EM Equity Strategy

2017 Outlook: Nervously Positive; ROEs are Key

Equity Strategy

Emerging Markets

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2017 Outlook: +4-5%

We are mildly (and nervously) positive on EM equities for 2017, with mid-single digit gains expected. Our end-year MSCI GEMs target is 900, but with upside risk. The UBS global macro base case for 2017 is fairly benign for EM: i) a modest pick-up in global growth; ii) the Chinese economy resumes a 'soft landing' trajectory; iii) two Fed rate hikes; iv) US 10-year yields drift back to 2.25%; v) the USD falls v. the Euro and Yen, with small gains against EM currencies; vi) Brent oil prices rise to an average of $60.

Can Higher ROEs Boost EPS in 2017 – and Allow Outperformance of DM?

Our top-down forecast for EM EPS growth is 6% ($) after 8-9% in 2016. The key upside risk to such modest growth comes from an extension of last year's tentative rebound in ROEs (as margins rose and capex was subdued) leading to higher operating leverage, with or without a rebound in revenue growth. EM enters 2017 at 11.9x forward (above its recent average of 10.9x). The valuation case for EM is relative to DM. If EPS and ROEs surprise, EM's P/BV discount to DM of 32% (v. an average of -13%) – with EM ROEs above DM and rising higher – should support EM equities v. DM.

Upside and Downside Scenarios: A Wide Array of Risks

The danger for 2017 is the wide array of possible scenarios around our base case, with manifest risks in both directions: i) **Upside (EM: +25%):** i) strong global growth, without rising inflation; ii) falling US yields, little Fed; iii) falling USD; iv) rising EM ROEs; v) increased flows and weightings in EM. **Downside (-11%)**: i) sharp rise in global inflation; ii) major slowdown in China, with a steep fall in CNY; iii) sharply higher US yields; active Fed; iv) further outsized USD gains; v) further political shocks in DM.

Strategy: Upgrade LatAm to Neutral, Financials, Energy to O/W

After lagging badly in 2016, Asia is an O/W going into 2017; we upgrade LatAm to Neutral and cut EMEA to U/W. We stay O/W in Russia, India, Korea, Taiwan, Hungary and Peru; we lift Colombia to O/W (oil prices) and cut Turkey to U/W. The 'carry' should still help Brazil and we upgrade to Neutral; China is a Neutral; Mexico and SA are U/Ws. We move O/W in Financials (improving fundamentals, steeper curves) and Energy (oil price upside) and cut IT, Consumer Discretionary and Health Care to Neutral. Our Top 40 EM Stock List includes: Petrochina, Shenhua Energy, CCB, Tencent, Hyundai Mobis, Hon Hai Precision, TSMC, SBI, HDFC, Petrobras, Itau Unibanco, Sberbank, Naspers.

Figure 1: UBS EM Equity Strategy Views

	Overweight	Neutral	Underweight	
Regions				
	Asia	Latin America ↑	EMEA ↓	
Countries				
	India	China	Mexico	Turkey ↓
	Korea	Brazil ↑	South Africa	Greece
	Taiwan	Indonesia	Malaysia	
	Russia	Thailand	Philippines	
	Colombia ↑	Poland ↑	Czech	
	Hungary		Chile	
	Peru			
Sectors				
	Energy ↑	Technology ↓	Materials	
	Financials ↑	Consumer Discretionary ↓	Consumer Staples	
	Industrials	Health Care ↓	Telecoms	
			Utilities	

Source: UBS estimates

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Contents

UBS Research THESIS MAP

PIVOTAL QUESTIONS

Q: Across the volatile global landscape, which are the key drivers of EM equities in 2017?

The paths of US bond yields (we think lower) and the dollar (flat to lower) are the keys for 2017. We think 'sub-par global growth, prolonged QE, flat dollar and low yields' are better for EM this year than 'stronger growth, stronger dollar, higher yields and an active Fed'. 'Liquidity' should trump 'growth'.

Q: Will further ROE gains drive upside surprises in EPS growth?

Top-down, we expect +6% EPS growth in EM in 2017. The key upside risk to this (and the thing to watch) is whether last year's upturn in ROEs is extended. Average EM ROE fell from 15.2% (9/2011) to 10.2% (4/2016) and is now up to 10.6%. ROEs are rising in Materials, Energy, Staples, Industrials and Utilities sectors.

Q: Can EM equities beat DM again in 2017?

EM is not cheap at 11.9x forward, but we think it is cheap compared to DM at a P/BV discount (32%) > average (-13%). The ROE relative between EM (10.6%) and DM (10.4%) has turned higher, in part as the DM ROE trend is now poor. Along with low investor weights in EM, we believe this is the case for EM to beat DM in 2017.

WHAT'S PRICED IN?

With the consensus EPS growth forecast for 2017 at 13% and EM at 9% above fair value, EM equities are pricing in EPS growth of over 20% or, alternatively, are borrowing some 2018 growth. However, at an EM/DM discount on P/BV of 32%, global equity markets are pricing sharply higher DM v. EM ROEs.

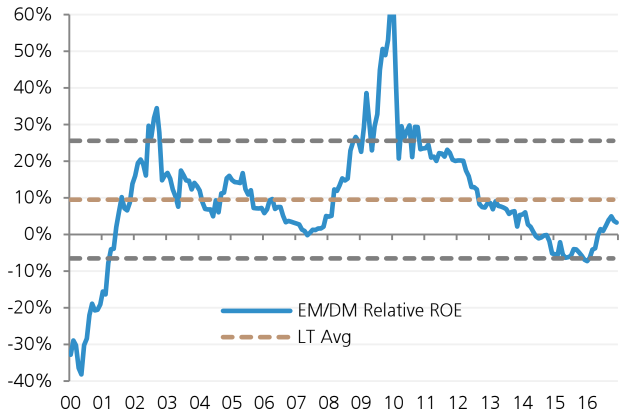
UBS VIEW

MSCI GEMs target of 900 (end-2017): mid-single digits upside. If global equity markets continue to perform well, there is upside risk to our target. We are O/W in Asia, Neutral in LatAm and U/W in EMEA. Favored markets: Russia (top pick), India, Korea, Taiwan, Hungary, Colombia and Peru. Favored sectors: Financials, Energy, Industrials.

RISKS

There are many. Upside: i) strong global growth, without sharply higher inflation; ii) falling US yields; iii) little Fed; iv) falling dollar; v) rising EM ROEs; vi) increased flows and weightings in EM. Downside: i) sharp rise in global inflation; ii) major slowdown in China and a steep fall in the CNY; iii) sharply higher US yields; iv) active Fed; v) further outsized dollar gains; vi) further political shocks in DM.

EM/DM Relative ROE



Source: MSCI, Datastream, UBS

Top 40 EM Stock List

Figure 2: UBS Top 40 EM Stock List

Name	Ticker	Price	MV (mn U$)	Country	Sector	Rating	17 PE	18 PE	EPS 17E Gro	EPS 18E Gro	DY 17E	vs target
PETROCHINA	857 HK	HK$5.97	212,055	China	Energy	Buy	21.2	10.4	370%	104%	2.1%	29%
SHENHUA ENERGY	1088 HK	HK$15.74	45,859	China	Energy	Buy	10.7	11.2	4%	-4%	3.4%	9%
CCB	939 HK	HK$5.85	188,311	China	Financials	Buy	5.5	5.2	4%	6%	5.4%	17%
CRCC	1186 HK	HK$10.38	22,809	China	Industrials	Buy	7.6	6.9	16%	11%	2.1%	36%
FOSUN INTERNATIONAL	656 HK	HK$10.96	12,213	China	Industrials	Buy	8.3	8.3	6%	1%	1.7%	45%
TENCENT	700 HK	HK$193.30	234,686	China	Info Tech	Buy	27.6	22.4	30%	23%	0.4%	28%
GUANGZHOU AUTO	2238 HK	HK$9.44	16,697	China	Cons Disc	Buy	6.7	6.1	13%	10%	4.6%	26%
CSPC PHARMA	1093 HK	HK$8.25	6,226	China	Health Care	Buy	19.0	15.7	23%	21%	1.6%	16%
NINE DRAGONS PAPER	2689 HK	HK$7.55	4,509	China	Materials	Buy	9.0	8.3	12%	9%	3.4%	27%
WH GROUP	288 HK	HK$6.29	11,579	China	Cons Staples	Buy	10.5	9.4	12%	11%	4.8%	40%
SAMSUNG F&M	000810 KS	₩272,500	10,822	Korea	Financials	Buy	9.9	11.1	23%	-11%	2.4%	25%
HYUNDAI GLOVIS	086280 KS	₩162,000	4,958	Korea	Industrials	Buy	10.3	9.6	5%	7%	2.3%	52%
LG DISPLAY	034220 KS	₩31,500	9,477	Korea	Info Tech	Buy	6.9	8.7	170%	-21%	1.7%	30%
NCSoft	036570 KS	₩261,000	4,567	Korea	Info Tech	Buy	15.9	14.6	40%	9%	1.7%	27%
HYUNDAI MOBIS	012330 KS	₩280,500	22,197	Korea	Cons Disc	Buy	7.6	7.2	5%	6%	2.9%	32%
LG CHEMICAL	051910 KS	₩267,500	14,751	Korea	Materials	Buy	11.4	10.0	21%	14%	1.7%	40%
HON HAI PRECISION	2317 TT	NT$84.0	45,392	Taiwan	Info Tech	Buy	10.0	9.6	14%	4%	3.7%	10%
TSMC	2330 TT	NT$183.5	149,145	Taiwan	Info Tech	Buy	13.5	11.2	6%	20%	3.8%	20%
ASE	2311 TT	NT$33.3	8,446	Taiwan	Info Tech	Buy	13.0	12.2	2%	6%	4.5%	32%
DELTA ELECTRONICS	2308 TT	NT$159.0	13,113	Taiwan	Info Tech	Buy	18.6	17.0	15%	10%	3.1%	21%
TAIWAN MOBILE	3045 TT	NT$107.5	9,019	Taiwan	Telecom	Buy	17.3	16.6	5%	4%	5.8%	21%
STATE BANK OF INDIA	SBIN IB	INR 245	26,976	India	Financials	Buy	11.3	8.3	58%	37%	1.9%	36%
HDFC BANK	HDFCB IB	INR 1,183	44,142	India	Financials	Buy	18.6	15.4	18%	21%	1.1%	22%
TATA MOTORS	TTMT IB	INR 502	24,833	India	Cons Disc	Buy	8.1	7.0	37%	15%	0.3%	33%
HINDUSTAN UNILEVER	HUVR IB	INR 832	26,457	India	Cons Staples	Buy	35.5	32.4	13%	10%	2.1%	20%
BANK RAKYAT	BBRI IJ	IDR 12,100	22,368	Indonesia	Financials	Buy	11.0	9.2	13%	20%	2.6%	15%
KASIKORNBANK	KBANK TB	THB 183.5	12,258	Thailand	Financials	Buy	11.8	10.3	-5%	15%	2.2%	7%
PETROBRAS	PETR4 BZ	BRL 15.75	68,899	Brazil	Energy	Buy	14.9	7.4	1103%	101%	4.9%	35%
ITAU UNIBANCO	ITUB4 BZ	BRL 35.58	73,209	Brazil	Financials	Buy	9.6	8.5	14%	12%	3.7%	28%
SABESP	SBSP3 BZ	BRL 29.61	6,327	Brazil	Utilities	Buy	7.2	5.6	11%	29%	4.2%	22%
BANORTE	GFNORTEO MM	MXN 100.14	12,983	Mexico	Financials	Buy	12.2	11.0	18%	11%	3.1%	29%
BANCO DAVIVIENDA	PFDAVVND CB	COP 31,300	4,744	Colombia	Financials	Buy	7.8	7.3	12%	7%	3.4%	25%
CREDICORP	BAP US	$164.2	13,095	Peru	Financials	Buy	11.8	10.3	11%	14%	2.9%	4%
SBERBANK	SBER RX	RUB 172	64,626	Russia	Financials	Buy	6.0	5.0	22%	19%	4.0%	14%
YANDEX	YNDX US	$21.88	6,985	Russia	Info Tech	Buy	22.6	16.0	35%	41%	0.0%	14%
X5 RETAIL	FIVE LI	$32.10	8,717	Russia	Cons Staples	Buy	13.8	10.1	31%	36%	0.0%	12%
DISCOVERY	DSY SJ	ZAR 11,449	4,988	S Africa	Financials	Buy	12.8	10.6	21%	20%	2.0%	29%
NASPERS	NPN SJ	ZAR 202,237	64,199	S Africa	Cons Disc	Buy	24.3	18.5	35%	31%	0.5%	71%
MOL	MOL HB	HUF 21,045	6,502	Hungary	Energy	Buy	9.0	8.2	1%	10%	3.6%	7%
PZU	PZU PW	PLN 32.82	6,881	Poland	Financials	Buy	11.5	11.0	12%	5%	6.5%	10%

Source: Reuters, UBS Estimates. Data as of 5 January 2017.

MSCI GEMs Target (2017: +4-5%)

We are mildly bullish on EM equities for the year ahead. Our end-2017 index target for MSCI GEMs is set at 900[1], but with upside risk, a dollar-adjusted gain of 4-5% and a Total Return (plus dividends) of around 7% for the calendar year. Our MSCI GEMs index target model is derived (see Figures 3 and 4 below) from:

- Forecast EPS growth for 2017 of 6% in US dollars, derived from our top-down earnings model for EM, as discussed later in the report; and

- A target multiple of 13.3x trailing earnings, just below the end-2016 multiple of 13.5x, but in line with the 15-year average.

This *central* scenario for EM equities for 2017 is fundamentally premised on several overarching (mainly global) assumptions (discussed in much more detail below) of which the most important are: i) global growth picks up slightly in 2017, mainly due, in DM, to the US and, in EM, to Brazil, Russia and India (FY18); however, overall, global growth remains sluggish, including in EM; ii) the Fed raises interest rates twice this year (total of 50bp); iii) US 10-year yields retreat to 2.25%; iv) the US dollar falls against the Euro to €1.13; v) Brent oil prices rise to an average of $60/barrel; and vi) the Chinese economy resumes a 'soft landing' trajectory.

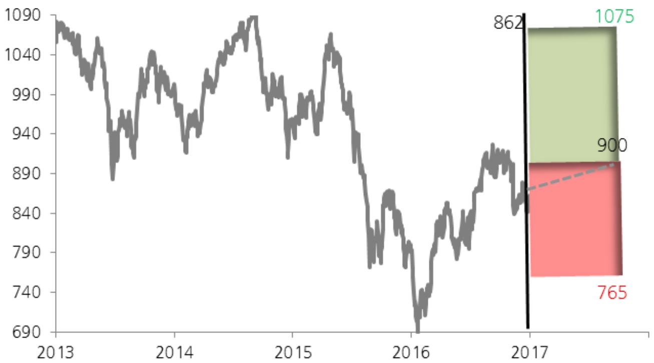
However, as argued throughout the UBS macro and strategy outlook reports for the year ahead, there are an unusually wide array of possible scenarios for the global economy and financial markets in 2017, leading to clear risks in both directions for this (rather dull) central scenario for EM equity markets. This large dollop of uncertainty about 2017 has many sources, often following on from last year's volatile events (especially late in the year), such as: i) sharply higher US bond yields, the dramatic outperformance of US stocks in late-2016 and, as a result, the savage rotation from bonds into stocks; ii) the stronger dollar; iii) ongoing concern over the Chinese RMB (and fear of a repeat of the particular weakness of markets in the first three weeks of 2016); and iv) the extraordinary political events of last year (notably, the UK referendum and the US election) which are generating fears of yet more political surprises in 2017.

Figure 3: MSCI GEMs Index: Base Case, Risk Scenarios

	Index (end'16)	Trailing P/E (end'16)	EPS Gro (2017E)	Trailing P/E (end'17)	Index Target (end-2017)
Base Case	862	13.5x	6%	13.3x	900 (+4%)
Upside Scenario	862	13.5x	18%	14.3x	1075 (+25%)
Downside Scenario	862	13.5x	0%	12.0x	765 (-11%)

Source: IBES, MSCI, Datastream, UBS estimates

Figure 4: MSCI GEMs Index Target, Risk Scenarios



Source: IBES, MSCI, Datastream, UBS estimates

Figure 3 (above) sets out upside and downside scenarios to our base case for EM for the year ahead. We initially couch these alternative scenarios (mechanically) in

[1] As initially set out in the equities section in of "EM Outlook 2017: Managing a ship adrift", Global Macro Strategy, Bhanu Baweja et al, Nov. 21, 2016.

terms of risks to our earnings growth forecasts in EM and to our target-multiple assumption. These, in turn, are partly (although not entirely) based on risks to our macro/market assumptions.

Upside Scenario (+25%)

Our top-down EM EPS forecast of 6% for 2017 is well below both the current consensus (+13%) and the UBS bottom-up (GEM Inc.) forecast of 24% growth[2]. Our upside scenario is a sharply higher MSCI GEMs target of 1,075 (+25% for the year) based on EPS growth of 18% (halfway between the above two 'risk' forecasts) and multiple expansion to a trailing P/E at end-2017 of 14.3x, equal to the all-time high for this metric.

More specifically, we see the following (often mutually exclusive) factors leading to an upside surprise to our base case of a 4-5% gain in MSCI GEMs in 2017:

- A strong rebound in global growth (including in the US, China and EM as a whole) partly due to pro-growth policy initiatives of the new US administration, without major increases in inflation and/or US bond yields;
- US bond yields pull back again and the Fed's rate-hiking cycle is slower than expected, due to a weak rebound in US growth this year;
- The dollar falls sharply and broadly;
- An extension of last year's rebound in ROEs and margins in EM with increased operating leverage as companies seek to re-build their profitability levels with or without a rebound in revenue growth;
- A better EM earnings trend leading to: i) investor flows returning to EM equity funds[3]; and ii) increased weights of global investors in undervalued EM (relative to DM) equities, leading to EM outperformance.

In summary, our core view is that the fundamental case for an upside surprise to our base case for 2017 has to be, as last year, positive surprises on earnings growth in EM, although improved liquidity flows into key markets, as US rates and yields stay low, would also be helpful.

Downside Scenario (-11%)

Our downside scenario is based on a return to disappointing earnings trends in EM (as in most of the 2011-15 period), with flat EPS in 2017, combined with a de-rating of EM equities back to a trailing multiple of 12x, or 10% below the long-term average of 13.3x. These assumptions translate into an end-2017 target for MSCI GEMs of 765, a decline of 11% in dollar terms.

We see the following factors leading to such a downside surprise to our base case:

- Any pick-up in global growth is accompanied by sharply higher inflation;
- A 'harder landing' in China with growth slowing sharply and the CNY coming under severe pressure;

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[2] This is a high number. However, excluding Samsung Electronics and Petrochina the two largest contributors to this forecast, GEM Inc. EPS growth for 2017 falls to 18%.

[3] In the end, the flows story for 2016 was very disappointing. Heavy outflows from EM funds after the US election ($14.5bn in 7 weeks) pushed the full year total back into negative territory (-$2.6bn); all of the 2016 outflows were accounted for by Asia ex-Japan funds.

- US bond yields rise significantly further from current levels, leading to an overall sell-off in global equities and a higher cost of capital in EM;
- The Fed's rate-hiking cycle is more aggressive than expected as inflation rises;
- The dollar continues to appreciate, particularly against EM currencies, leading to some 'crises' in certain EM FX markets; in general, the impact of a rising USD reduces the dollar value of local currency earnings in EM;
- Further political shocks in DM with a focus in 2017 on elections in some key EU member countries.

Asset Allocation

EM Factor Model

Our asset allocation views by region, market and sector within EM equities are subject to continuous change. They are a continuum with our earlier work and they do not have to change drastically just because a new year, with new total returns projections, has begun. These asset allocation recommendations are neither made in a vacuum nor are they derived purely from a subjective analysis.

Figure 5: GEMs Country and Sector Factor Model – end December 2016

	2017-18 EPS Growth	2017-18 EPS Growth Rank	P/B Valuation Discount	PBV Rank	Domestic Policy Rank	External Risk Rank	Overall Rank
GEMs	12.8%		-17%				
Brazil	13.8%	9	-9%	15	1	7	**5**
Chile	6.0%	20	-18%	11	8	14	**15**
China	14.3%	7	-24%	8	12	16	**7**
Colombia	22.9%	1	-21%	10	2	16	**3**
Czech	-6.7%	22	-23%	9	12	3	**10**
Greece	12.2%	10	-73%	1	12	2	**2**
Hungary	5.4%	21	-9%	14	12	7	**17**
India	16.9%	4	-9%	16	8	19	**11**
Indonesia	14.1%	8	-12%	13	14	21	**20**
Korea	11.0%	14	-27%	6	12	3	**6**
Malaysia	6.7%	18	-17%	12	8	12	**13**
Mexico	15.0%	6	-8%	19	18	19	**21**
Peru	18.1%	2	-32%	4	12	12	**4**
Philippines	9.3%	17	6%	22	12	14	**22**
Poland	6.4%	19	-28%	5	14	9	**11**
Qatar	12.0%	11	-24%	7	16	11	**8**
Russia	11.4%	13	-34%	3	1	1	**1**
South Africa	17.9%	3	-9%	17	12	22	**17**
Taiwan	9.6%	16	-9%	18	10	9	**15**
Thailand	10.6%	15	-1%	20	10	6	**14**
Turkey	15.3%	5	-46%	2	22	16	**8**
UAE	11.9%	12	0%	21	16	5	**17**
Energy	20.1%	2	-44%	1	-	-	**1**
Materials	6.4%	9	-24%	3	-	-	**7**
Cons Disc	15.9%	6	-5%	6	-	-	**7**
Cons Staples	16.0%	5	13%	10	-	-	**9**
Industrials	16.6%	4	-15%	5	-	-	**2**
Financials	8.9%	8	-33%	2	-	-	**4**
Health Care	21.5%	1	-3%	8	-	-	**2**
Info Tech	17.6%	3	-4%	7	-	-	**4**
Telecoms	11.1%	7	-22%	4	-	-	**6**
Utilities	2.2%	10	3%	9	-	-	**10**

Source: IBES, MSCI, Datastream, UBS estimates

Figure 5 (above) sets out our simple asset allocation model across countries and sectors which ranks four variables across emerging markets:

- **Expected Earnings Growth:** in dollars, for 2017-18;
- **Valuations:** P/BV ratio discount/premium to the long-term average for the country/sector in question;
- **Domestic Policy**: the forecast path of interest rates to the end of 2017;
- **External Policy**: vulnerability to global liquidity trends measured by a combination of: i) forecast currency moves against the dollar to end-2017; and ii) current account balances as a % of GDP for 2017.

