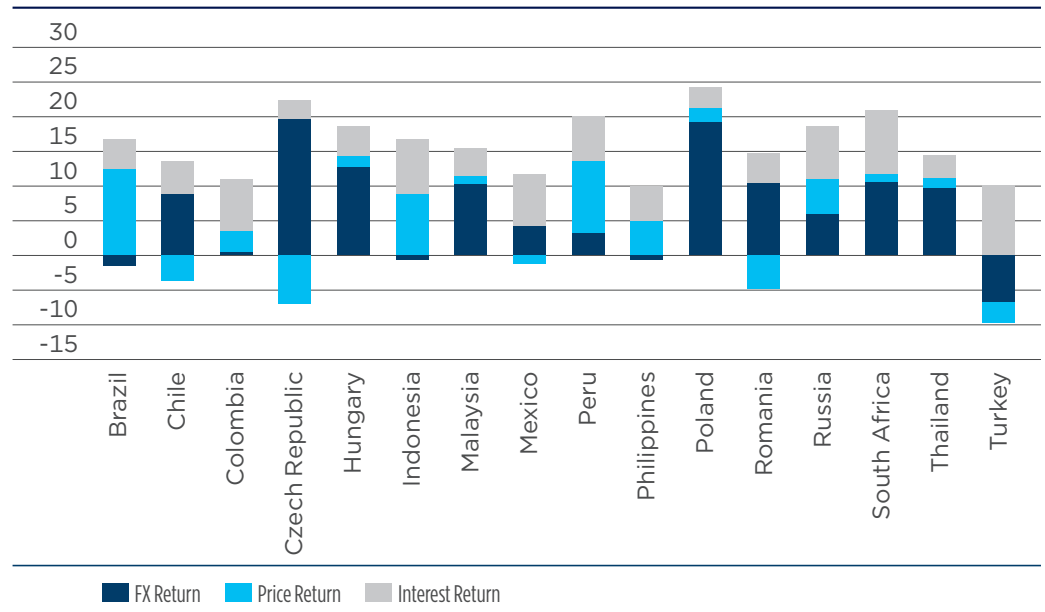
*A flexible approach to EM bond investing can potentially benefit from multiple sources of potential returns given the broad investment universe that EM offer.*

**3. Wide range of opportunities across countries, sectors and currencies**

A flexible approach to EM bond investing can potentially benefit from multiple sources of returns given the broad investment universe that EM offer.

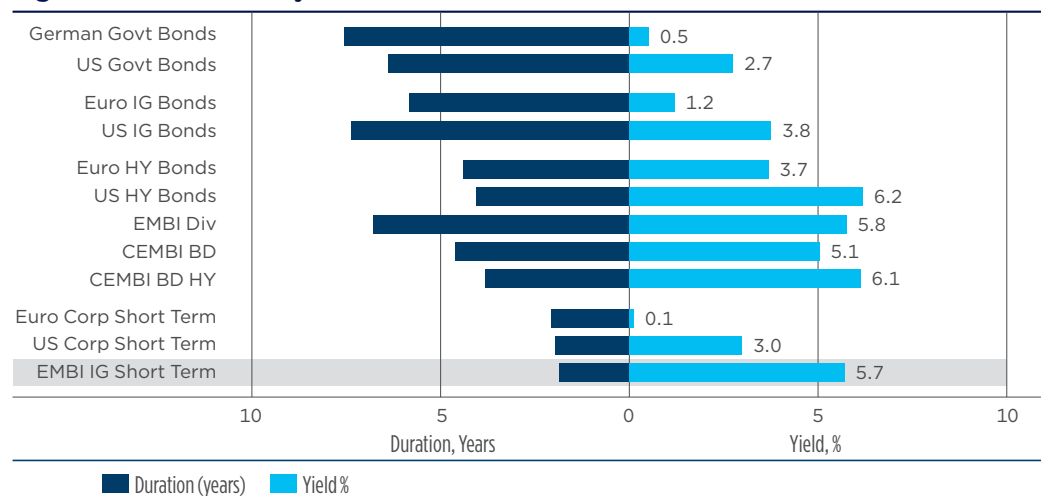
<sup>11</sup>Number of bps of spread divided by the issuer's turn of leverage (here Net DEBT to EBITDA)



**Figure 18: EM bond return contribution in 2017**

Source: Bloomberg. Data as at December 29, 2017.

A flexible approach, in fact, should allow the expression of a specific investment theme using diverse instruments ranging from hard currency to local currency debt, on the basis of liquidity or valuation assessments, while also actively managing market risk (beta) and increasing country differentiation to generate alpha<sup>12</sup>. Alpha in fixed income strategies may come from multiple sources: for example, from bond and corporate selection, duration positioning or currency trading.

**Figure 19: Bond sector yields and duration**

Source: Amundi analysis on Bloomberg. Data as of 29 March 2018. German Govt Bond = JPMorgan GBI Germany Index; US Govt Bonds = JPMorgan GBI US Index; Euro IF Bonds = Bloomberg Barclays Pan European Aggregate Corporate; US IG Bonds = Bloomberg Barclays US Aggregate Corporate; Euro HY Bonds = Bloomberg Barclays Pan-European High Yield; US HY Bonds = Bloomberg Barclays US Corporate High Yield; EMBI Div = JPMorgan EMBI Global Diversified; CEMBI BD = JPMorgan CEMBI Broad Diversified; CEMBI BD HY = JPMorgan CEMBI Broad Diversified HY; Euro Corp Short Term = Bloomberg Barclays Euro Corporate 500 1-3 Years; US Corp Short Term = Bloomberg Barclays US Corporate 1-3 Years; EMBI IG Short Term = JPMorgan EMBI Diversified 1-3 Years. All indexes are in local currency.