The final column in the table shows the ranking of the average of these four factors for each country (with a low score being best); for the sector model, we use the first two of the four factors above. While the model provides a very helpful check on country and sector data, we use the resultant ranking as a guide (only) to our asset allocation views.

Going into 2017, our asset allocation views across EM equities are in Figure 6.

Figure 6: UBS EM Equity Strategy Views

	Overweight	Neutral	Underweight	
Regions				
	Asia	Latin America ↑	EMEA ↓	
Countries				
	India	China	Mexico	Turkey ↓
	Korea	Brazil ↑	South Africa	Greece
	Taiwan	Indonesia	Malaysia	
	Russia	Thailand	Philippines	
	Colombia ↑	Poland ↑	Czech	
	Hungary		Chile	
	Peru			
Sectors				
	Energy ↑	Technology ↓	Materials	
	Financials ↑	Consumer Discretionary ↓	Consumer Staples	
	Industrials	Health Care ↓	Telecoms	
			Utilities	

Source: UBS estimates

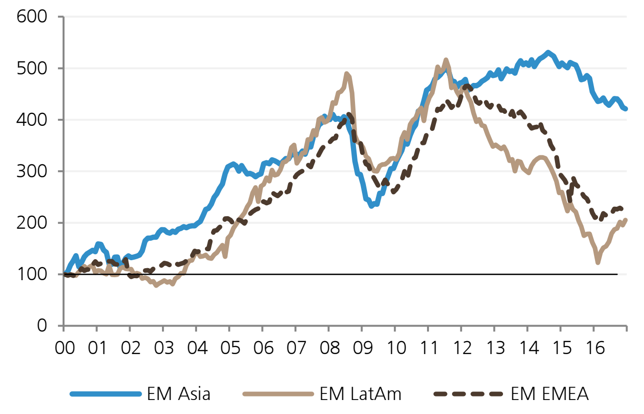
Regions: O/W Asia, Neutral LatAm, U/W EMEA

Last year saw a sea-change in the trend of corporate earnings in EM, including by region. As discussed in the earnings section below, it looks like EM EPS in calendar 2016 will have increased around 8-9% in dollar terms, the best year since 2011. However, importantly for regional allocation, 2016 saw the start of a sharp rebound in earnings in Latin America and a modest bounce in EMEA, with commodity prices, the weaker dollar and base effects explaining the bulk of these recoveries. Meanwhile, earnings in Asia stayed weak (Figure 7 below). This led to the big (and long-awaited) rotation out of Asia into the other two regions in 2016.

Despite the strong 2016 equity market rally in the EM commodity regions and the significant underperformance of Asia (or, maybe, *because* of these events), we recommend going into 2017 with an Overweight in Asia again. However, we do make one change with an upgrade of Latin America to Neutral and a downgrade of EMEA to Underweight from Neutral. This allocation is for four main reasons:

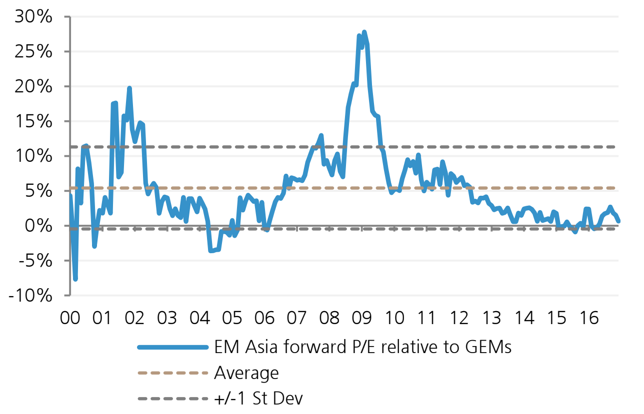
- **Commodity Prices/US Dollar:** One of our central (if hardly controversial) EM strategy theses is that Asia's relative performance to GEMs is negatively correlated to commodity prices, while LatAm's relative is positively correlated. The results for the dollar are the opposite - Asia's relative is positively (and strongly) correlated to the dollar TWI, while LatAm's relative is negatively correlated. EMEA is somewhere in the middle; neither variable (commodity prices nor the dollar) has a close link to the EMEA/GEMs relative. Therefore, last year's rebound in commodity prices (CRB index: +12.9%), especially since late-January, and the flatter performance of the dollar TWI (+1.2%)[4], plus Brazilian politics, supported the strong rebound of LatAm markets. Looking ahead to this year, these supports should be less visible. On commodities, while UBS expects oil prices to rise further, we see iron ore prices (average forecast of $56/tonne in 2017) as very vulnerable to the expected slowing of the Chinese economy; on the USD, while we expect a pullback in USD/Euro to €1.13 at year-end, we see further falls in EM FX v. the dollar, with our EM Currency Proxy down by 1.8% this year;

Figure 7: EM Trailing Earnings (January 2000 = 100)



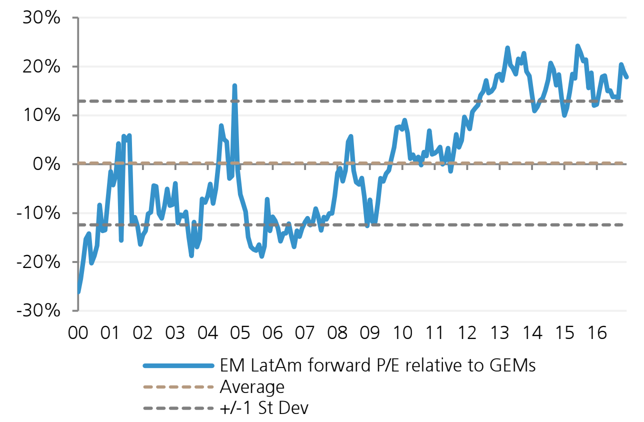
Source: IBES, UBS

Figure 8: EM Asia Forward P/E relative to GEMs



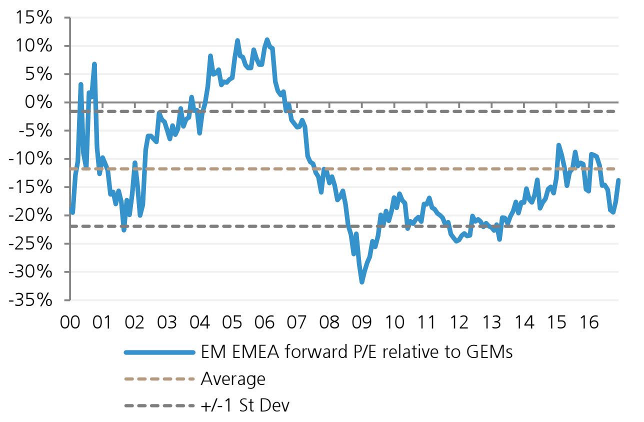
Source: IBES, MSCI, Datastream

Figure 9: EM LatAm Forward P/E relative to GEMs



Source: IBES, MSCI, Datastream

Figure 10: EM EMEA Forward P/E relative to GEMs



Source: IBES, MSCI, Datastream

- **Earnings Growth:** Notwithstanding the start of a recovery in corporate earnings in Latin America and EMEA in 2016, the outlook for EPS growth

[4] Our EM Currency Proxy actually rose by 1.4% (versus the dollar) in 2016.

across EM for the new year (given the prior views on commodity prices and the USD) still favours Asia. Consensus EPS growth forecasts for EM regions in 2017 range from 14% in Asia, to 9.6% in LatAm with EMEA at 11.5%. Based on our macro scenario, there should be some catch-up in Asian earnings in 2017.

- **Valuations:** A year ago, we wrote that: 'Asia's earnings outperformance (since 2010) versus Latin America in particular actually exceeded its market outperformance. As a result, Asia is still trading at a slightly lower premium to MSCI GEMs than its historical average premium, while LatAm forward P/E valuations ended 2015 at a premium to GEMs compared to a recent average discount'[5]. Twelve months on, this picture of relative regional valuations has moved even further in favour of Asia. The end-2016 forward P/E premium of Asia to GEMs is 1% (12x v. 11.9x), just below the recent average of 5% (Figure 8 above); more remarkably. LatAm's P/E has shot up to a premium of 18% to GEMs (14.1x v. 11.9x), versus a long-term average of equal P/E ratios (Figure 9). The P/E discount of EMEA to GEMs remains at 13% (10.3x v. 11.9x), close to its end-2015 level and to its long-term average of -12% (Figure 10). Combining the last two arguments, Asia provides the best mix of earnings growth and valuations across EM for the year ahead;

- **By Country:** As discussed in detail in the next section, our upgrade of LatAm to Neutral reflects a partial move back into Brazil (which we raise to Neutral) and a move to Overweight in Colombia. In the opposite direction, we have cut back on our preferred markets in EMEA, with a downgrade of Turkey to Underweight, leaving only Russia and Hungary as Overweights in the region, so leaving the region as an Underweight. We retain three preferred 'big markets' in Asia – Korea, Taiwan and India – to underpin our Overweight in the region.

O/W: Russia, India, Korea, Taiwan, Colom'a, Peru, Hungary

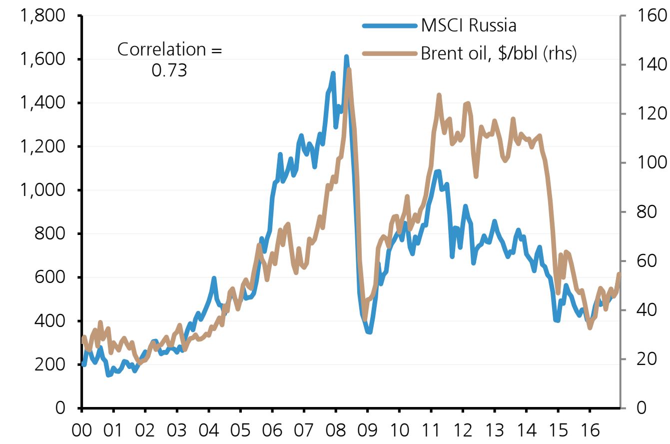
Our Overweight markets within GEMs at the start of 2017 are as follows[6]:

- **Russia:** We stay O/W in Russia, which is our top EM pick for 2017, based on: i) we expect Brent oil prices to average $60/barrel, a positive for Russian equities (Figure 11); ii) the economy should return to growth this year (1.3% v. -0.6% in 2016), driven by a stronger consumer and support from higher oil prices; iii) we expect interest rates to fall by 200bp in 2017[7]; iv) against the EM trend, RUB/USD is forecast to rise to 55 by end-2017; v) Russia remains the cheapest EM at 6.3x forward, a 10% discount to its long-term average of 7x and v. GEMs at 11.9x. Ongoing geopolitical risks seem priced into current valuations;

- **India:** While our Asian team is Neutral in India, we stay O/W the market in GEMs. In the wake of the 'demonetization' cash crunch, our 'Slower Recovery' base case assumes around six months of disruption with FY17 GDP growth down to 6%, and a bounce to 8% in FY18. We now see two rate cuts in 2017. India lagged GEMs post-demonetization to end-year (-6.2% v. -4.4%) and de-rated in 2016 (to 16x forward v. an average of 14.6x – Figure 12) and more EPS cuts look likely. However, India remains the best growth story in EM and with low debt and ongoing balance sheet repair should see higher ROEs in 2017;

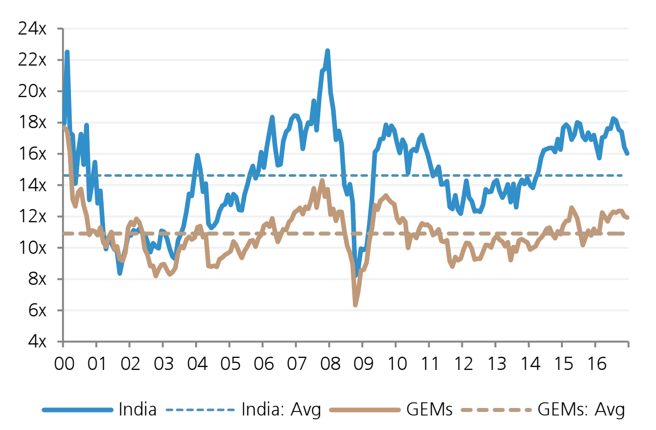
[5] See "2016 Outlook: Finally a Cyclical Bounce in EPS". EM Equity Strategy, Geoffrey Dennis, January 6, 2016.
[6] A summary of all our EM Country Views is set out in the appendix at the end of the report.
[7] "Emerging EMEA Economic Outlook, 2017-18", EMEA Economic Perspectives, Gyorgy Kovacs, Anna Zadornova, November 15, 2016

Figure 11: MSCI Russia index, Brent Oil Price



Source: MSCI, Datastream, UBS

Figure 12: Forward P/E: India, GEMs



Source: MSCI, IBES, Datastream, UBS

- **Korea/Taiwan:** We stay O/W in Korea and Taiwan as both should benefit from a modest cyclical pick-up in global growth this year; we think they are under-owned and we expect 25bp of interest rate cuts in each in 2017, plus only modest FX weakness. In Korea, earnings momentum has begun to improve, making a market trading at 10x forward (cheap to EM, but rich v. its own average of 9.2x) interesting, although the consensus EPS forecast for 2017 of 14% growth looks high to us. Payout ratios are rising, although average ROEs (9%) are low. Our Korean strategist [8] believes the top-down outlook is lackluster, but the bottom-up perspective is more dynamic. In addition to the above, Taiwan (unusually) looks cheap, ending the year at 12.9x forward or 9% below its long-term average of 14.2x; this metric is also based on a consensus EPS growth forecast of 11% for 2017 (in USD) which we see as realistic. Taiwan should benefit from the expected pick-up in export volumes although the market will continue to depend on the volatile and unpredictable tech cycle, which remains a risk. We believe Taiwan is particularly exposed to any further unexpected rise in US yields;

- **Hungary/Peru:** We retain 'single-stock' O/Ws in Hungary (MOL replaces OTP) and Peru (Credicorp) heading into 2017. Despite decisively beating EM again last year (+32% v 8.6%), we still like Hungary based on: i) GDP growth is forecast to pick up to 2.7% in 2017 and, based on NBH and official forecasts, there is upside risk to our call; ii) the external balance is strong; and iii) we expect no rate hikes until 2018. Valuations look rich (11.8x v. a long-term average of 9.8x) but not prohibitive v. EM. We think Peru is the best growth story in LatAm with our 2017 GDP forecast of 4.4% supported by fiscal easing, a bullish copper forecast and positive sentiment on the new government; interest rates should be on hold in 2017. Valuations are only just over fair value (12.1x v. 11.8x) despite last year's substantial outperformance (+54% v. +8.6% for GEMs), while Credicorp remains one of our most preferred banks in EM.

- **Colombia:** We lift Colombia to O/W given our forecast of a further rise in oil prices to $60 (Brent - average) in 2017, coupled with scope for a 150bp drop in interest rates and cheap valuations (12.4x forward v. a long-term average of 13.9x). Colombia is the top pick of our LatAm Strategist, Alan Alanis, followed

[8] "Top-down lackluster; bottom-up dynamic", Korea Outlook 2017, Young Chang, November 24, 2016

by Peru. The key risks to the call are wide deficits on the fiscal balance (3-3.5%/GDP) and current account (>4%/GDP); the tax reform bill in Congress is vital for the long-term. We add Banco Davivienda to our Top 40 EM Stock List;

Our Underweight markets across GEMs at the start of 2017 are as follows:

- **South Africa:** We think the Rand has overshot and the SA market is rich and so we stay U/W. The local investor mood has improved, boosted by rising markets, hints of economic recovery and the scope of Finance Minister Gordhan's reform plans[9]. However, despite de-rating since early-2015, MSCI SA still trades (14.3x forward) well above its long-term average of 11.2x. Although we see downside in the Rand (to ZAR15.25 at end-2017), should the markets believe that the ANC's internal dynamics may change for the better, this would provide support for the currency. The risk of South Africa losing its IG status has receded. Overall, however, we want yet lower valuations and the ZAR to fall towards a fairer value before adding;
- **ASEAN – Malaysia/Philippines:** we retain a net U/W in ASEAN markets, which all trade above the EM P/E average and are exposed to higher US rates. Malaysia and the Philippines remain U/Ws. In Malaysia, EPS growth is soft (consensus: +5.6% in 2017, after falling in 2016) with the market still rich (15.6x forward v. a recent average of 14.6x) despite falling by 7% last year. The impending election, which must be held by August 2018, remains a concern, although it could lead to a fiscal boost for the economy. MSCI Philippines crashed by over 18% in the second half of 2016 (v. EM +3.4%) on concerns over the security policies of the new government There is little rush to buy given still-high valuations (16.6x v. 15.2x – the highest in EM alongside Mexico), sluggish EPS growth (7-8% for 2016-17) and FX risk as US rates rise. The main support is policies to reduce poverty via higher government spending.
- **Turkey:** Our 2016 O/W call on Turkey has been off-side since the attempted coup in mid-July. While we believe an increasingly cheap equity market has been a reason for hope, we now see the risks for EM investors as too high and cut to U/W: i) local interest rates (including CBT policy rates) are too low, in our view (Figure 13 below), given a forecast inflation rate of 7% this year; ii) a higher current account deficit to 5.8%/GDP in 2017 – the highest in MSCI GEMs countries – due mainly to rising oil prices, to which Turkey is particularly exposed, and falling tourism revenues; iii) the bulk of the above c/a deficit is financed by short-term capital flows into both debt and equity (Figure 14); iv) together these factors imply that Turkish asset prices, especially the lira, are particularly exposed to higher US yields and a stronger USD; v) tied to the above point, the lira accounted for virtually all of the 18% drop in the MSCI Turkey index in the second half of last year (at a time when MSCI GEMs rose by 3.4%); we believe the risk is now that the equity market eventually gives up some ground also, not least as the weaker lira is a substantial negative for companies given the overhang of foreign currency debt. So, although we believe the equity market is cheap (7.8x v. an average of 9.5x), we believe GDP should grow 3% in 2017-18 (although the risk here is to the downside) and our base case is for a flatter Lira in 2017. Therefore, in overall terms, we think risk trumps reward in Turkish equities.

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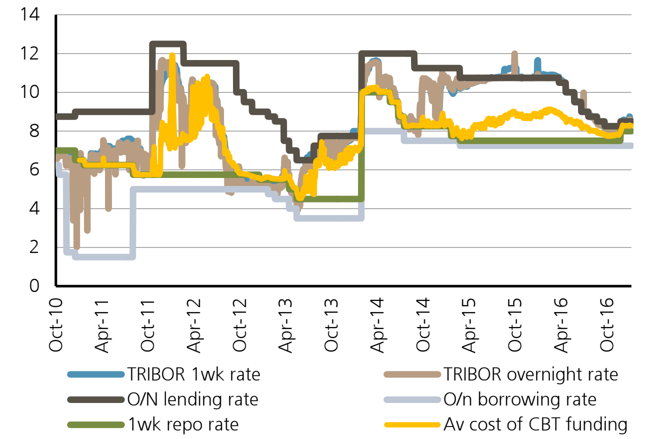
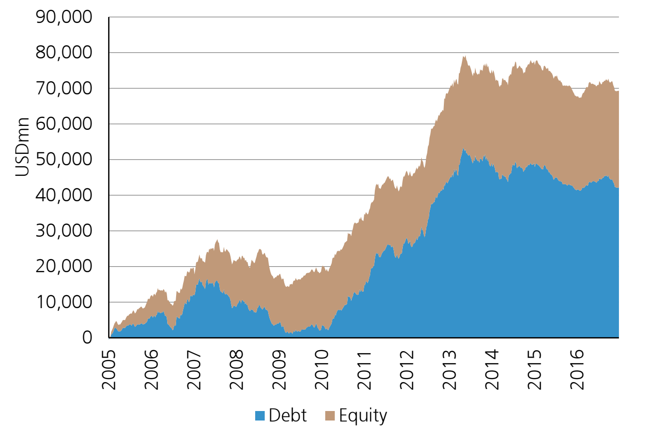
[9] "Visit notes from South Africa", Macro Keys, Gyorgy Kovacs and Geoffrey Dennis, October 19, 2016.

Figure 13: Turkey: CBT Policy rates



Source: CBT, Haver, UBS

Figure 14: Turkey: Cumul'e flows into local curr'y assets



Source: Haver, UBS

- **Mexico:** Despite lagging EM badly in 2016 (-11% v. +8.6%), we stay U/W. While it may have been tempting to 'buy the (US election) news', macro, peso and trade risks remain high. Our U/W is based on: i) a rich market (16.5x forward) where high valuations are now less easy to justify; ii) weak growth (1.7%e in 2017), hurt by a slow consumer, little help from the US economy and rising inflation; iii) tight fiscal/monetary policy; we expect rates to rise by 75bp in 2017 to 6.5%; iv) EPS growth estimates for 2017 look too high (18%). The risk of some economically-damaging 'renegotiation' of NAFTA is clear;

- **Chile:** We stay U/W in Chile, our regional strategist's least preferred Andean market. Ex-copper, GDP is growing around 3%, and we see scope for copper prices to rise in 2017. However, while we expect 50bp of rate cuts this year, credit demand and wage growth are weak and fiscal policy looks likely to turn more restrictive. Investment is also still weak, held back by policy uncertainty, ahead of the Presidential election in November 2017. We think the market seems rich at c15.3x forward, although in line with its long-term average;

- **Czech Rep/Greece:** We are U/W both Czech and Greece, which both trade at around 14x forward, well above the EM average (11.9x). We believe the macro in the Czech Rep remains good, rates and inflation are rock-bottom and the currency is solid; the problem is finding a stock that looks attractive. Macro risks are still high in Greece although we expect growth of 2% this year and 2.6% in 2018. The main current uncertainty is the second review of Greece's third bailout package and related issues such as debt relief, IMF participation in such a program and Greece's potential inclusion in the ECB's QE. Despite falling 13% in 2016, it may be too early to enter the market;

We enter 2017 with Neutrals in the following markets:

- **China:** MSCI China performed well in H2 (+5.4% v. EM at +3.4%) after a poor H1 (-6.4%, v. +5%) as quieter markets (v. early-2016) and low valuations attracted buyers. We remain Neutral. The EPS outlook seems solid for 2017 (cons: +15%) and the market is still fairly cheap (11.4x fwd v. a LT average of 12.1x). Also, after the launch of Shenzhen Connect, southbound flow should improve and we think the A/H-share valuation gap is attractive. Rebalancing of the economy continues and the RMB should drift lower still (we expect CNY7.3 at end-2017). The main upside risk we see is faster than expected SOE reform;

- **Brazil:** The 11% fall in MSCI Brazil from end-October to year-end improved risk-reward at the margin and we upgrade Brazil to Neutral. The negatives have increased with new political turmoil threatening the reform agenda and macro data hinting at a very weak GDP bounce; we expect growth of +1.3% in 2017. EPS estimates look high except in a few sectors (e.g. Financials). While pension reform should become law in 2017, the drag on growth from an over-sized government remains. However, the case for more optimism in 2017 is that rates look set to fall by 300bp+ in 2017 to 10.5%, and we expect the Real to rise to BRL3.00 at year-end, as global liquidity conditions provide support.

- **Poland:** The market lagged again last year (-2.2% v. +8.6%) and we now see Polish equities as an opportunity; we upgrade to Neutral. Despite risks to the economy (GDP in 2017-18 of 3.1%e) from a budget deficit near 3%/GDP - which may force counter-cyclical fiscal adjustment – and weak internal political cohesion, the market now looks cheap at 11.9x fwd (v. its avg of 12.4x). We believe currency risk is low so Poland should be defensive to global volatility; inflation is rising but we see rates growing by only 25bp to 1.75% in 2017. This is good for banks; we add PZU (Financials) to our Top 40 EM Stock List.

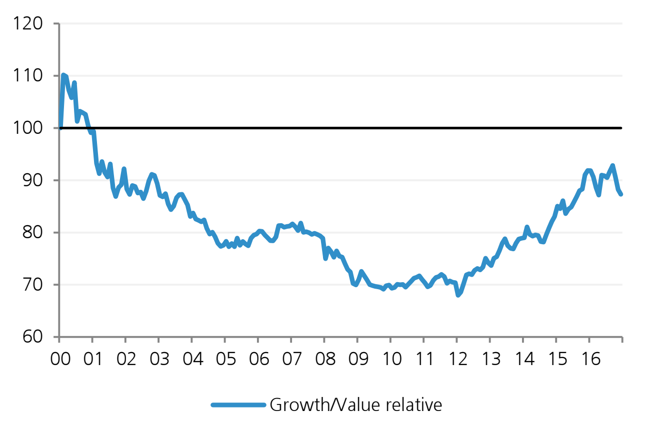
- **ASEAN – Indonesia/Thailand:** In our ASEAN Underweight, our Asian team prefers Indonesia and Thailand which are rated Neutral within GEMs. Of the two, Indonesia looks best positioned given: i) a manageable external deficit; ii) ongoing reforms; and iii) low debt levels. However, the market seems rich (15.4x fwd v. a recent avg of 11.1x), with a 2017 cons EPS forecast of 19% that looks high to us. We expect 50bp of rate hikes this year although higher US rates may still put pressure on the Rupiah. The Thai market is grappling with the latest bout of political uncertainty; valuations appear high (14.6x v. 12.2x) although consensus EPS of 9% in 2017 looks fair. We expect a further boost to fiscal spending and the Baht looks to be the lowest ASEAN FX risk.

O/W Sectors: Energy, Financials, Indust'ls – Value v. Growth

Turning to sectors, we make wholesale changes to our recommended portfolio heading into 2016. We upgrade Energy and Financials to Overweight and cut IT, Consumer Discretionary and Health Care to Neutral; we remain Overweight in Industrials and Underweight in Materials, Consumer Staples, Telecoms and Utilities. Overall, we have a clear preference for cyclicals over defensives and for value over growth

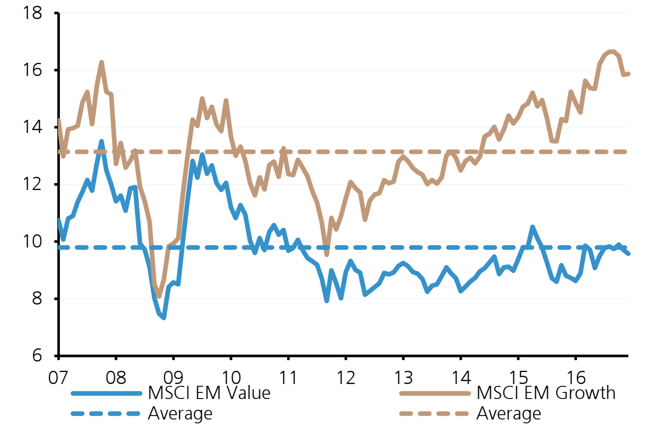
- **Value v. Growth:** Within EM, Growth has outperformed Value (based on MSCI sub-indices) since early-2012. However, since last summer, there have been signs of a turn in this relative (Figure 15). We have modelled the change in this style relative and found that Growth tends to outperform Value when: i) EM equities outperform EM bonds; ii) EM equities underperform DM equities; iii) the USD TWI rises; and iv) EM exports fall. Paraphrasing this, EM Growth has tended to outperform Value in recent years in falling markets and 'risk-off' environments. Given our mildly bullish view of EM equities this year, our fairly benign outlook for global liquidity and relative valuations – with Growth currently trading (15.9x forward) at a 21% premium to its long-term average of 13.1x forward, while Value is at a 4% discount to its average of 9.8x (Figure 16) – we have a strong preference for Value over Growth within EM;

Figure 15: MSCI EM Growth/Value Performance



Source: MSCI, Datastream, UBS

Figure 16: EM Growth Value: 12M Forward P/E



Source: Bloomberg, UBS

- **Energy (Overweight):** After upgrading Energy at the start of 2016 and then pulling it back to Neutral around mid-year, we now lift the sector to O/W again. We retain our strong preference for Energy over Materials, where we stay U/W. It is not too late, in our view, to buy Energy (+32.5% in 2016) based on: i) oil prices (Brent) forecast to rise further to average $60/barrel in 2017 and higher beyond this year; ii) 2017 is likely to be the year that the oil rally comes through to corporate earnings. Consensus EPS gains of 20% for 2017 have left the sector at 9x forward still, very cheap to EM (11.9x), although this is above the sector's long-term average of 7.7x. We would add exposure;

- **Financials (Overweight):** We upgrade EM Financials to O/W. While our Global Banks Strategist, Philip Finch, has recently turned slightly more cautious on EM (v. DM) banks, given the post-US election impact on EM equities of rising US yields and a stronger dollar, he notes three reasons for optimism on the sector for 2017[10]: i) EM Financials should benefit from the recent rise in global yields via higher NIMs; the correlation between higher yields and EM bank valuations has been high in recent years; ii) improving sector fundamentals with an inflection point in asset quality, signs of a pick-up in loan growth and in earnings momentum; and iii) valuations. The sector is one of only two in EM (the other being Utilities) with a forward P/E below its long-term average (9x v. 9.9x), while EM banks trade at a discount of over 30% to their recent average P/BV (1.7x) with a sector ROE (11.7%) just a percentage point below its long-term average (12.7%). Within EM banks, UBS likes banks in Hungary, Indonesia, Mexico, Peru and Russia (see our Top 40 EM Stock List).

- **Industrials (Overweight):** We play our strategy of having some weight in domestic cyclicals - looking for exposure to sectors linked to our forecast of a modest pick-up in global growth - by retaining our Overweight in Industrials. The sector underperformed last year (-3.7% v. +8.6% for GEMs); while the sector is still expensive at 13.1x (v. a long-term average of 11.6x), earnings growth is likely to rebound strongly to 20%+ this year. Within the sector, we have exposure on our Top 40 EM Stock List to Industrials in China (railway construction and an industrial conglomerate) and transportation in Korea;

[10] "Can EM banks perform with rising US bond yields?", LatAm Financials Insights, Philip Finch, November 20, 2016.

- **Neutral:** We are Neutral in three sectors – IT, Consumer Discretionary and Health Care - all of which are cut from Overweight. Aside from the global cyclicals, **IT** was the best-performing EM sector last year (+15%). We switch our favoured 'big' sector call from IT to Financials for 2017 (both are around 23-24% of MSCI GEMs) based on IT's strong outperformance last year and given that the sector now looks slightly expensive at 14.3x forward (v. an average of 13.5x), with a consensus EPS forecast for 2017 as high as 22%, and at 2.39x BV (v. a mean of 2.48x), albeit with a high sector ROE of 13.7%. Even after a flat 2016 (-0.4%), **Consumer Discretionary** is also now expensive at 14.1x forward (v. 11.3x), but with strong earnings momentum heading into next year (17% assumed for 2017), above the EM average; the sector also tends to do well when interest rates fall but, aside from Brazil, Colombia and Russia, the scope for monetary easing across EM in 2017 looks limited. We are also Neutral in **Health Care** - small, expensive at 21x forward and traditionally defensive, but which was the worst-performing EM sector in 2016 (-8.3%);

- **Materials (Underweight):** We stay Underweight in Materials, a sector that outperformed strongly in 2016 (+29% v. +8.6% for GEMs), including since the US elections, as metals prices rallied strongly. We see the latter (especially iron ore) as much more fundamentally driven by growth of the Chinese economy (which is likely to slow again over the medium-term) rather than the US. UBS expects iron ore prices to fall significantly this year (to an average of $56/tonne) as the property sector boom in China cools and the overall economy resumes its soft landing path, heading for only 6% growth by 2018;

- **Underweight:** Our other Underweight sectors are defensive: Consumer Staples (still very rich at 20x forward v. a long-term average of 16.3x, despite falling by 1.6% last year), Telecoms (rich at 15x forward v.13.1x, also despite a poor performance in 2016 as earnings fell); and Utilities (very cheap on an earnings basis at 9.5x forward v. a long-term average of 11.5x and fair value on P/BV at 1.05x, just above its long-term average of 1.02x).

Global Macro: Growth Picking Up in 2017

UBS economists are more positive on the outlook for the global economy for the year ahead than they have been for some time. Global growth in 2017 is expected to jump to 3.6% (the highest growth rate since 2011) from a disappointing 3% last year (Figure 17). The forecast pick-up is, however, narrowly-based, being mainly due to sharp rebounds in a few countries, notably in emerging markets. We expect US growth to rise to 2.4% in 2017 from a sub-par 1.5% last year for two main reasons: i) no repeat of the big drag on growth from inventories in 2016 H1; and ii) a modest pick-up in capex, mainly in Energy (as oil prices have rebounded); this 2017 growth forecast has not changed since the US election. Elsewhere in DM: i) Eurozone growth should slip to 1.3% in 2017 from 1.6%, as the exceptional boost to domestic demand in 2016 from low oil prices and low inflation fades; ii) the post-referendum UK economy may not be as weak as feared, but growth is still forecast to halve to 1% this year; and iii) Japanese growth is expected to edge up to 0.8% in 2017 from 0.5%. Overall, DM growth is forecast to rise to 1.8% in 2017 from 1.5% last year.

Figure 17: UBS Global/EM Growth Forecasts (2015-2018)

		GDP Growth				CPI Inflation (%y/y)			
%y/y	Weight	2015	2016E	2017E	2018E	2015	2016E	2017E	2018E
US	0.19	2.6	1.5	2.4	2.5	0.1	1.3	2.3	2.3
Japan	0.05	0.6	0.5	0.8	0.9	0.8	-0.3	0.5	0.6
Eurozone	0.11	1.9	1.6	1.3	1.2	0.0	0.2	1.4	1.8
UK	0.03	2.2	2.0	1.0	0.7	0.0	0.7	2.8	2.8
Asia	0.42	6.1	5.7	5.9	5.8	2.4	2.5	2.8	2.7
China	0.22	6.9	6.7	6.4	6.0	1.4	2.0	2.3	1.8
India	0.09	7.6	6.0	8.0	7.8	4.9	4.7	4.1	4.9
Korea	0.02	2.6	2.8	2.6	2.5	0.7	0.9	1.8	1.7
Taiwan	0.01	0.6	1.6	1.0	1.8	-0.3	1.2	1.5	1.1
Latin America	0.09	-0.4	-1.0	1.6	2.3	4.9	6.5	4.2	4.3
Brazil	0.03	-3.8	-3.6	1.3	2.6	9.0	8.8	4.5	4.6
Mexico	0.02	2.5	2.2	1.7	2.0	2.7	2.8	4.2	4.2
Emerging EMEA	0.09	0.2	1.1	2.1	2.4	9.0	5.7	4.6	4.5
Russia	0.04	-3.7	-0.6	1.3	1.7	15.5	7.0	4.9	4.2
South Africa	0.01	1.3	0.6	1.2	1.6	4.6	6.3	5.7	5.6
Advanced	0.46	1.9	1.5	1.8	1.9	0.2	0.7	1.8	1.9
Developing	0.54	4.4	4.2	5.0	5.1	4.7	4.2	3.8	3.6
WORLD	1.00	3.3	3.0	3.6	3.6	2.6	2.6	2.9	2.8

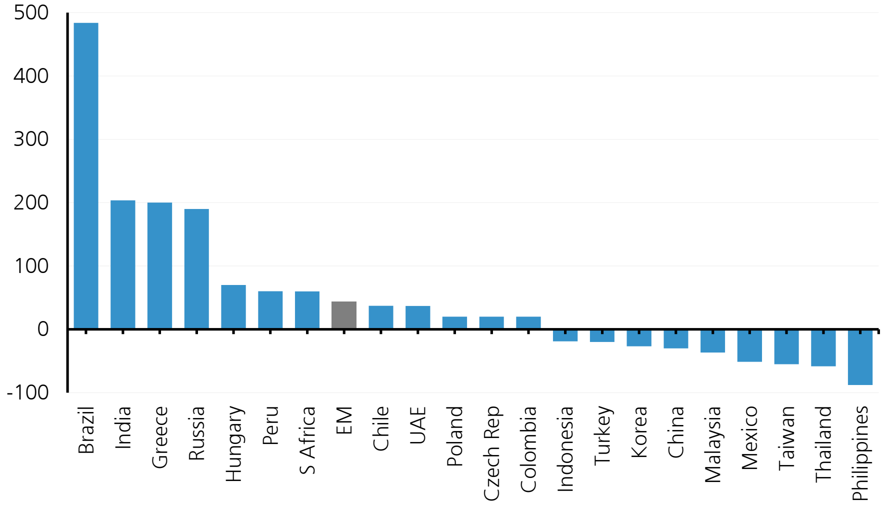
Source: UBS estimates

Although EM growth (defined above as 'developing') is forecast to rise sharply to 5.0% in 2017 (from 4.2% last year), investors should not get too excited, in our view. The underlying pace of economic growth in EM remains 'subdued' – especially in Asia. The stronger growth this year in EM is essentially due to

- Recovery from recession to positive (although low) growth in **Brazil** and **Russia** and from zero growth in **Greece**; and
- A sharp rebound in FY18 growth in **India** from the disruptive near-term effects of de-monetization.

Only twelve of the MSCI GEMs index countries that we cover (21 of the 23) are expected to see a pick-up in growth this year from 2016 (Figure 18); further, on an MSCI GEMs-weighted basis, GDP growth is, anyway, at a much lower level although still expected to rise this year to 3.7% from 3.3% in 2016 – see below.

Figure 18: Forecast EM GDP Growth in 2017 v. 2016 (bps)

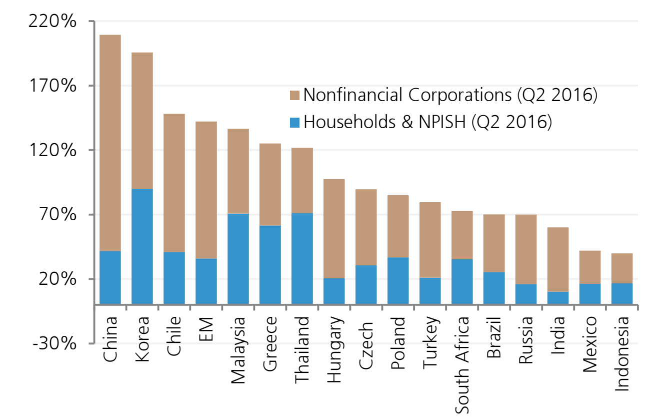


Source: UBS Forecast

We expect the long-term constraints on the pace of EM growth that we have noted for some time will remain firmly in place in 2017:

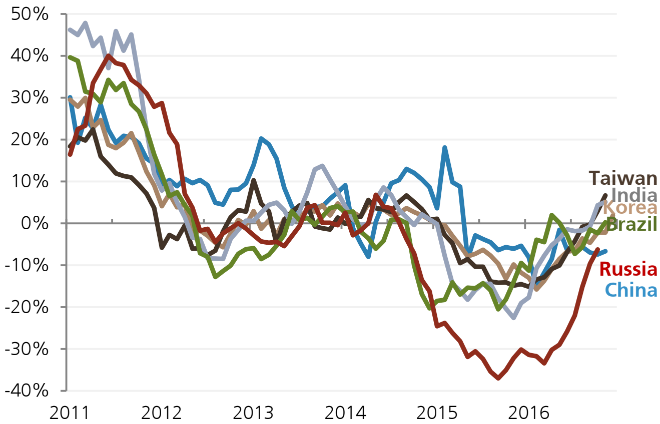
- **The significant overhang of private debt in many EM countries,** notably China and Korea, which has grown rapidly since 2008 (Figure 19);
- **Weak global trade growth (below-average world trade multiplier).** Although export growth, measured in nominal dollars, has begun to rebound across EM in recent months (see Figure 20 for data for some of the major EMs), this is mainly due to a rebound in commodity prices/fall in the US dollar that started last year (reversing the drags from the opposite moves in 2015).