Yield is the yield to worst, duration is the modified duration except for EM indexes where it is the interest rate duration to worst.

*EM bonds with short duration can offer an interesting carry with low interest rate risk compared to other fixed income sectors.*

**In conclusion**, in this market environment, EM bonds with short duration<sup>13</sup> can offer an interesting carry with low interest rate risk compared to other fixed income sectors. For credit investors, EM corporate bonds remain relatively cheap versus developed markets. In a base case scenario, with no major disruption, we expect average returns of 4-5% for 2018 in EM debt in hard currencies and 7-8% for those in local currencies.

<sup>12</sup>Beta: The additional return above the expected return of the beta adjusted return of the market; a positive alpha suggests risk-adjusted value added by the money manager versus the index.

Alpha: The additional return above the expected return of the beta adjusted return of the market; a positive alpha suggests risk-adjusted value added by the money manager versus the index.

<sup>13</sup>Duration: a measure of the sensitivity of the price (the value of principal) of a fixed income investment to a change in interest rates, expressed as a number of years.

## Conclusions

*Exploiting opportunities in EM requires a strong understanding of the macroeconomic backdrop of each country.*

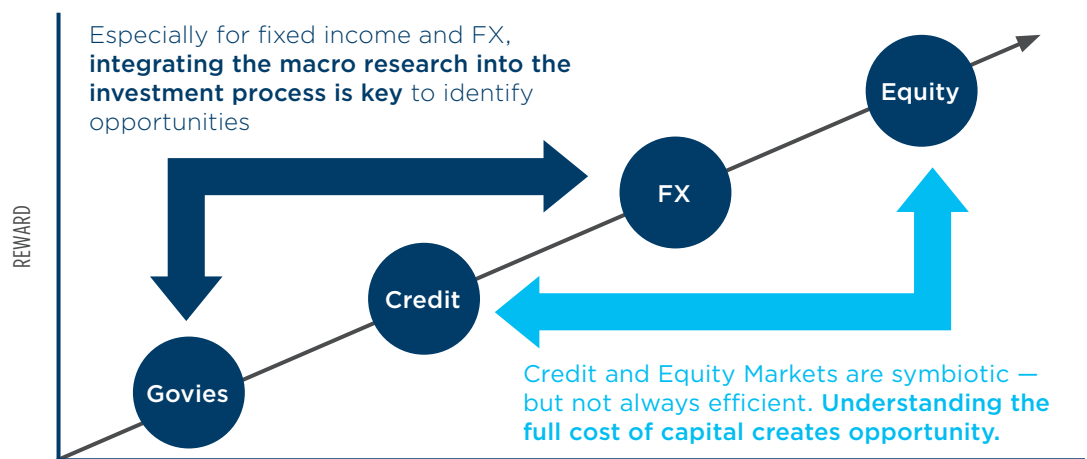
Given the macroeconomic and investment backdrop discussed in the previous chapters, we think it is time for investors to reassess the role of EM assets in a portfolio and to give them more space in a strategic asset allocation.

Investors should also consider moving away from an “asset class” perspective regarding EM to embrace a more selective approach to capture country, sector or even company-specific stories and to avoid major areas of risk.

To best exploit these opportunities, we believe that investors should rely on a strong understanding of the macroeconomic backdrop of each country. As EM countries are at different phases in the business cycle, with different growth and inflation dynamics, different vulnerabilities to external shocks, and with different CB policy trajectories, the macro assessment of each country is paramount to not only identifying the most compelling opportunities, but also to avoiding areas where political risk goes together with poor fundamentals, which remains a very relevant issue in EM.

To do this, we believe that an integrated research (both macro and bottom up) and investment expertise to Emerging Markets can provide the best set up.

**Figure 20: The value added of integrated research teams**



Source: Amundi.

*The accessibility to research through an integrated platform allows portfolio managers to identify the most valuable areas of the entire capital structure and to uncover opportunities in phases of market disruption.*

In fact, a strong integration of macro research into the investment process is key to identifying the themes and the structural changes that could drive specific country, sector or currency opportunities as well as to create important feedback loops to further investigate the macro trends. The country risk valuation is a good example of the process of “connecting the dots”: defining the sovereign risks based on macro risk factors (i.e. leverage, liquidity) and identifying the areas where the risk is well remunerated (maybe FX, or rates or even the stock market) could unveil opportunities and lead to superior results.

Bottom-up research is also relevant and highly symbiotic with macro research, which can provide ideas on sectors that could best benefit from specific reforms or growth dynamics. The accessibility to credit and equity research within an integrated platform constitutes an efficient leverage for portfolio managers in order to analyze the capital structure in its entirety, to identify the most valuable areas and to uncover opportunities in phases of market disruption.

We believe it is time for investors to exploit opportunities in EM with a selective and active approach that can focus on the most attractive investment ideas, while also aiming at mitigating risk through a strong research framework.

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