Figure 19: EM: Private Sector Debt (end-Q2 2016, %/GDP)



Source: BIS, UBS

Figure 20: EM Majors: Export Growth (y/y, 3MMA)

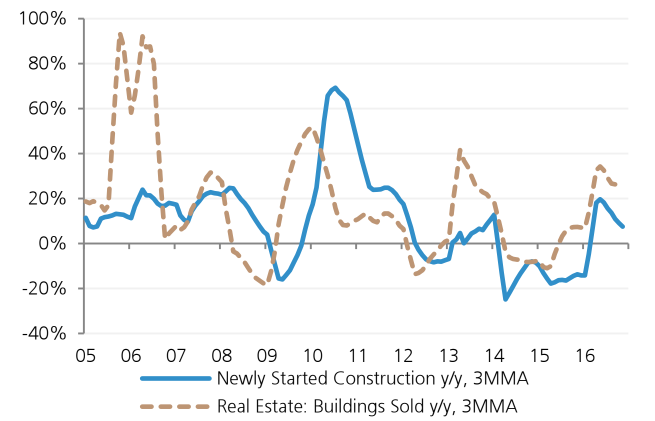


Source: Haver, UBS

Looking at the 2017 outlook for EM growth in more detail:

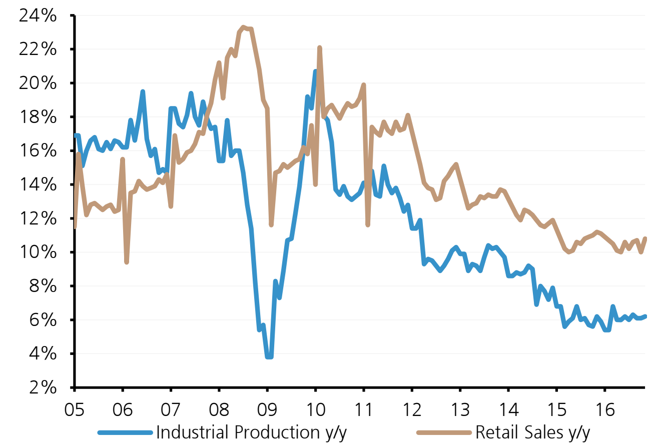
- The macro data in **China** improved for several months last year, mainly due to the rebound in property sales and starts (Figures 21-22). However, the sector is already slowing again and our base case is for overall growth momentum to slow modestly in 2017, as the economy's 'soft landing' trajectory is restored; UBS expects GDP growth of 6.3% this year and 6% in 2018, down from 6.7% in 2016[11]. The key upside risk to growth in 2017 is further policy stimulus (fiscal and credit) ahead of the 19th Communist Party Congress in late-2017; the key downside risks are: i) a sharper property sector adjustment; ii) weaker exports, due to rising protectionism; and iii) a resumption of large-scale capital outflows and, therefore, a bigger fall in the RMB;

Figure 21: China: Prop'y Sales, New Constr'n Starts (Y/Y)



Source: Haver, UBS

Figure 22: China: Industrial Production, Retail Sales (Y/Y)



Source: Haver, UBS

- By far the best EM growth story **(India)**, in our view, has seen a setback from the immediate effects of the de-monetization reform announced in early-November. Our economists' underlying assumptions are: i) near-term disruption to the economy; ii) medium-term support for the credit cycle; and iii) increased formalization of the economy. Their preferred scenario – 'Slower Recovery' – assumes six months of disruption; they have cut their GDP growth forecast for FY17 (to March 2017) to 6% from 7.4% and lifted their call for FY18 to 8% from 7.6%. They see scope now for another 50bp of rate cuts in 2017;

- Ex-India, growth in every country in **EM Asia** is forecast to slow in 2017[12]. This is not just about weaker Chinese growth, but also a more modest pick-up in export volumes than in nominal exports and the position of most of EM Asia in the later stages of a domestic credit expansion that is losing momentum. The rebound in India from the de-monetization disruption (we assume calendar year GDP growth of 8% in 2017) still pulls overall EM Asia growth up to 5.9% this year from 5.7% in 2016; the standouts in the region should remain the Philippines (6% expected in 2017) and Indonesia (4.8%);

- We believe the major cyclical driver of stronger EMEA growth in 2017 will be the rebound of the **Russian** economy to 1.3% growth from -0.6% last year[13]. This recovery is supported by higher oil prices and rising consumer spending,

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[11] "China Economic Outlook 2017~2018", China Economic Perspectives, Tao Wang, November 14, 2016.
[12] "Asian Economic Outlook 2017-2018", APAC Economic Perspectives, Duncan Wooldridge, November 15, 2016.
[13] See "Emerging EMEA Economic Outlook 2017-18", referenced above.

based on a resilient labour market, lower inflation, targeted social spending increases and household deleveraging. We expect interest rates to fall by a further 200bp to 8% in 2017 and the Ruble to rise to RUB55 by year-end. Russia remains an Overweight within EM and our top market pick for 2017;

- For overall **EMEA**, UBS economists expect growth to jump from 1.1% last year to 2.1% in 2017. While the recovery in Russia is the main contributor to this pick-up, all other regional economies - except Turkey - should see stronger growth this year. The key regional themes for 2017 are expected to be: i) higher oil prices; ii) a less supportive global interest rate environment; iii) the scope for countercyclical fiscal policy; and iv) how much re-leveraging?;

- After contracting by over 7% in the past two years (2016: -3.6%), we expect GDP in **Brazil** to recover modestly in 2017 (+1.3%)[14]. The factors supporting a modest macro bounce are: i) improved confidence levels; and ii) a lower cost of capital. However, the pace of recovery is likely to remain disappointing given high unemployment, a high consumer debt load, extensive excess capacity and weak exports. We believe there is room for ample monetary stimulus with the Selic rate expected to fall by 325bp to 10.5% by end-2017.

- The 2017 outlook for **Mexico** is cloudy, not least because of the uncertainty surrounding US President-elect Trump's policies on trade and immigration. At a minimum, this is likely to lead to a postponement of investment decisions. The consumer is slowing and we see little boost to Mexican manufacturing from stronger US growth. Add to this the ongoing fall in oil output, budget cuts, higher inflation and the prospect of further rate hikes and UBS economists have cut their Mexican GDP growth forecast for 2017 from 2.2% to 1.7%;

- For **LatAm** as a whole, the outlook is for a slow recovery in 2017 (+1.6%) – led by Brazil and Argentina - from two years of contraction, but where potential growth rates in the region have slumped to 2-3%[15]. The economic adjustment forced by falling commodity prices is underway with external deficits shrinking. Domestic demand, especially investment, should pick up slowly given falling interest rates, some fiscal room and a need to rebuild inventories.

This UBS global outlook for 2017 translates into a widening of the gap between EM and DM growth to 320bp (EM at 5% v. DM at 1.8%) from 260bp (4.2% v. 1.6%) last year (Figure 23 below). This would be the biggest annual increase in this EM-DM growth gap, defined this way, since 2009 (when, after the Global Financial Crisis, EM growth fell sharply but DM growth turned negative). However, if we use MSCI index weights for both parts of this calculation (where, as noted above, EM growth comes out much lower), we estimate that the EM-DM growth gap will be largely unchanged in both 2017 (3.7% v. 2.0%) and 2018 (3.9% v. 2.1%) versus a gap of 180bp last year (3.3% v. 1.5%).

This is important. It is well-understood that there are disconnects between: i) GDP growth and EPS growth; and ii) EPS growth and equity performance, However, there has been, in fact, a remarkably close link between the EM-DM GDP growth gap and the relative performance of EM/DM equities in recent years especially since 2000 (Figure 24). Simply put, surging EM (v. DM) growth in 2002-7 was

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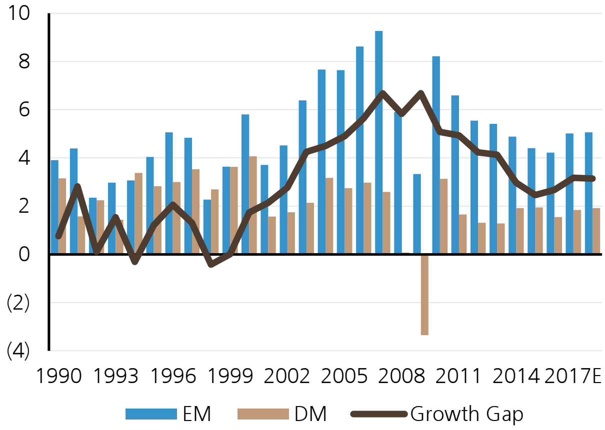
[14] "Latin America Economic Outlook 2017-2018". Latin American Economic Perspectives, Rafael de la Fuente, Guilherme Loureiro, November 15, 2016.
[15] "Is 2% the new 4%? Re-examining Latin America's Potential Growth", Macro Keys, Thiago Carlos, December 8, 2016.

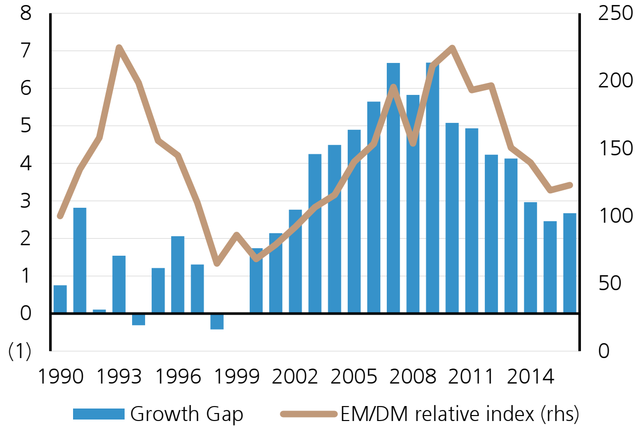
accompanied by major outperformance of EM equities; both trends then decisively reversed from 2010 to 2015, when DM growth rates fell less than those in EM (and the EM-DM growth gap hit a 14-year low of 250bp (4.4% v. 1.9%), or 110bp (3.3% v. 2.2% on an MSCI-weighted basis). Then, last year's higher growth gap was accompanied by slightly better performance of EM equities. Looking ahead, these trends are neutral to positive for EM equities relative to DM in 2017, notwithstanding the rally in US equities and the rotation from EM into DM since the US election.

Figure 23: EM v. DM (and Relative) Growth (1990-2018E)



Source: Haver, IMF (1990-2002),UBS estimates (2003-2018E)

Figure 24: EM/DM GDP Gap and Market Relative (y/y)



Source: MSCI, Datastream, Haver, IMF (1990-2002),UBS estimates (2003-2018E)

EM and Global Markets: Plenty of Volatility

It is well-understood that EM equities are at the high-risk end of the financial asset spectrum. Our view has always been that the further towards that high-risk tail an asset is, the more dependent its price is on the performance, volatility etc. of other (bigger) asset markets. While this has always been the case, it seems that the volatility of these key asset drivers in the past year has been even greater than usual, so affecting EM significantly. Evidence of this includes the fact that MSCI GEMs fell by 13.5% in the first three weeks of the year, rose by 34.5% to the high for the year in early-September and then fell by 7% to the year-end. The periods immediately after the UK referendum on June 23rd (positive for EM) and the US election on November 8th (negative for EM)[16] were particularly choppy within an overall volatile year.

With global markets having moved from 'recession-panic' at the start of 2016 to the 'reflation trade' by the end of the year, the scope for more volatility in 2017 seems high. Before we set out our central scenario for EM equities for the year ahead, based on the assumed global backdrop, we repeat some of the basic linkages that we rely upon between key global market variables and EM equities:

- Higher US bond yields are negative for EM equities (usually);
- Fed tightening is negative for EM equities;
- A lower dollar is positive for EM equities;
- Higher oil prices are positive for EM equities (usually).

With these linkages in our back pocket, how does our Global Macro Strategy team see 2017 playing out[17]? Since the US election, markets have moved to price in higher growth, higher inflation and regulatory easing; however, our base case is that the path to 'global reflation' is 'narrow', although 'visible'; if 'lower for longer' (growth, inflation, rates and yields) has become less easy to defend in recent weeks, the mantra of 'low trend growth and low core inflation' remains broadly intact. There is more attractive risk-reward from positioning for higher growth than there is for higher inflation; however, we have not changed our US GDP growth forecast for 2017 of 2.4% since the election. We believe that recent market moves are premature based on the macro foundations, although the potential for large-scale fiscal easing and higher inflation have increased upside risk to yields.

We think global markets have moved too far. The hawkish interpretation of the mid-December FOMC's decision to raise the 'dot plot' from 2 rate hikes to 3 in 2017 (despite no change in the 'balanced' view of the risks to the macro outlook), with long rates moving sharply higher again – putting new pressure on EM equities - is more likely to be disinflationary than the opposite[18]. Indeed, recent events may already be establishing negative 'feedback loops' whereby a hawkish Fed, higher yields and a stronger dollar are negative for economic activity, which may ultimately reverse the dollar's appreciation and, presumably also, the rise in yields.

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[16] "EM into DM: Is the Rotation over Already?", Macro Keys, Geoffrey Dennis, December 6, 2016.
[17] See "2017 Markets Outlook: What needs to happen for '17 to be a game-changer year?" Global Macro Strategy, Yianos Kontopoulos, November 15, 2016.
[18] "Fed too hawkish for markets, negative feedback loops re-emerge", Global Macro Strategy, Chirag Mirani, December 14, 2016.

In sum, our base case for EM equities in 2017 to be developed below is premised on the views that, from current levels: i) US bond yields fall back again; ii) the Fed moves slowly; iii) the USD falls v. DM currencies; and iv) oil prices rise further. Let us look at the impact of all of these assumptions on EM equities.

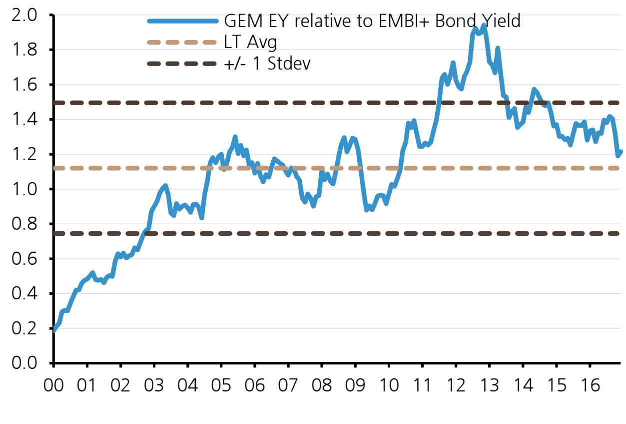
US Bond Yields

The outlook for global fixed income markets will, in our view, remain the key macro driver of EM equities in 2017. Last year's rally in MSCI GEMs (still worth as much as 25% at year-end from the late-January trough) received solid support from lower benchmark yields and falling EM spreads. However, the H2 back-up in US 10-year yields (almost a doubling from a post-UK referendum low of 1.36% to 2.6% in mid-December), with the biggest move occurring since the US election before which yields were 'only' 1.85%) damaged the supportive liquidity backdrop for EM equities and caused an abrupt drop in the EM Earnings Yield Ratio (versus EM bonds), moving equities back close to fair value v. bonds (Figure 25 below).

This surge in yields had two other effects. First, it abruptly ended, at least for now, one of last year's key EM themes – the 'hunt for yield' - as US bond yields and EM dividend yields converged again. Secondly, it also revived the debate over whether EM equities prefer 'stronger global growth, a stronger USD, higher DM yields and even more Fed' over 'ongoing sub-par growth, more/prolonged QE, a flat USD and stable bond yields'. Given recent events, the latter 'liquidity' scenario should, in our view, provide a more solid base for EM equities in 2017 ('carry v. growth'); therefore, our assumptions from here of flat/falling US yields and a broadly flat USD (below) are crucial to our outlook for EM equities in 2017.

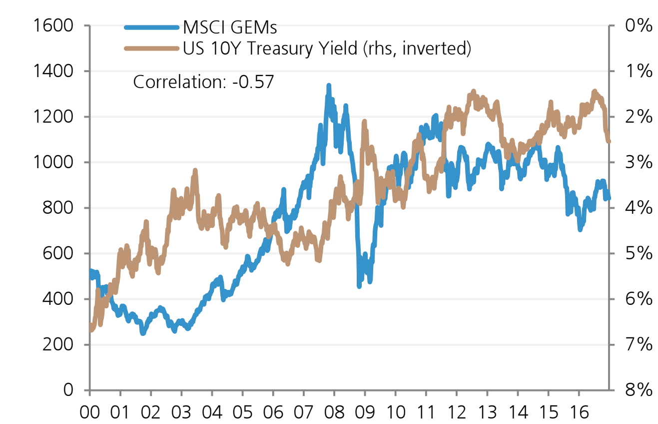
But, let us look at the data first. The link between US Treasuries and EM equities is negative although - with a correlation of only -0.57 – not that tight (Figure 26). A better way to look at this bond/equity linkage may, therefore, be to focus on the impact on EM equities of two major bond market sell-offs in recent years.

Figure 25: GEMs Earnings Yield Ratio (EY/BY for EM)



Source: IBES, MSCI, Datastream, UBS

Figure 26: MSCI EM vs 10Y Treasury Yield



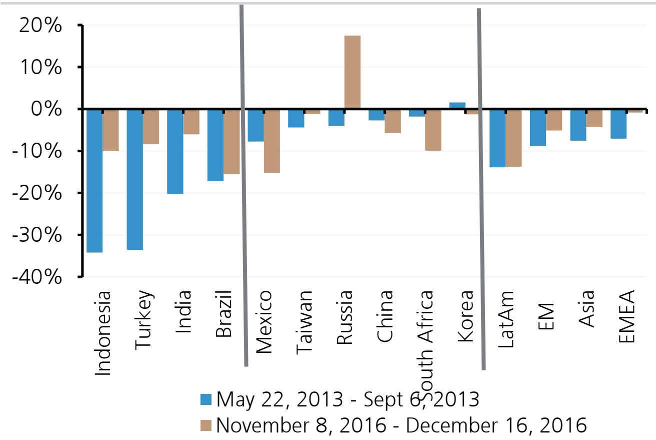
Source: IBES, MSCI, Datastream, UBS

EM investors remember, with little fondness, the so-called 'taper tantrum' of 2013 when an unexpected comment in late-May by then-Fed Chairman Bernanke that QE tapering may be close at hand was greeted by a major bond and EM equity sell-off. It is reassuring that, despite recent weakness (MSCI GEMs ended last year down 7% from its early-September high), the latest ('election'?) sell-off has been less damaging to EM equities than was the earlier episode:

- **Taper Tantrum (2013).** US 10-year yields rose by just over 100bp (1.94% to 2.95%) from late-May 2013 - after the Bernanke tapering comment - to early September. (This was the period that famously launched the concept of the 'Fragile Five' in emerging markets.) MSCI GEMs fell by 8.8% as yields rose, exactly half of which was currency-related (Figures 27-28 below). There were some substantial equity market losses over this period with Indonesia and Turkey down around 34% (in USD), India by 20% and Brazil by 17%; for India and Brazil over half of the decline was due to currency. The other major markets in the chart outperformed GEMs during this taper tantrum, notably Korea (+1.6%), South Africa (-1.8%; interestingly, as it had been designated as one of the 'Fragile Five') and China (-2.7%). Latin America (-13.9%) lagged the GEMs index badly while Asia and EMEA outperformed, falling by only 7-8%;

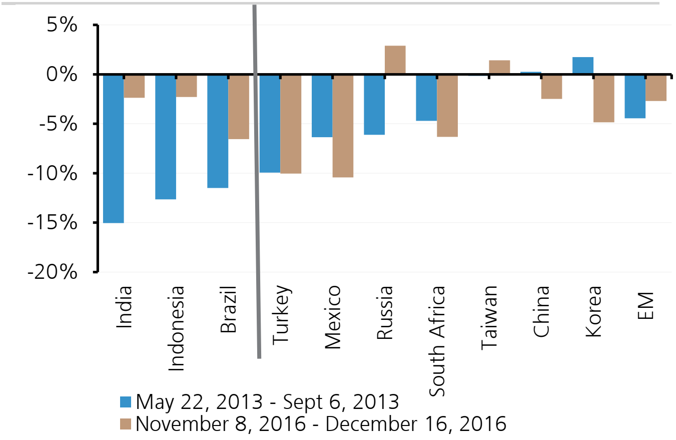
- **Election Rotation (2016).** Whether we focus on the US bond market sell-off since the election, as here, or the more extended bounce in yields from the July trough, the impact on EM equities of last year's sell-off episodes was less than in 2013[19]. Taking the 75bp rise in US yields in well under two months from the US election to the yield high in mid-December, MSCI GEMs fell by 'only' 4.9% with, again, around half being due to currency. While the magnitude of the EM losses was much less this time, the pattern of relative performances was similar to the 2013 episode. Brazil and Mexico led the way in terms of losses (-15%) and, while Indonesia, Turkey and India all lagged again, the magnitude of their declines was far less (especially in India at -6%[20]). Taiwan and Korea (small falls) outperformed the GEMs index, as did Russia (substantially: +17.5%). Latin America (-13.8%) again underperformed significantly. In terms of FX, however, the pattern *was* very different from 2013 with Mexico and Turkey falling the most (-10%) and the Ruble and the Taiwan dollar actually rising.

Figure 27: EM Performance in US Bond Sell-Offs ('13, '16)



Source: MSCI, Datastream, UBS

Figure 28: EM FX Perform'e in US Bond Sell-Offs ('13, '16)



Source: MSCI, Datastream, UBS

Looking ahead, what is our central case for the US bond market, given that the tug-of-war between higher yields/better growth and flat yields/lower growth looks

[19] This may be for many reasons including; i) lower equity valuations compared to May 2013; ii) the pursuit, mainly, of orthodox monetary policies across EM in recent years; iii) lower current account deficits; and iv) a rebound in commodity prices. Whatever the reason(s), the better performance is clear.

[20] The coincident introduction of 'de-monetization' in India clearly contributed to these losses. The shock de-monetization announcement was made on the same day as the US elections (November 8th).

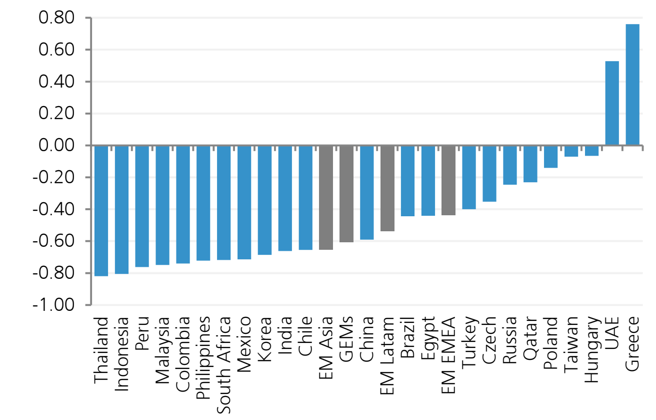
likely to remain the key driver of EM equities in 2017? Overall, we reiterate our view that global markets may have already moved too far. Our Global Macro Strategy team has argued that the impact of US fiscal and regulatory easing suggests that a 10-year yield range of 2.2-2.8% is appropriate and yields are currently around the middle of this range[21]. Indeed, for yields to break out above this range, on fundamental grounds, we estimate that US trend growth would have to rise by 0.5% or more per annum from current levels. This base-case scenario should not represent major new headwinds for EM equities in 2017; indeed, our point forecast is for US yields to decline again to 2.25% by year-end.

Certainly, a better global growth trend (due to higher US growth under a Trump administration) *would* boost top-line revenues in EM, adding fuel to the pick-up in EPS growth arising from recent signs of a rebound in ROEs (below). However, the risks from this scenario are clear: yet higher US yields (and a stronger dollar) may lead to an even bigger rise in EM yields (as spreads widen) while threatening to reverse the almost relentless recent flow of money into EM fixed income markets.

Finally, in this section, we update our correlation work to show where the greatest responsiveness is in EM equities to lower US bond yields as, from current levels, in our base case for 2017:

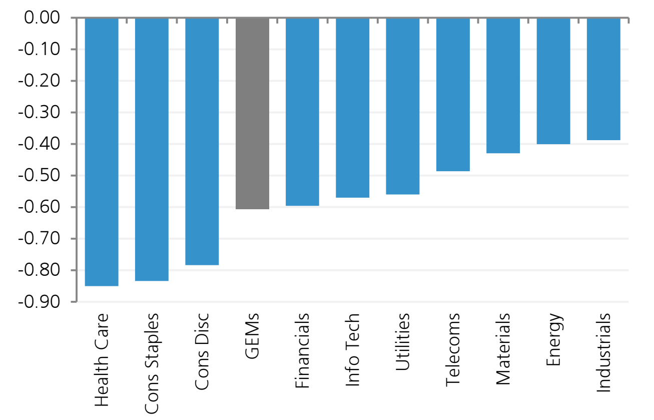
- **Regions**: Based on this work, lower US yields seem to have limited differential impact across the EM regions, with Asia being marginally the most favoured and EMEA receiving the least benefit (Figure 29);
- **Markets**: The ASEAN region, Peru, Colombia and Mexico (within LatAm) and South Africa, should receive the most benefit from lower US yields. On the other hand, the least responsive markets to lower US yields (and the most defensive to higher yields) include a raft of EMEA markets – UAE, Qatar, Greece, all of CE3 and Russia – plus Taiwan. Somewhere in the middle as beneficiaries of lower US yields are China, India, Korea and Brazil.

Figure 29: EM Country Correlations vs US 10Y Yields



Source: MSCI, Datastream, UBS. Correlations based on monthly data since 1999

Figure 30: EM Sector Correlations vs US 10Y Yields



Source: MSCI, Datastream, UBS. Correlations based on monthly data since 1999

- **Sectors:** Sector correlations suggest that domestic defensive (and rich) sectors – Health Care and Consumer – would benefit the most from lower US yields

[21] See "US Yields Unlikely to Rise A Lot Further Without Growth Evidence", Global Macro Strategy, Themos Fiotakis, December 15, 2016.

(Figure 30), while Industrials, Energy and Materials receive the least benefit. The logic is that lower US 10 yields should imply growth disappointments and/or lower inflation which would hurt the global cyclical sectors.

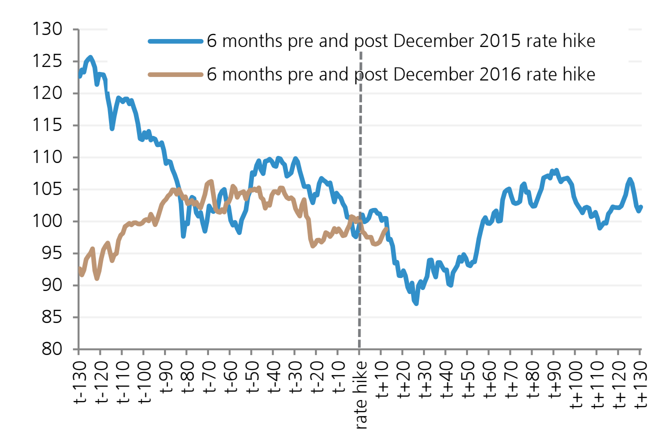
Fed Funds: Less is (still) less

Investors have been worrying for some time that the similar timing of the Fed's rate hike this December (only the second of this cycle) to the December 2015 (first) rate hike of the cycle runs the risk of a market meltdown as in early-2016, when MSCI GEMs lost over 13% in the first three weeks of the year; the macro data deteriorated at that time, the CNY/USD rate fell and the Fed was 'raising rates anyway'. The recent negative reaction to the increase in the number of rate hikes 'expected' by the FOMC in 2017 (the 'dot plot') from two to three at the mid-December FOMC has only added to this fear of 'déjà vu'.

Apart from the idea that history rarely repeats itself exactly, we doubt a repeat scenario for three main reasons:

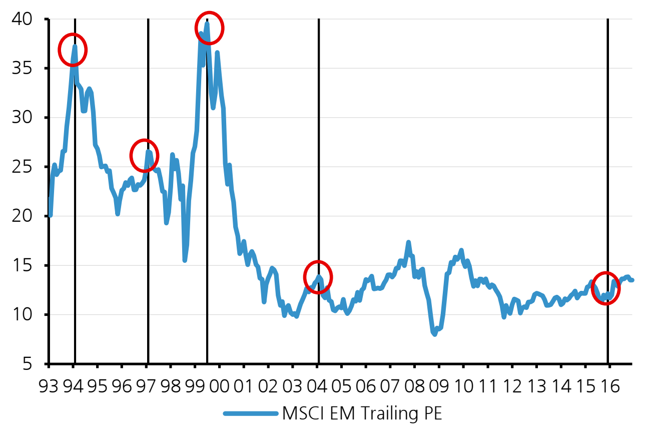
- First, our US economists still expect only two rate hikes in 2017 and have not changed that view since the recent FOMC[22]. They note that the Fed's statement on the risks to the macro outlook remained 'balanced', Chairman Yellen herself argued that the policy shift was 'modest', while any renewed overreaction to the shift in the dots might be self-defeating if financial conditions tightened as a result. Our US economists' view is 'don't focus on the dot forecast' this time;
- Secondly, although EM equities (despite the recent sell-off) have been stronger in the run-up to this Fed hike than they were in December 2015 (Figure 31), the horizon ahead (for 2017) still looks more benign compared to the apparent outlook for the year ahead in late-2015/early-2016. At that time, the Fed's 'dot plot' was signalling four hikes in the year to follow – a real cycle. In hindsight, the Fed tightened just only once last year and so this does not yet really look like a 'cycle'. Despite the assumed acceleration of the pace of rate hikes in 2017 compared to last year (1 to 2), the outlook for US short rates looks a less fearsome prospect for risk assets such as EM equities than it was a year ago.

Figure 31: MSCI GEMs around Fed hikes: Dec 2015 vs 2016



Source: BIS, UBS

Figure 32: MSCI GEMs Trailing P/E and Fed Cycles



Source: MSCI, IBES, UBS. Circles denote trailing P/E at the start of Fed hike cycles

[22] See "Dots move, but FOMC language does not.", US Economic Comment, Drew Matus, December 14, 2016.

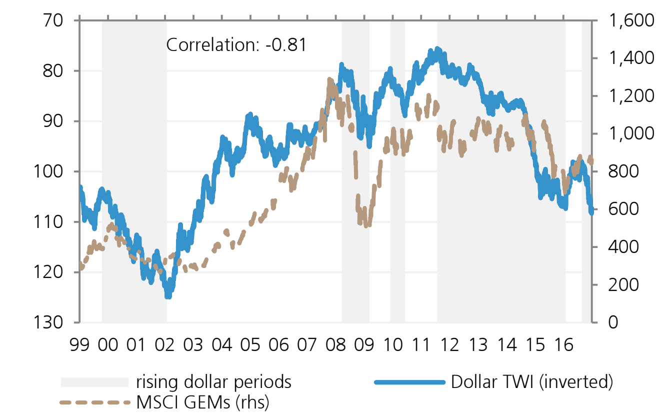
- Thirdly, as have noted many times before. It seems the main US-rates driver of EM equities in the current cycle is the long end of the curve rather than short rates - and our outlook is for 10-year yields to fall over the next twelve months. A flattening of the yield curve as the Fed raises rates modestly this year is not an overly negative scenario for EM, even relative to 2016.

Further, we reiterate our long-held view that it is simply not true that EM equities always do poorly when the Fed raises interest rates. The only really bad Fed cycle for EM equities was 1994-5 (firmly buried in the history books now) when US rates rose 300bp in twelve months, the Fed was not as transparent about its policy intentions as today and EM valuations were particularly high (Figure 32). The only reasonable cycle parallel to today, at least in terms of valuations, is the bull market of 2004-7, when the trailing P/E at the start of the cycle was 13.5x, in line with its current value. While we do not expect a repeat of that positive cycle (the USD was trending lower and EM EPS was rising by around 30% per annum), the outlook for US rates should not be a major negative for EM equities in 2017; the bigger risk, in our view, is that our call for lower US long rates is proved wrong.

US Dollar: (A Little) Less Help than in 2016

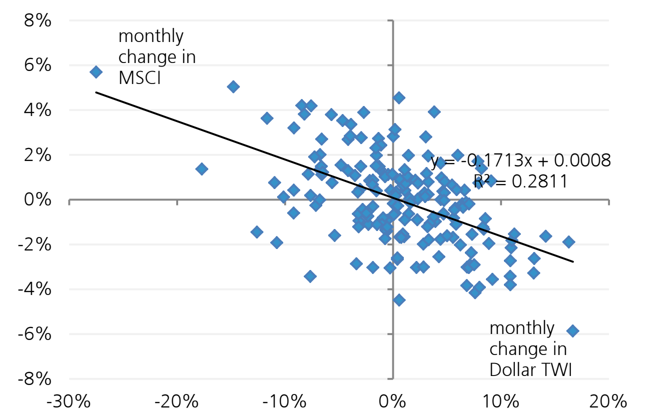
One of our strongest conviction equity strategy views is that EM equities are closely and inversely correlated to the US dollar, with the primary reason being that a rising dollar tends to suck capital from emerging markets and back into the US, damaging both risk appetite and liquidity conditions in EM. There is a tight, negative correlation (-0.81) between the dollar trade-weighted index (TWI) and the MSCI GEMs index (Figure 33) although the scatter plot of monthly changes (Figure 34) is much less convincing with a correlation of only -0.28.

Figure 33: MSCI GEMs ($) vs Dollar TWI



Source: MSCI, Datastream, UBS

Figure 34: MSCI GEMs vs Dollar TWI, Monthly % Change



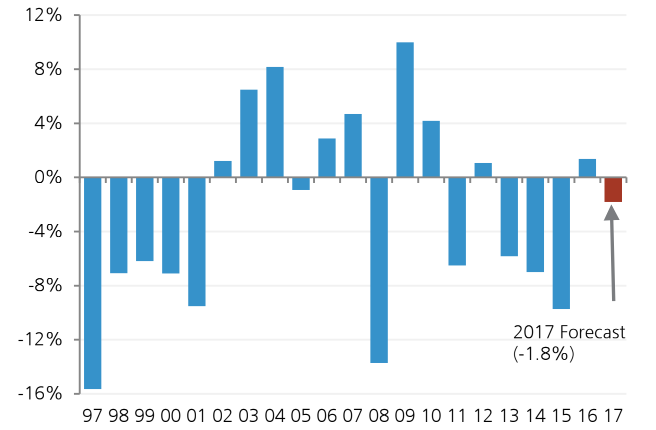
Source: MSCI, Datastream, UBS

This dollar/MSCI GEMs link worked to the marginal benefit of EM equities in 2016. For the year, MSCI GEMs rose by 8.6%, with our EM Currency Proxy (MSCI GEMs ($)/MSCI GEMs (local)) rising by 1.4%, so accounting for 16% of the gain in the equity index. While last year's currency gain was, in the event, disappointing (at its mid-August peak, our Currency Proxy was up 4.5%), this was still the best year for EM currencies (measured this way) since 2010 (Figure 35). More importantly, last year broke the steady downtrend in the EM Currency Proxy in place since the spring of 2011 (Figure 36).

Looking to 2017, the 'big picture' dollar outlook should be broadly favourable for the asset class, although it may still be a mixed bag for EM currency markets. Our

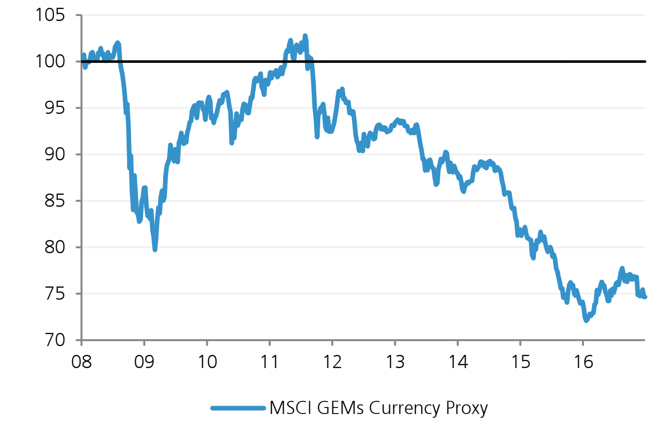
Macro Strategy team continues to argue that the US dollar has peaked against most other DM currencies with forecast decline to EUR/USD 1.13 and USD/JPY110 by end-2017.

Figure 35: EM Currency Proxy: Annual Change (%)



Source: MSCI, Datastream, UBS

Figure 36: EM Currency Proxy (since 1/1/08)



Source: MSCI, Datastream, UBS

However, we are more constructive on the dollar versus most EM currencies[23] and our EM cross-asset team still sees FX as the 'weakest link' among EM assets. While UBS forecasts call for further solid gains in 2017 in the RUB and BRL, the general EM trend, even against a drifting dollar, is towards slightly more weakness in 2017 across most of Asia (including China, India and Indonesia) and in South Africa and, slightly, in Mexico. Based on our full-year 2017 FX forecasts, we project a 1.8% drop in our EM Currency Proxy this year. In short, we don't expect a super-strong dollar in 2017 (for example, a move to parity and beyond versus the Euro) which would be a major negative for EM equities, but we still expect some selective EM FX weakness in the year ahead.

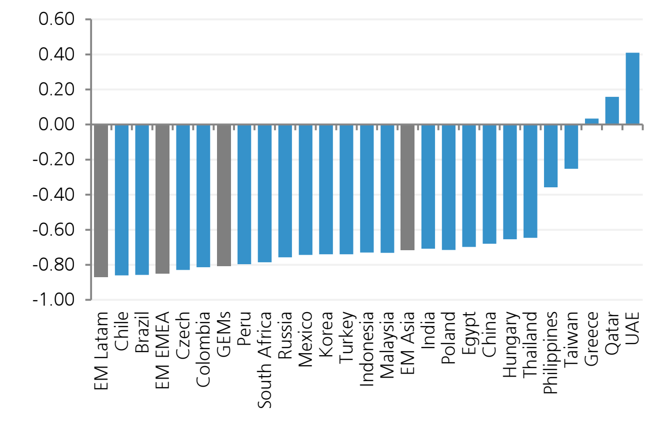
We have often set out in great detail the predictable impact over time of a period of sustained USD weakness in boosting EM equities (in absolute terms and relative to DM[24]) and leading to outperformance by riskier, high-beta markets and sectors within EM. In Figures 37-38, we update our correlation work to show where the greatest responsiveness is in EM equities to moves in the US dollar, focusing on our 2017 base case, which is for slightly weaker EM currencies versus the USD:

- **Regions**: In the event of some modest gain in the US dollar versus EM FX in 2017 (or an upside surprise in the USD if, for example, US bond yields continue to rise), Latin America looks the most at risk region, with EMEA not far behind; Asia looks by far the most defensive region.
- **Markets.** Brazil (and Chile) look the most risky markets in LatAm to an upside move in the dollar while, within EMEA, Czech Rep (surprisingly), South Africa, Russia and Turkey look most at risk; in Asia, Korea and Indonesia look most at risk. The most defensive markets to a rising dollar appear to be the GCC

[23] See "Global FX Atlas: Trade for growth, inflation or politics", Global Macro Strategy, Dan Waldman, December 20, 2016.
[24] See, most recently "EM into DM: Is the Rotation Over Already?", Macro Keys, Geoffrey Dennis, December 6, 2016.

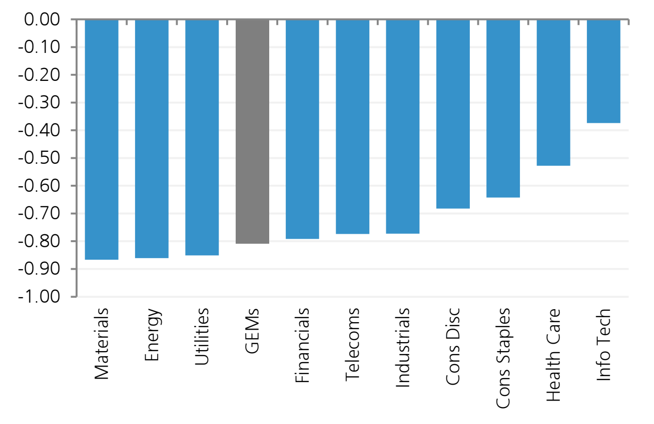
(assuming their fixed dollar pegs hold), Greece (assuming it stays in the Euro), Taiwan, Philippines, Thailand, China and the rest of CE3;

Figure 37: EM Country Correlations vs Dollar TWI



Source: MSCI, Datastream, UBS. Correlations based on monthly data since 1999

Figure 38: EM Sector Correlations vs Dollar TWI



Source: MSCI, Datastream, UBS. Correlations based on monthly data since 1999

- **Sectors:** The sectors most exposed to a rising dollar are Materials and Energy (dollar up, commodity prices down), Utilities and Financials (Figure 36 above), with the most defensive sectors being IT, Health Care and Consumer.

These results are broadly confirmed by looking at asset price performances during individual, discrete periods of dollar strength and weakness over the past 15 years (plus overall averages for these periods) as set out in Figure 83 in the appendix at the back of the report. The exceptions in the most recent period of USD strength (+10.4% from late-August to end-November) were: i) Asia has underperformed; EM Energy and Materials have outperformed; ii) Consumer sectors have underperformed; iii) MSCI Russia has actually risen over this period, while MSCI Brazil has barely fallen.

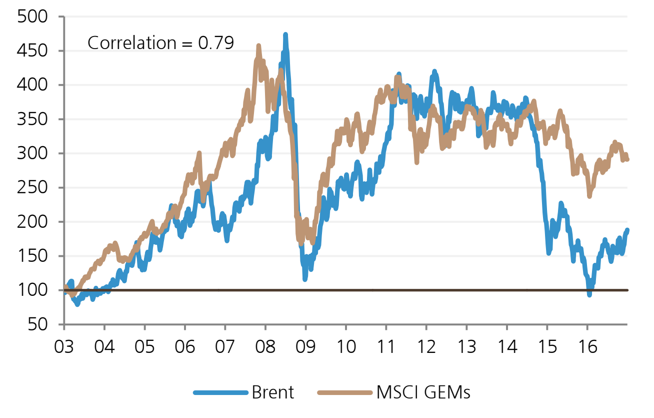
Oil Prices: Demand to Take Over?

Oil prices have been an important driver of EM equity markets in recent years, with a positive correlation of the Brent price to MSCI GEMs of +0.79 (Figure 39 below). We have long argued that this strong link implies that most of the major moves in oil prices over time have been driven by demand shifts. Rising overall global demand tends both to increase the demand for oil and also to boost EM equity markets. This dominant link between growth and EM equities seems to exist despite only five of the 23 countries in MSCI GEMs being net oil exporters (Figure 40).[25]

The most obvious break in this pattern (which has relevance for the rise in oil prices in late-2016) occurred in the second half of 2014 when oil prices halved (Brent fell from $113/barrel in mid-year to $56 at end-year) while EM equities held up fairly well. In our view, this relative resilience reflected the overriding supply-side driver of this oil price plunge - sharply higher OPEC output, especially from Saudi Arabia, to seek to drive lower-cost non-OPEC producers out of the market.

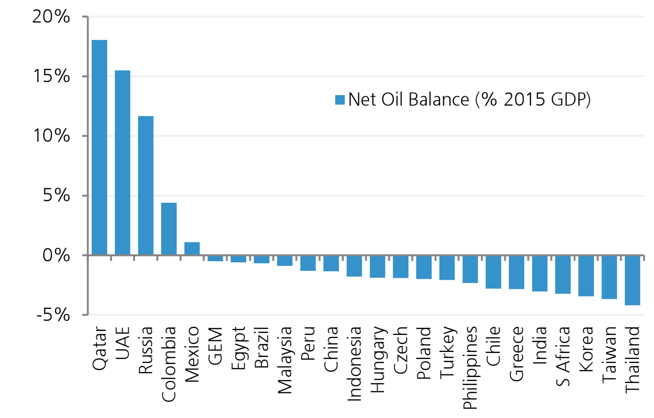
[25] We define a net oil exporter as oil output/GDP > oil demand/GDP.

Figure 39: Brent Crude vs MSCI GEMs



Source: MSCI, Datastream, UBS

Figure 40: EM: Net Oil Balances (%/GDP)



Source: EIA, Haver, UBS

These twin drivers have been in play recently also. The better year for EM equities in 2016 mirrored the sharp rebound in oil prices from a 13-year low of the $28 in late-January (the best indicator at that time of the poor expectations about the global economy) to over the $45-50 range in early-fall, on demand-side factors, as fears over global growth faded. More recently, however, supply factors seem to have taken over again with the 21% rise ($10) in Brent by year-end from the late-November OPEC deal to reduce output, including success in bringing some non-OPEC members on board: i) MSCI GEMs rose by 32% as oil prices rose from their late-January low to an interim peak of $53 in mid-October; ii) after a modest pullback, the $10 OPEC-led-spike left EM equities virtually flat (+0.4%) to year-end with US 10-year yields rising by 15bp from 2.30% at the time of the OPEC deal.

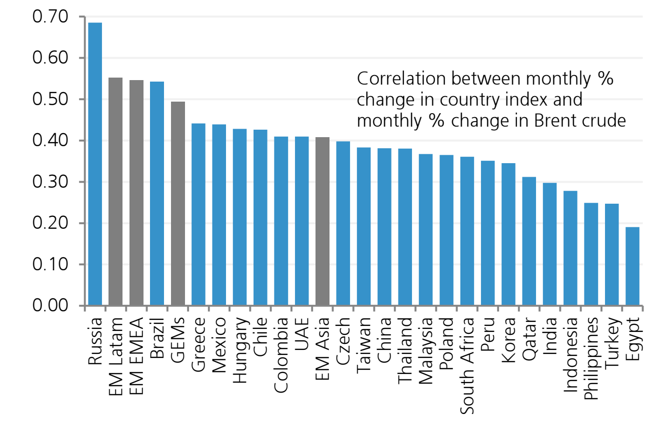
The recent rise in oil prices has, however, been in the direction forecast by our oil team, which expects further gains to an average of $60/barrel for Brent in 2017[26]. Their view has been that a mix of supply constraints and stronger demand (both modest) would push oil prices up to their forecast in 2017. In some sense, we have already had the supply hit – although let us see if the OPEC deal holds – and, from here, our oil team sees most of the upside being due to modestly stronger demand as global growth picks up, a more favourable trend again for EM equites.

So, who benefits from the next leg up in oil prices? Such a move will boost:

- The macro story in major oil-exporting countries such as Russia, Colombia, the GCC and, to a lesser extent, Mexico;
- Equity markets with high weights (>10%) in oil-production and exploration in their Energy sectors such as Russia (especially), Brazil and Colombia and, by region, both EMEA and Latin America; we are Overweight in Russia and Colombia and Neutral in Brazil;
- All MSCI GEMs markets have a positive correlation to oil prices, but the closest links are with Russia, Brazil, Mexico and, oddly, Greece and Chile (Figure 41);
- Similarly, all EM sectors have a positive correlation to oil prices, the closest links are with Energy (naturally) and Materials – a classic commodity play (Figure 42).

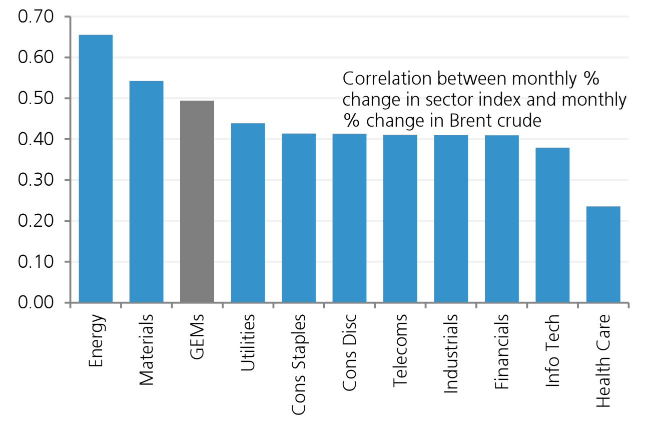
[26] "2017 Outlook: A delicate balancing act", European Oil & Gas, Jon Rigby, December 21, 2016.

Figure 41: Country Correlations vs Brent Crude (10 Years)



Source: MSCI, Datastream, UBS

Figure 42: Sector Correlations vs Brent Crude (10 Years)



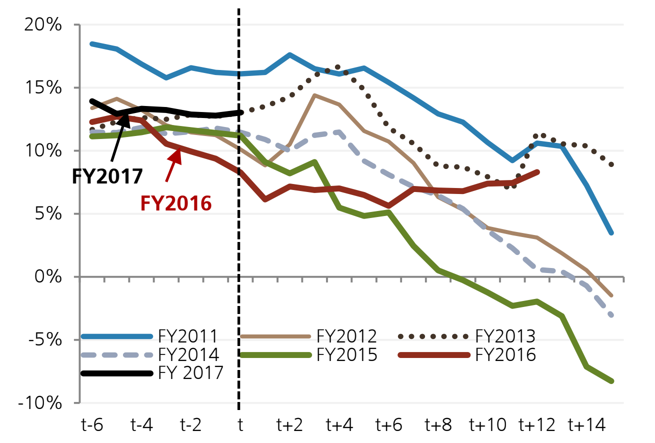
Source: MSCI, Datastream, UBS

The Importance of Earnings: Better Again in 2017?

The gloom over earnings growth in emerging markets has lifted somewhat. Twelve months ago[27], the narrative was of EPS having fallen by 29% (in dollars) over the prior five years. Our hopes for a better 2016 were built mainly on a smaller bite being taken out of earnings by the dollar and commodity prices (than in 2015). However, we also argued that the structural drags on EM earnings – weak GDP growth, weak global trade growth and low profitability (still falling ROEs) were still in place, despite 'a likely bounce in margins' in the year ahead. Our top-down forecast at that time was for below-consensus EPS growth of 5% in 2016.

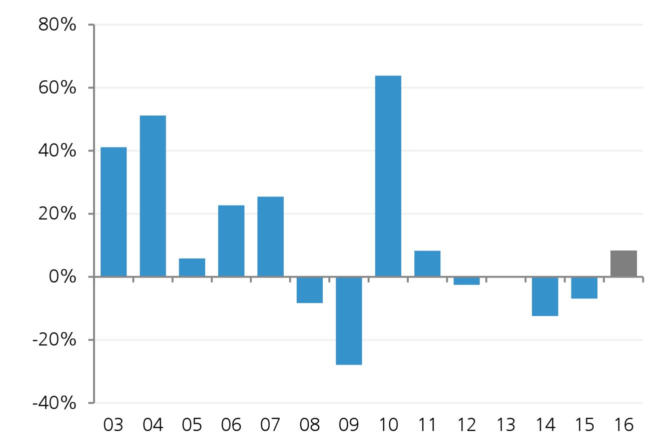
Twelve months on, things do look better for EM earnings. Although falling steadily at the start of 2016 (as had been the case for several years), the consensus EPS forecast for last year has been stable now for several months (currently at over 8%) and looks the most constructive for some time (Figure 43). This is close to the growth rate (8.3%) in the last year (before 2016) of rising EM earnings, way back in 2011, when earnings were still rebounding from their Global Financial Crisis trough (Figure 44). On our current estimates, close to half (48%) of the upgrade to 2016 consensus growth from its February low has been due to the falling dollar, with the slightly larger share due to rising local currency earnings.

Figure 43: EM Consensus EPS Growth Forecasts, Annual



Source: MSCI, IBES, Datastream, UBS. The vertical line indicates the start of the year in question with t=the prior year-end.

Figure 44: EM Annual EPS Growth



Source: MSCI, IBES, Datastream, UBS. CY2003-CY2015 EPS growth is based on actual trailing 12m EPS. CY2016 forecast is based on IBES consensus

So, what about 2017? As noted at the start of this report, our top-down model[28] of EM earnings predicts another year of modest growth of around 6% in dollars, similar to our 2016 forecast at the start of last year. Again, this is far below the current consensus forecast for 2017 of 13%, as well as the UBS bottom-up (GEM Inc.) forecast. The upside risks to our 6% call for 2017 arise from:

- Upside surprises in growth across the global economy, including in emerging markets, to drive an acceleration in top-line growth;

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[27] See EM Equity Strategy 2016 Outlook report, referenced earlier.

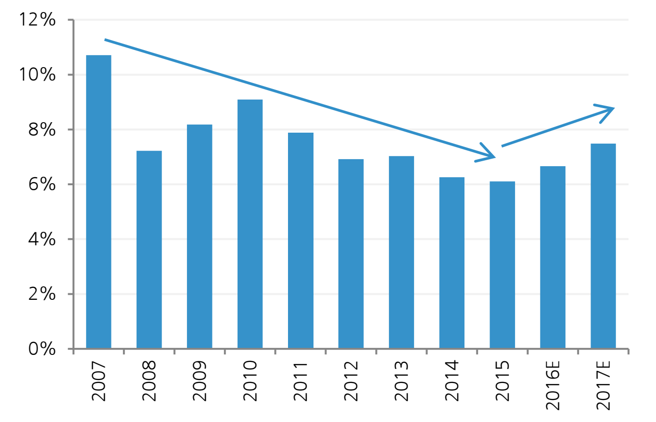
[28] The model uses as explanatory variables: i) change in EM industrial production; ii) change in EM exports; iii) commodity prices (oil prices, with a 60% weight, and metals prices, at 40%), and iv) MBS spreads. Exports and spreads have the highest explanatory power in the model.

- Further dollar weakness and gains in commodity prices, an important fuel of last year's rebound in EPS growth and rally in EM equities;

- Most hopefully, an extension of last year's long-awaited signs of a rebound in ROEs, as margins rose and capex growth was subdued, leading to increased operating leverage with or without a rebound in revenue growth,

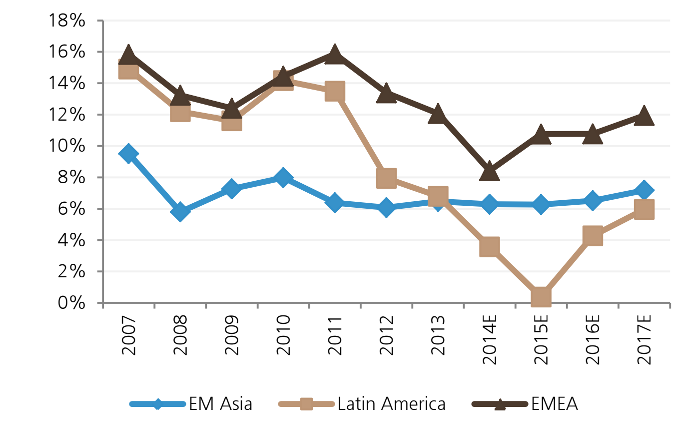
Exploring this last point in more detail, the charts below show improved bottom-up earnings trends. The long downtrend in EM net margins (-460bp since 2007 to 6.1% in 2015) began to reverse last year with a forecast bounce to 6.7%; for 2017, we expect another rise in margins of 80bp to 7.5% (Figure 45). The margin data by region remains fascinating (Figure 44). The biggest margin compression during the long downturn were in the commodity regions (especially Latin America); strong rebounds are now underway, with LatAm margins rising from 0.4% in 2015 to 4.3% last year and to a forecast level of 6% in 2017; in EMEA, where margins did fall but are at higher levels, we look for a rebound of 110bp to 11.9% this year, further above the 2014 trough of just 8.4%. The Asian data are also very telling; margins there are typically the lowest in EM (Asian companies have been the most prone, over time, to 'over-investment' and 'over-production'), but after stability in in a 6-6.5% range since 2011, we expect a 70bp rise in net margin to 7.2% in 2017.

Figure 45: GEM Inc: Net Income Margin (2007-2017E)



Source: UBS GEM INC estimates

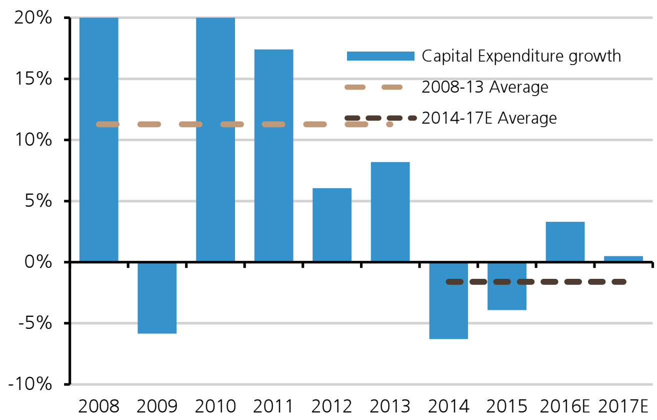
Figure 46: Net Income Margin by Region (2007-2017E)



Source: UBS GEM INC estimates

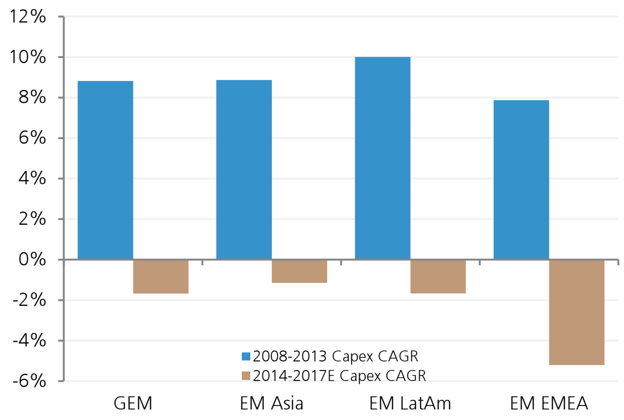
Capex goes a considerable way to explaining these margin/ROE trends (Figure 46). From annual average growth of 11.3% from 2008-2013 (7.2% p.a. in 2012-13), EM capex growth (real) turned negative in 2014 and has averaged a contraction of 1.6% per annum since (Figure 47), including the forecast for this year (despite a pick-up in 2016, most likely tied to the Energy sector as oil prices rallied). The same pattern – sharply higher capex in earlier years, followed by a decline since 2014 – applies to all three EM regions (Figure 48).

Figure 47: EM Capex Growth (2008-2017E)



Source: UBS GEM INC estimates

Figure 48: EM Capex Growth, Regions



Source: UBS GEM INC estimates

In the other direction, we think the chief sources of downside surprises to EPS growth in 2017 would likely be global and EM growth disappointments (notably, a 'hard landing' in China), a stronger than expected dollar and (related to this) weaker than expected commodity prices. However, based on our central scenario, another year of positive, if subdued, EPS growth in 2017 should support further modest gains in EM equities.

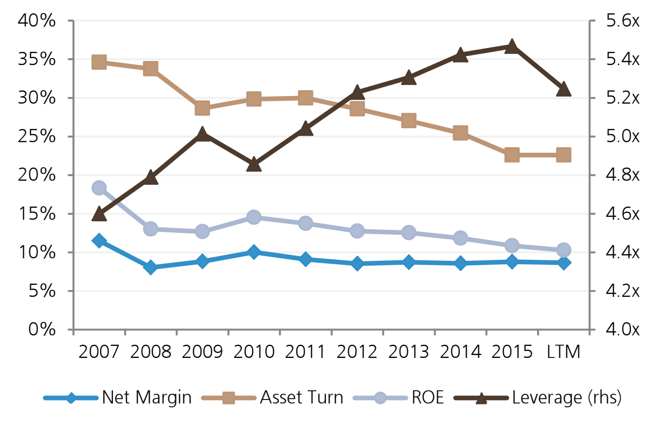
Will EM ROEs Continue to Rebound?

In our view, the most positive indicator of change to EM earrings growth in the last twelve months has been the evidence of a rebound in ROEs, a topic that was barely on the agenda at the end of 2015. Looking ahead to this year, the mid/high single-digit outlook for EPS growth in 2017, based on our top-down model, could be substantially enhanced by more evidence that companies are squeezing higher profitability from their businesses. In a detailed recent report[29], we argued that the challenge facing EM companies is to raise profits in a world of only 4-5% GDP growth in EM (acceleration of which may be difficult, whatever fiscal actions are taken by the new US government); this remains the case.

As we show again here, evidence of a decisive fundamental turn in ROEs in EM is still patchy. The extent of the 'ROE challenge' facing EM companies is clear from an aggregate DuPont analysis (derived from GEM Inc.) in Figure 49, which is based on annual data. (The latest data is for the twelve months to end-Q3 2016, and so does not pick up the rebound since early last year – below.) EM ROEs have fallen steadily since 2010, despite rising leverage, as the latter has been overwhelmed by falling margins and asset turns. The fundamental case for higher ROEs is better cost control and lower capex which, as noted above, is already happening to boost margins (as companies belatedly realize that the years of super-charged, top-line and GDP growth are over) and, perhaps, share buybacks. These trends are crucial and, if continued, a clear reason to be more optimistic on EM equities, in our view.

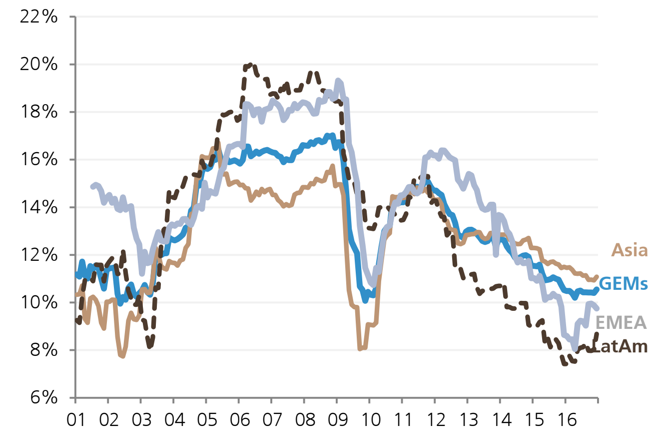
[29] "Searching for the Rising ROE Gems", EM Equity Strategy, Geoffrey Dennis, September 29, 2016.

Figure 49: MSCI GEMs ROE: DuPont Decomposition



Source: UBS Quant, Bloomberg, MSCI, UBS

Figure 50: EM Regions: Return on Equity (ROE)



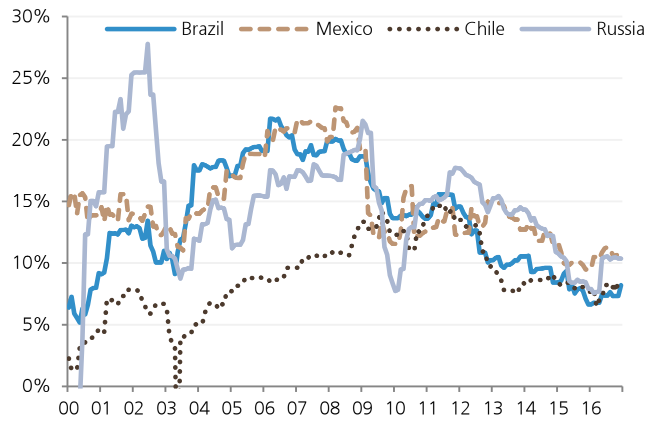
Source: MSCI, Datastream, UBS

Turning to aggregate ROE data across EM (using monthly data from MSCI), once again it is apparent that the evidence of a decisive turn is lacking:

- **Regions:** After falling for five years from a recent peak of 15.2% in September 2011 to a low of 10.2% last April, the average EM ROE had rebounded marginally to 10.5-10.6% by December – good, but not yet a decisive turn (Figure 50 above). The leaders of what turn *is* under way are the commodity-heavy regions, in particular EMEA (mainly due to Russia), where the average ROE bottomed out at 8.5% (from a peak of over 16%) and had rebounded to 9.9% before settling at 9.8% by year-end. The picture for LatAm is similar, but not as robust, as the average ROE hit bottom at 7.4% (from a 2011 peak of 15.3%) and has now bounced to 8.7%. Most interestingly, Asian ROEs are not yet turning, at least in aggregate, with the ROE hitting a new cycle low of 10.9% late last year (and 11.1% at end-2016) from an earlier peak of 14.8%; as we note below, the main reason that the overall Asian ROE is still falling is China (which makes up 48% of EM Asia);

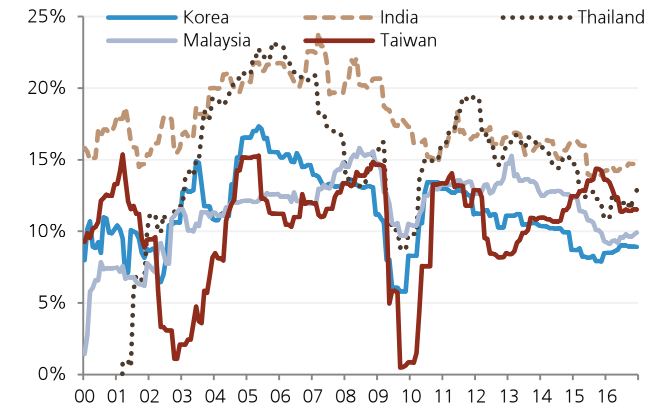
- **Countries:** We have limited the countries included in the ROE charts below to those with clear evidence that ROEs are now recovering. There are only two groups of countries where this is happening: i) the 'cyclical' markets (Figure 51) led by rebounds of 280bp in Russia to a current ROE of 10.4% and of 170bp in Mexico to 10.2%; ii) non-China Asia (Figure 52), led by India, where ROEs are among the highest (14.8% at end-2016) and Taiwan, where the pattern is different, with the average ROE having risen sharply from a trough of 8.2% to a recent peak of 14.4% before dipping below 12% at present. China (not shown) is an outlier – but, a big one - with ROEs showing no signs yet of bottoming out at 11.9%, at present, down from a late-2011 peak of 17.1%. Other large EMs where ROEs are still falling are Indonesia (15%), Philippines (12.6%), Turkey (12.5%) and South Africa (10.9%);

Figure 51: EM Country ROEs – Cyclical Markets



Source: MSCI, Datastream, UBS

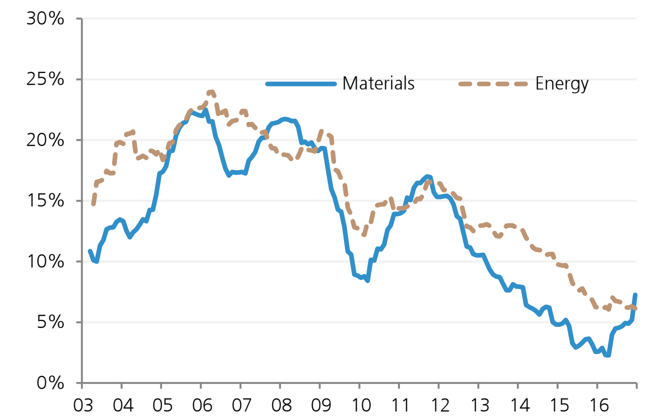
Figure 52: EM Country ROEs – Non-China Asia



Source: MSCI, Datastream, UBS

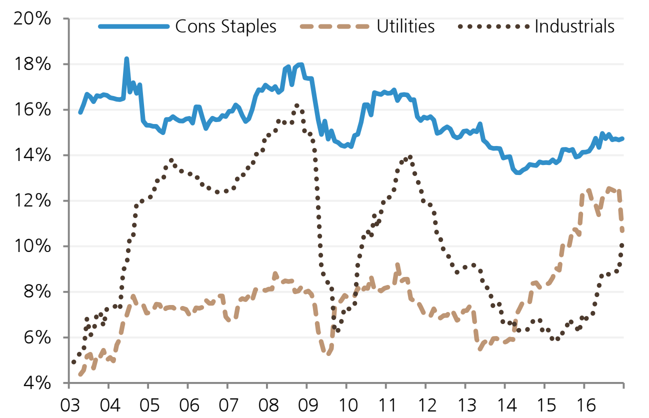
- **Sectors.** The ROE data by sector looks more hopeful with a higher proportion of sectors showing ROEs on the rebound in recent months; the problem is that many of these are small sectors[30]: i) ROEs are rising in the global cyclical sectors (Figure 53) led by Materials (the ROE has almost tripled from 2.3% in April 2016 to 7.2% at year-end), with much less bounce in Energy (+100bp to 7.1% last May before falling back to 6.1% by year-end); ii) other sectors where ROEs are clearly recovering (Figure 54) are Utilities (+710bp from early 2013 to 12.6% before falling to 10.7% in December), Industrials (+430bp from May 2015 to 10.2%) and Consumer Staples (+150bp from early 2014 to 14.7%); iii) sectors with a hint of ROE recovery are, importantly, Financials (where ROEs fell from 14.9% in early 2014 to a recent trough of 11.2% and are now up to 11.5%) and Health Care (where the rebound has been less flashy, but has been underway for some time – Figure 55); and iv) sectors where ROEs show no sign, as yet, of rebounding (Figure 56) are IT (ROE of 13.7%), Consumer Discretionary and Telecoms (both at 10.1%).

Figure 53: EM Sector ROEs



Source: MSCI, Datastream, UBS

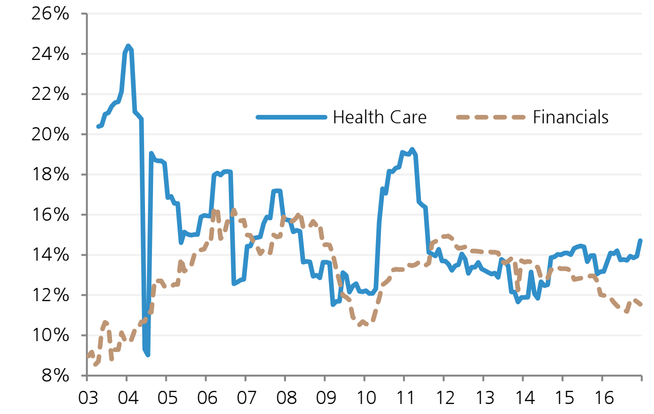
Figure 54: EM Sector ROEs



Source: MSCI, Datastream, UBS

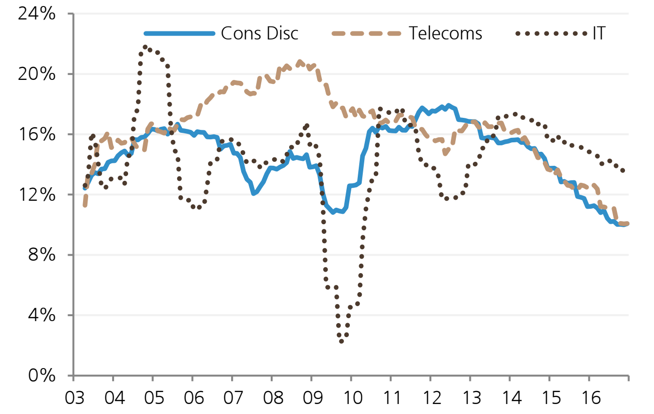
30 Financials (24.4% of MSCI GEMs at end-2016) and IT (23.3%) make up close to half of the index. The ROE in IT is still falling and that in Financials is only now showing tentative signs of a rebound. The five sectors where ROEs are now definitely rising (Figures 51-52) make up only 33% of MSCI GEMs.

Figure 55: EM Sector ROEs



Source: MSCI, Datastream, UBS

Figure 56: EM Sector ROEs

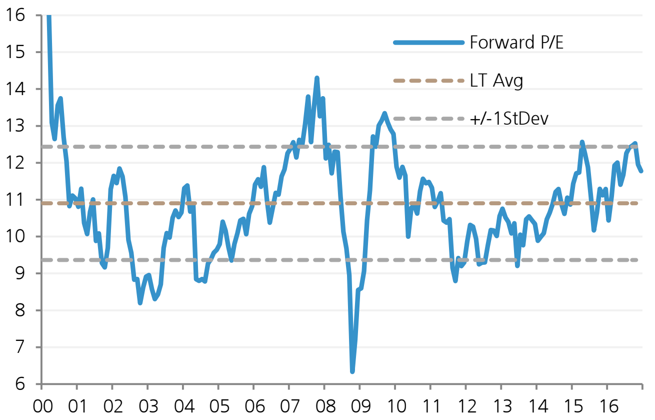


Source: MSCI, Datastream, UBS

Valuations: Focus on P/BV v. ROE

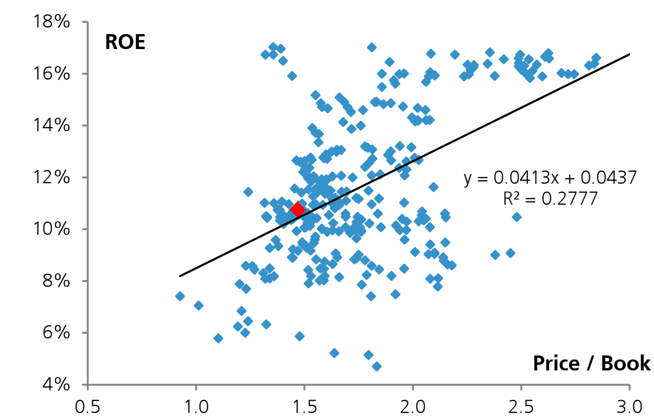
Our view for some time has been that the only compelling valuation argument for EM equities at present is relative to DM. The late-year pullback in MSCI GEMs to a gain of only 8.6% for calendar 2016 (while still up 25% from its seven-year low in late-January) has left EM equities advancing for the full year broadly in line with the consensus EPS growth forecast for 2016 of 8%. The EM forward P/E, which traded rich all last year, had fallen back to 11.9x by year-end from 12.4x at the late-summer market peak (close to a six-year high on this metric); by year-end, this had cut back the premium to the forward P/E's long-term average (10.9x) to 9% again from a recent peak of 14% (Figure 57).

Figure 57: MSCI GEMs Forward P/E Ratio



Source: MSCI, IBES, Datastream, UBS

Figure 58: MSCI GEMs: Price/Book vs ROE (Since 1990)



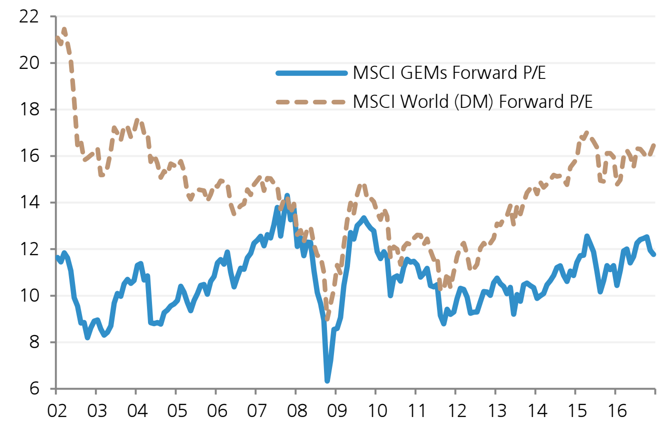
Source: MSCI, Datastream, UBS

On P/BV, EM equities look optically cheap, trading at just over 1.5x BV at year-end, a 17% discount to the long-term average of 1.83x. However, adjusted for the ROE (currently 10.6%) which is still 19% below its long-term average (13.1%), EM equities look much less cheap. Updating our 25-year plot of P/BV v. ROE (Figure 58 above), EM equities are only 'fair value' on this adjusted metric.

However, there is certainly a better argument for EM equities looking at valuations relative to DM. During the five years (2011-15) of extreme EM underperformance (EM: -31%; DM +30%[31]), DM became richer, while EM valuations moved in opposite directions according to the metric being used: drifting erratically higher in terms of the forward P/E and falling in P/BV terms (Figures 59 and 60).

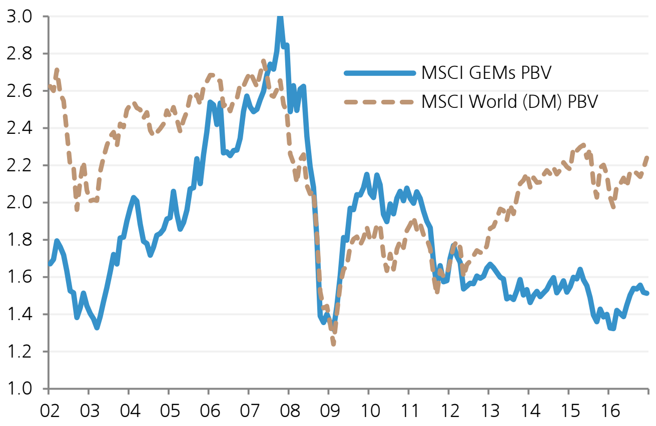
[31] From the EM peak in early-May 2011 to its trough in late-January 2016, EM actually fell 43% while DM rose by 7.6%.

Figure 59: EM and DM Forward P/E Ratios



Source: MSCI, IBES, Datastream, UBS

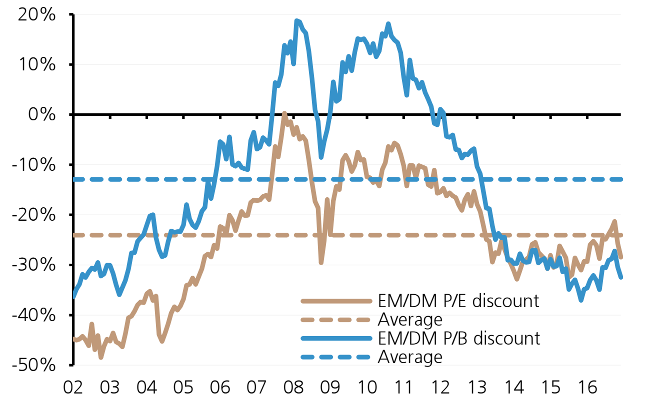
Figure 60: EM and DM P/BV Ratios



Source: MSCI, Datastream, UBS

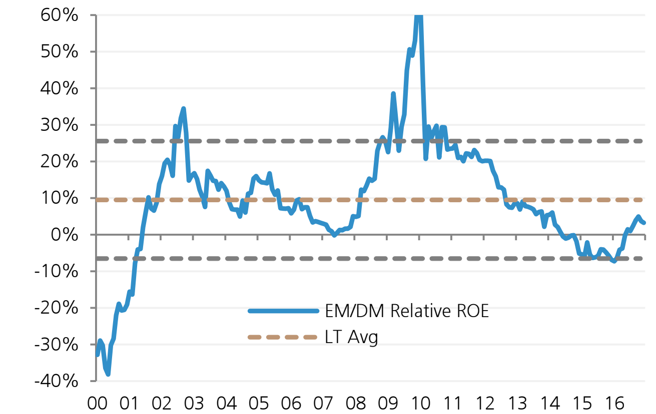
These medium-term trends led (by 2015) to a sharp rise in the discount of EM v. DM valuations to over 30% - above long-term average discounts on both metrics (Figure 61). While last year's EM rally led to these valuation gaps narrowing again, the renewed EM underperformance relative to DM after the US election pushed these discounts wider again. By the end of last year, our models show EM as undervalued v. DM on both a forward P/E (a discount of 28% (v. a long-term average of 24%) and P/BV basis (-32%, far above its long-term average of 13%).

Figure 61: EM/DM Forward P/E and P/BV Relative



Source: MSCI, IBES, Datastream, UBS

Figure 62: EM/DM ROE Relative



Source: MSCI, Datastream, UBS

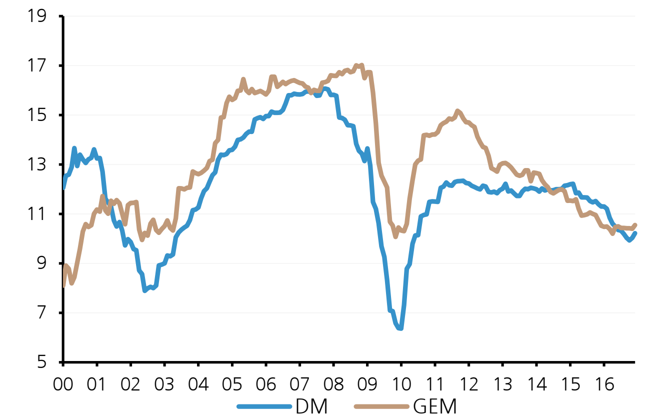
In turn, this still-wide EM/DM P/BV gap has been convincingly 'justified' over time by the steady collapse since early-2010 of ROEs in EM relative to those in DM (Figure 62). However, as we noted in a report last year[32], this downtrend seems to have ended as the ROE relative rebounds in EM's favour from a 15-year wide EM-ROE gap of -370bp last January to +650bp at year-end. If this relative ROE trend continues to move in favour of EM (supported by the developments discussed

[32] "Searching for the Rising ROE Gems", EM Equity Strategy, Geoffrey Dennis, September 29, 2016.

above), this would be very positive for EM equities. We consider the above relative ROE chart to be one of the best supports for further EM outperformance in 2017[33].

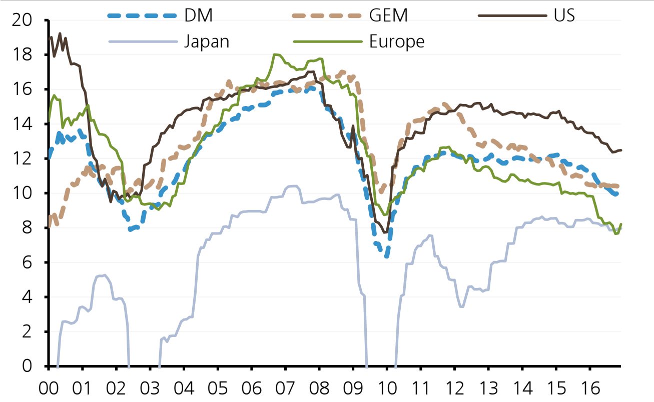
Will the early signs of a better trend in EM ROEs be extended? The following charts are fascinating and should help with this question. The upturn in the relative ROEs between EM and DM is occurring both because EM ROEs began to bounce several months ago, while DM ROEs have fallen steadily over the past two years (Figure 63). Breaking out the main regions, the fall in the DM ROE since early-2015 has been due to: i) a falling (although still high) ROE in the US; ii) very low, but flat, ROEs in Japan; and iii) a recent sharp decline in European ROEs to Japanese levels (Figure 64). Set against this DM data, the recent (and developing) ROE story in EM does not look that bad at all.

Figure 63: GEM and DM ROEs



Source: MSCI, IBES, Datastream, UBS

Figure 64: ROEs: GEM, DM, US, Japan, Europe



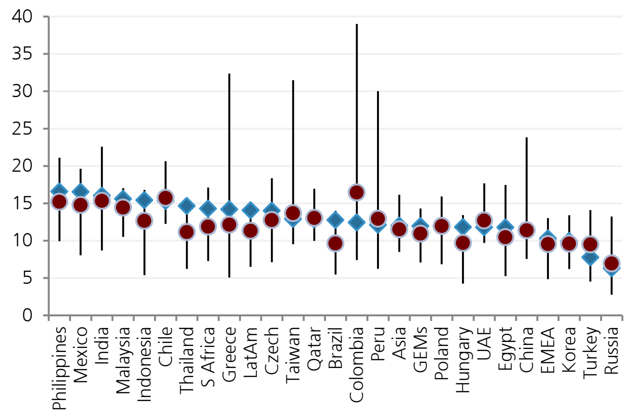
Source: MSCI, IBES, Datastream, UBS

We want to look at EM valuations in two other ways:

- **Country/Sector Valuations Relative to History.** We have argued for some time that there are few really cheap EM equity markets. However, looking at this question in forward P/E terms, the market pullback in late 2016 altered that conclusion to some degree. At year-end, there were, in fact, ten MSCI GEMs markets with a multiple below (or equal to) its own 10-year average, with the list dominated by EMEA markets (Russia, Turkey, Poland and the GCC) – see Figure 65 below; this same result applies to all three Andean markets and, in Asia, to China (equal to long-term mean) and Taiwan; the market trading at the biggest discount to its own average at end-2016 was Colombia (-24%). In the other direction, the biggest premium to its long-term average was Brazil (+33%)[34]. By contrast, only two EM sectors – Utilities (-18%) and Financials (-12%) – traded at year-end cheap to their own long-term average P/E (Figure 66); the richest sectors relative to their own average multiples were Materials (+26%), Consumer Discretionary (+23%) and Telecoms (+19%).

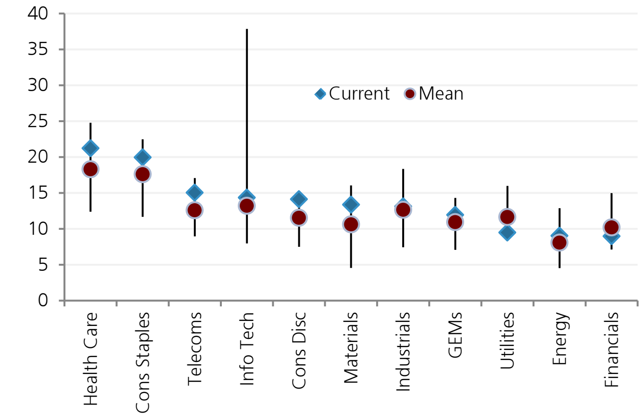
[33] See our section "EM Equities: Can EM build on its ROE improvement" in "EM Outlook 2017: Managing a ship adrift", Global Macro Strategy, Bhanu Baweja et al, November 21, 2016.
[34] However, we have argued that the 10-year average mean of MSCI Brazil is distorted in a downwards direction given the much smaller weight of cyclical (cheaper) stocks in the index today compared to the peaks of the 2007 bull market.

Figure 65: EM Forward P/Es vs 10 Year Range



Source: Datastream, MSCI, IBES, UBS

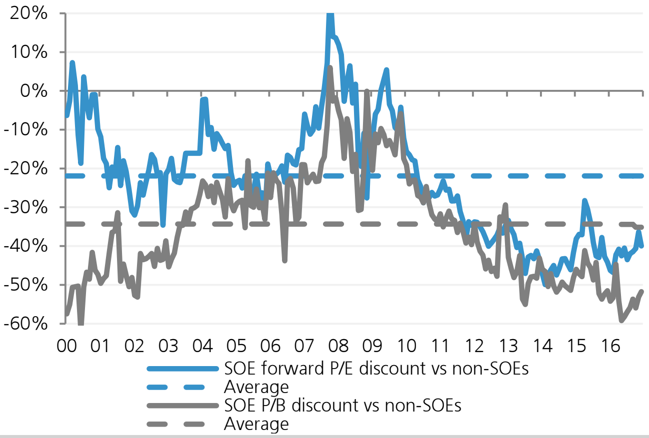
Figure 66: EM Sector Forward P/Es vs 10 Year Range



Source: Datastream, MSCI, IBES, UBS

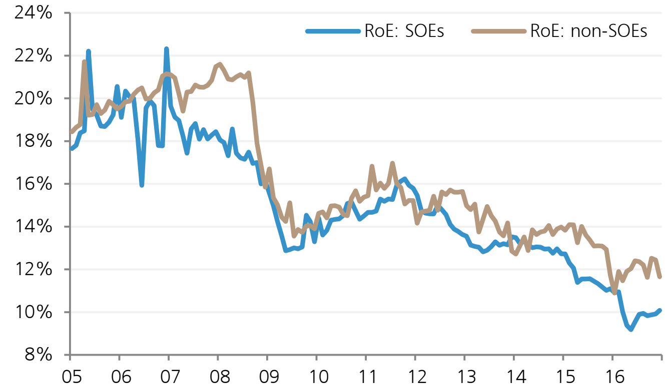
- One explanation we have cited for the ongoing valuation bifurcations across EM equity markets is the role of State-Owned enterprises (SOE), which have seen wide valuation gaps open up since 2010 versus non-SOEs on both a forward P/E and P/BV basis (Figure 67)[35]. We estimate that at end-2016, EM SOEs traded at a 40% discount to non-SOEs on forward P/E (close to a record high) and at an even bigger discount of 52% on P/BV (back to 2002 levels). We explain much of this discount via relative ROEs; at end-2016 (Figure 68), the average ROE for the SOEs (10.1%) was 14% below that in the non-SOE sector (11.7%). The substantial valuation discounts on EM SOEs are: i) a key implied driver of the structural reform agenda in EM (particularly in China), part of which is aimed at improving the productivity, efficiency and, so the ROEs, of SOEs; and ii) a major constraint on overall EM market upside, as non-SOE valuations (currently at 14.2x forward) are higher than the EM index as a whole.

Figure 67: SOEs v. non-SOEs: Valuation Discounts



Source: Datastream, MSCI, IBES, UBS

Figure 68: SOEs v. non-SOEs: Return on Equity



Source: Datastream, MSCI, IBES, UBS

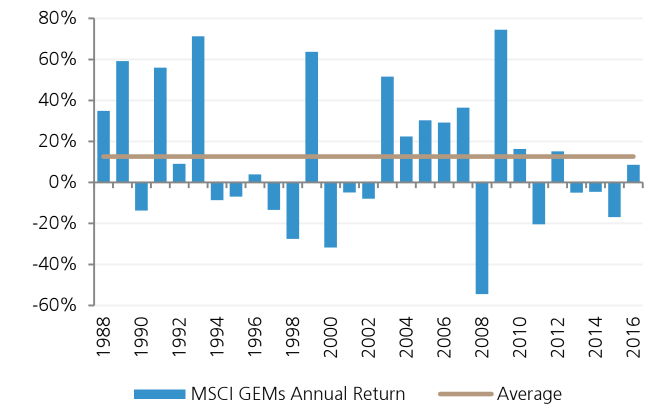
[35] Based on the latest full update (March 2016) of our proprietary SOE database, we estimate that 27% of the market cap of the MSCI GEMs index is made up of SOEs, mainly in Energy, Financials, Telecoms and Utilities.

2016 Performance Recap: Better, but Volatile

Last year saw EM equities record their first positive year since 2012, with a gain of 8.6% in the MSCI GEMs index in dollar terms (Figure 69). However, the path to this improved outcome was very tortuous; the 260-day volatility of MSCI GEMs index remained above the 2015 levels all year.

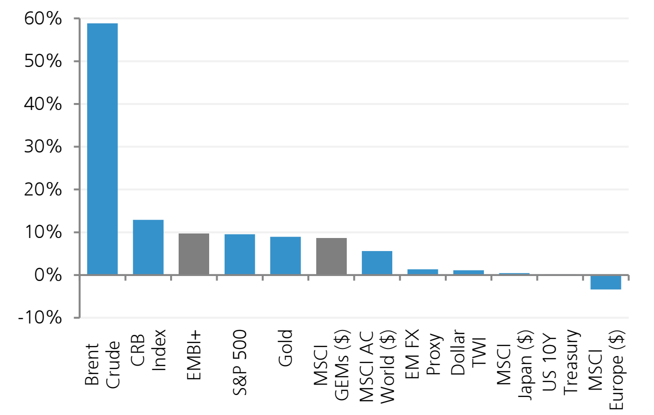
In terms of medium-term market phases, EM stocks sold off sharply early in 2016, mainly on China fears, falling by as much 13.3% by January 21st. The index then rallied dramatically (+24%) in the next three months on a strong rebound in commodity prices and a weaker dollar, before pulling back by 7% by the end of the UK referendum sell-off in late-June; by then, despite all the volatility, MSCI GEMs was within 1% of its starting-point for the year. The second ('liquidity') leg of the 2016 rally then took EM back up by another 17% to the high of the year on September 8th; the full Jan-Sep rally was an impressive 34.7%, the best of the seven mini-rallies since the EM peak in May 2011. The index then drifted before falling sharply after the US election (-7% in four days on the rotation out of bonds into US stocks) and was then quiet to year-end, gaining just 2.7% from its post-election low. The only hint of a 'seasonal rally' was a rise of 2.4% from December 23rd.to year-end. The 8.6% gain for EM at year-end was a poor outcome compared to the peak YTD gain of nearly 17% in early-September.

Figure 69: MSCI GEMs Index: Annual Changes (%)



Source: MSCI, Datastream, UBS

Figure 70: 2016 Asset Class Returns (%)

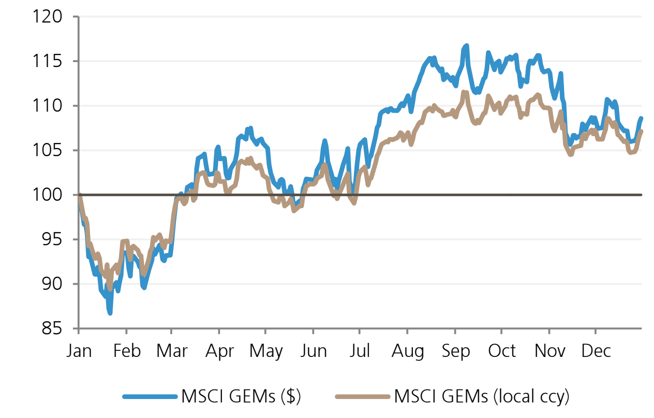


Source: MSCI, Datastream, UBS

Nonetheless, EM equities ranked much better last year amongst a list of alternative assets than in 2015 (Figure 70 above). While Brent oil prices led the way in 2016 by some distance (+59%), several other assets (CRB, EM bonds, the S&P Composite and Gold) rose just slightly more (up to 12.9% for commodity prices) than EM equities. The non-US DM regions did poorly last year, with MSCI Japan up just 0.5%, while MSCI Europe fell by 3.4%. Three assets – our EM Currency Proxy, the USD TWI and 10-year US bonds - eked out gains of less than 1%.

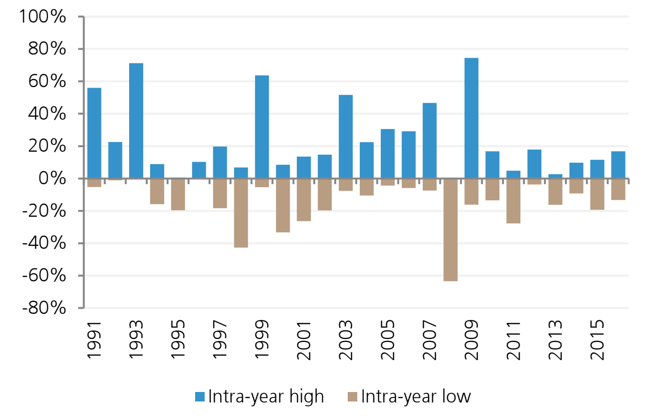
Currencies were a modest tailwind for EM equities in 2016; our EM Currency Proxy (MSCI GEMs ($)/MSCI GEMs (local)) rose by 1.4% (Figure 71), accounting for 16% of the 8.6% gain in the equity index. This was the first positive year for EM FX (measured this way) since 2012 and their best year since 2010 (+4.2%). Again, however, last year's currency gain was, in the event, disappointing compared to a peak YTD advance of 5.3% in mid-August; most of this narrowing of the gap between MSCI GEMs in USD and in local currency (fall in our Currency Proxy) occurred after the US elections.

Figure 71: MSCI GEMs: $ v Local Currency (2016)



Source: MSCI, Datastream, UBS

Figure 72: MSCI GEMs: Intra-Year Performance Range



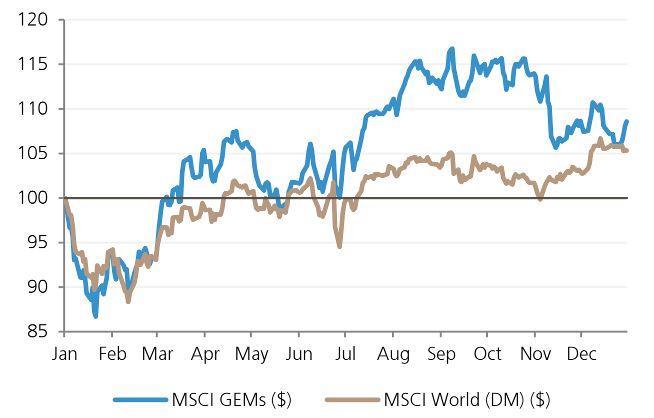
Source: MSCI, Datastream, UBS

The intra-year performance range of MSCI GEMs (between the index peaks and troughs for the year) was 3010bp (from +16.7% to -13.3% – Figure 72) last year, (remarkably) almost identical to 3090bp (+11.6% to -19.4%) in 2015. This is a narrow performance range in an historical context (the LT average is 4075bp), but (apart from 2015) was still the widest such range since 2011 (3260bps).

EM v. DM – the Best Year since 2010

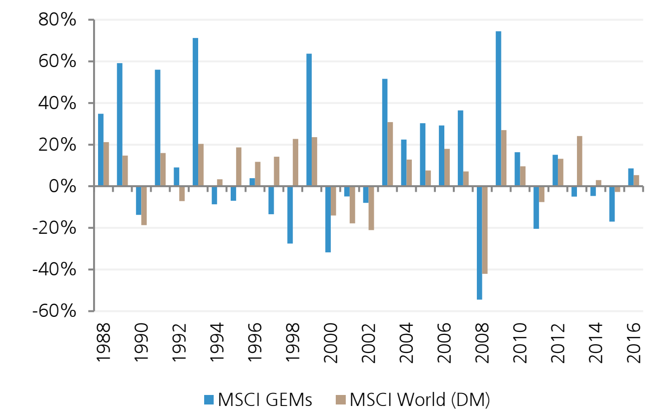
EM equities beat DM equities last year for the first time since 2012 (Figure 73) – by 330bp (+8.6% v. +5.3%). This outperformance was concentrated into two periods (early-spring and early-Q3), with the peak outperformance being 1120bp in late-October (13.6% v. 2.4%) before the major post-US election rotation back to DM erased the lion's share of these relative gains. Indeed, by late-December, this performance gap was almost down to zero (+6% v. +5.8%), before a modest rally in EM to year-end took the relative back up again. This was the first year since 2012 that both EM and DM indices rose (Figure 74) and the best year of relative performance for EM since 2010 (710bp).

Figure 73: EM, DM Performance (2016)



Source: MSCI, Datastream, UBS

Figure 74: EM, DM Annual Returns (%)



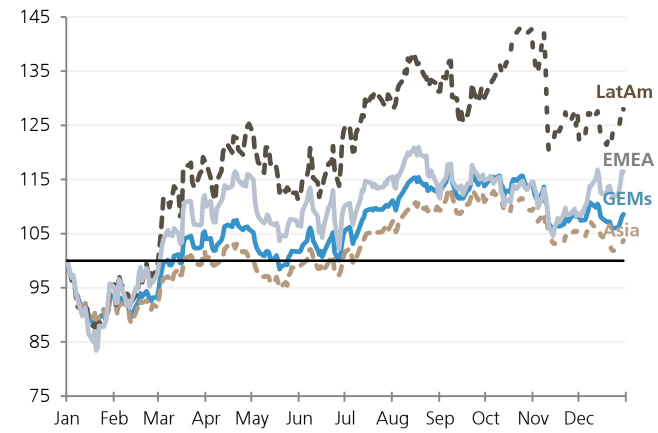
Source: MSCI, Datastream, UBS

Regions – LatAm Outperforms

In direction opposition to the result in 2015, all three EM regions rose in 2016 (Figure 75), with dominant gains by Latin America (+27.9%) and EMEA (+16.4%).

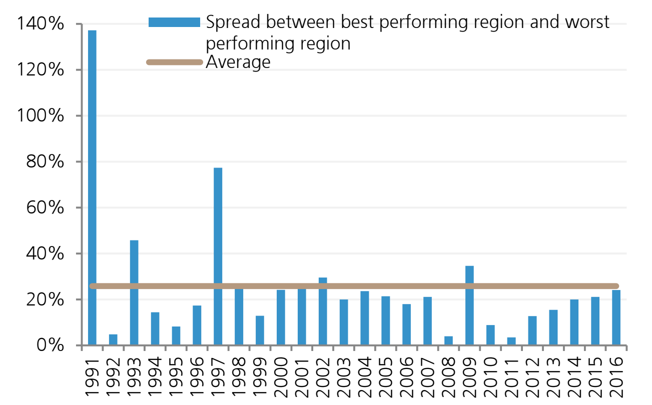
Asia lagged badly (+3.8%), dragged down mainly by China and India. This broke a five-year streak of Asian outperformance. However, LatAm did suffer the biggest losses during the EM/DM rotation after the US elections and ended the year down nearly 11% from its late-October high, while MSCI EMEA had moved to a new post-election high by year-end. The performance gap between the best and the worst performing regions in 2016 (2390bp) was the biggest since 2009 (Figure 76) and was not far below the long-term average for this metric of 2570bp; this regional gap has been rising steadily since 2011. Given Asia's underperformance last year (and despite favourable changes to the stock components of the EM index), its weight in MSCI GEMs fell to 70.1% at the end of 2016 from a year-end record high of 72.2% in 2015.

Figure 75: MSCI GEMs: Regional Performance (2016)



Source: MSCI, Datastream, UBS

Figure 76: GEMs Regions: Best vs Worst Performer



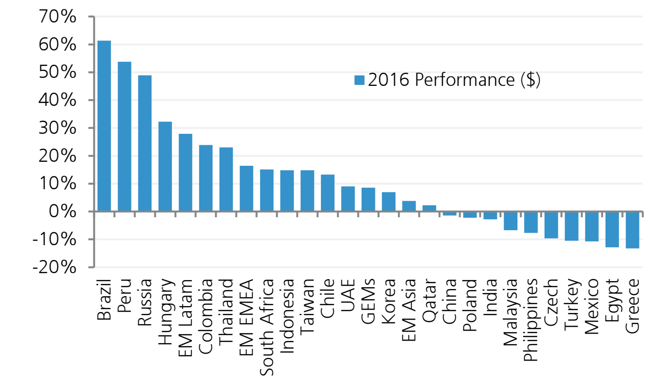
Source: MSCI, Datastream, UBS

Markets: Index Up, but Nearly Half of EMs Fall

Despite a solid rise for MSCI GEMs last year (+8.6%), only 13 of the 23 index markets saw gains in 2016 (Figure 77). Even in Latin America (+27.9%), a major market actually fell last year (Mexico: -10.7%). The main EM winners in 2016 were two other LatAm markets - Brazil (+61.3%) and Peru (+53.8%) – plus Russia (+48.9%). There was little pattern to the other country winners, although the tendency for big markets to do well (as in 2015) was not repeated with only South Africa (+15.1%) and Taiwan (+14.8%) of others in this category outperforming last year. EMEA accounted for five of the ten falling markets last year – Greece (-13.2%, the worst-performing EM, as in 2015), Egypt, Turkey, Czech Rep and Poland; four of the eight Asian markets also fell, led by the Philippines (-7.7%), and also including Malaysia, India and China.

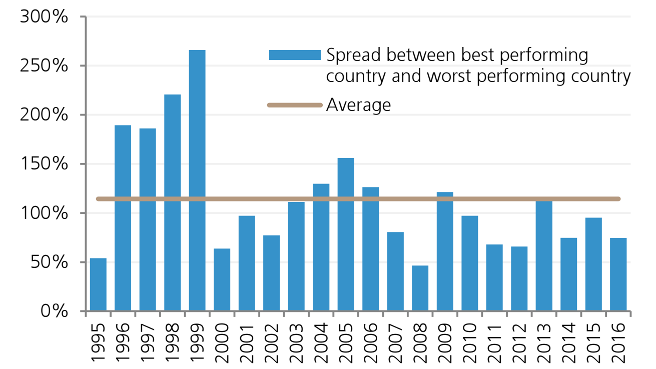
The gap between last year's best and worst-performing markets (Brazil – Greece) actually fell last year to 7,450bp and was well below the long-run average spread of 11,450bp (Figure 78).

Figure 77: MSCI GEMs: Country Performance (2016)



Source: MSCI, Datastream, UBS

Figure 78: GEMs Countries: Best vs Worst Performer

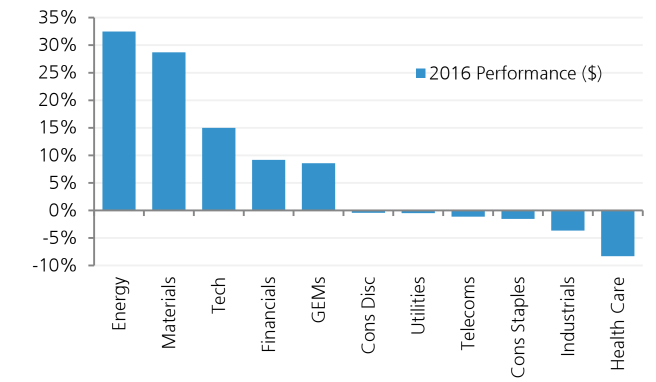


Source: MSCI, Datastream, UBS. Based on current MSCI EM country constituents

Sectors: Global Cyclicals Dominate

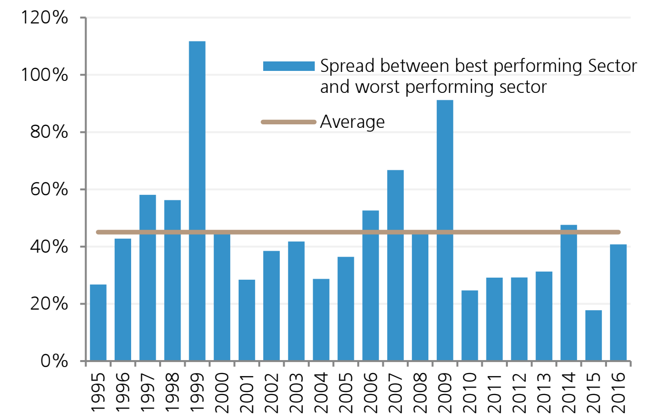
The percentage of 'down sectors' (6 of 10) within EM last year was even greater than for individual markets, even as MSCI GEMs rose by close to 9%. The clear winners were Energy (+32.5%) and Materials (+28.7%), followed by the two biggest sectors in EM: IT (+15%) and Financials (+9.2%); all four sectors (which account for 63% of the GEMs index) not only rose last year, but also outperformed (Figure 79). The other six sectors all fell last year, led by Health Care (-8.3%), with the remaining sectors drifting down by between -0.4% (Consumer Discretionary) and -3.7% (Industrials).

Figure 79: MSCI GEMs: Sector Performance (2016)



Source: MSCI, Datastream, UBS

Figure 80: GEMs Sectors: Best vs Worst Performer



Source: MSCI, Datastream, UBS

Given the strong gains in global cyclicals, the spread between the best and worst sectors (Energy – Health Care) shot up to -4080bp last year from a record low of 1770bp in 2015 and was the second widest (after 2014) since the big bull run of 2009 (Figure 80 above).

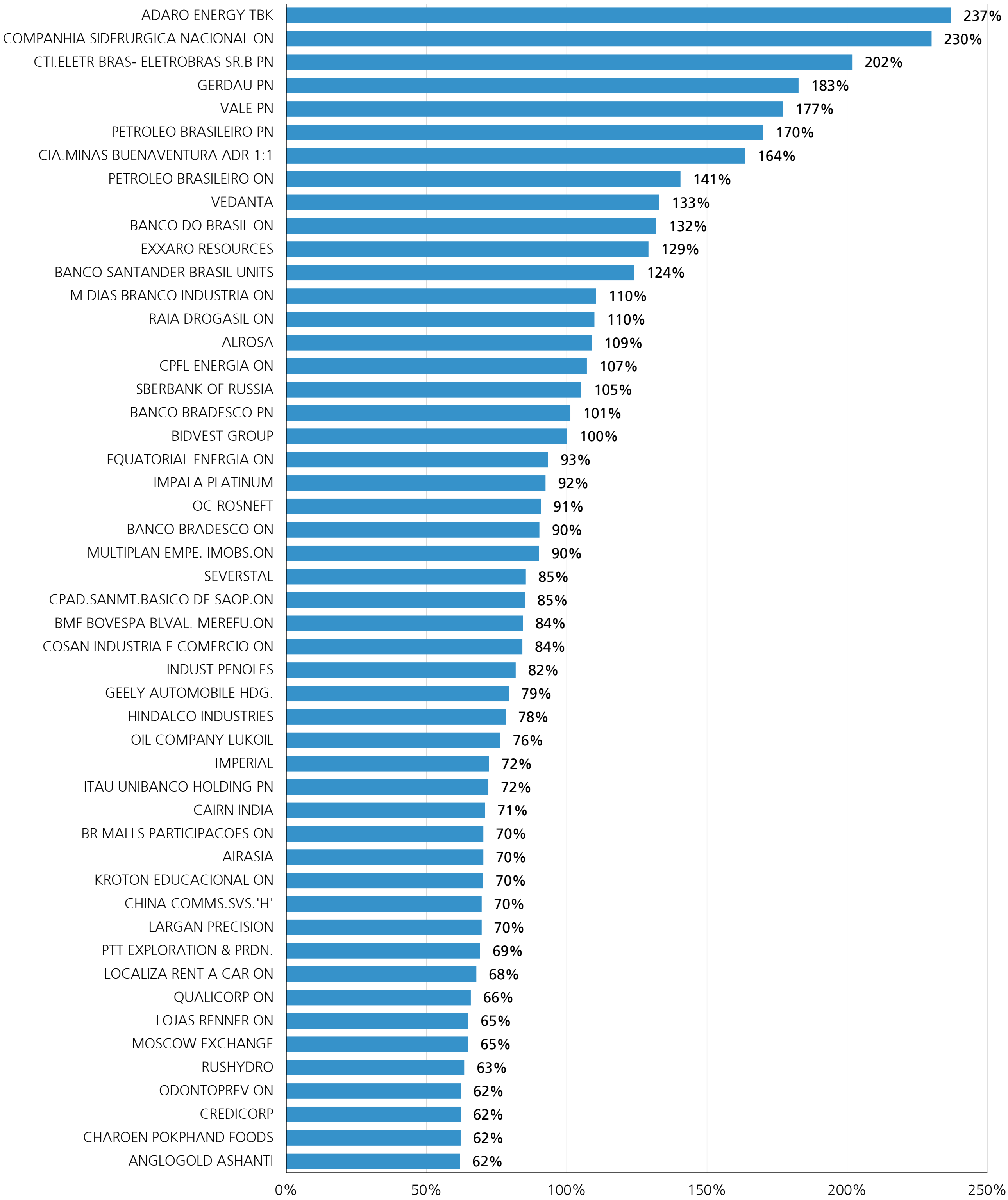
Stocks: Brazil Takes over Half of the Top Spots

Finally, Figures 81-82 (below) list the 50 best- and worst-performing stocks in the MSCI GEMs index in 2016. There are some interesting (albeit fairly obvious) themes:

- As expected, Latin American stocks took 29 of the 50 slots for the best performing stocks last year, with 26 of these being from Brazil (just over the EM total);
- The others on this list of best performers were neatly split between EMEA (11 of 50, led by 7 Russian stocks) and Asia (10 of 50, fairly evenly split across several markets);
- After Adaro Energy (Indonesia) - the top performer in 2016, the next eight best performers were all from Brazil[36];
- The list of the 50 worst performers in 2016 was dominated, again as expected, by Asia (36 names, with 13 from China and 11 from Korea);
- Only 8 of the bottom 50 stocks were from EMEA (although, as last year, Greek banks were prevalent accounting for 2 of these slots) and just 6 of these 50 names were from LatAm, all but one (Embraer – Brazil) being from Mexico.

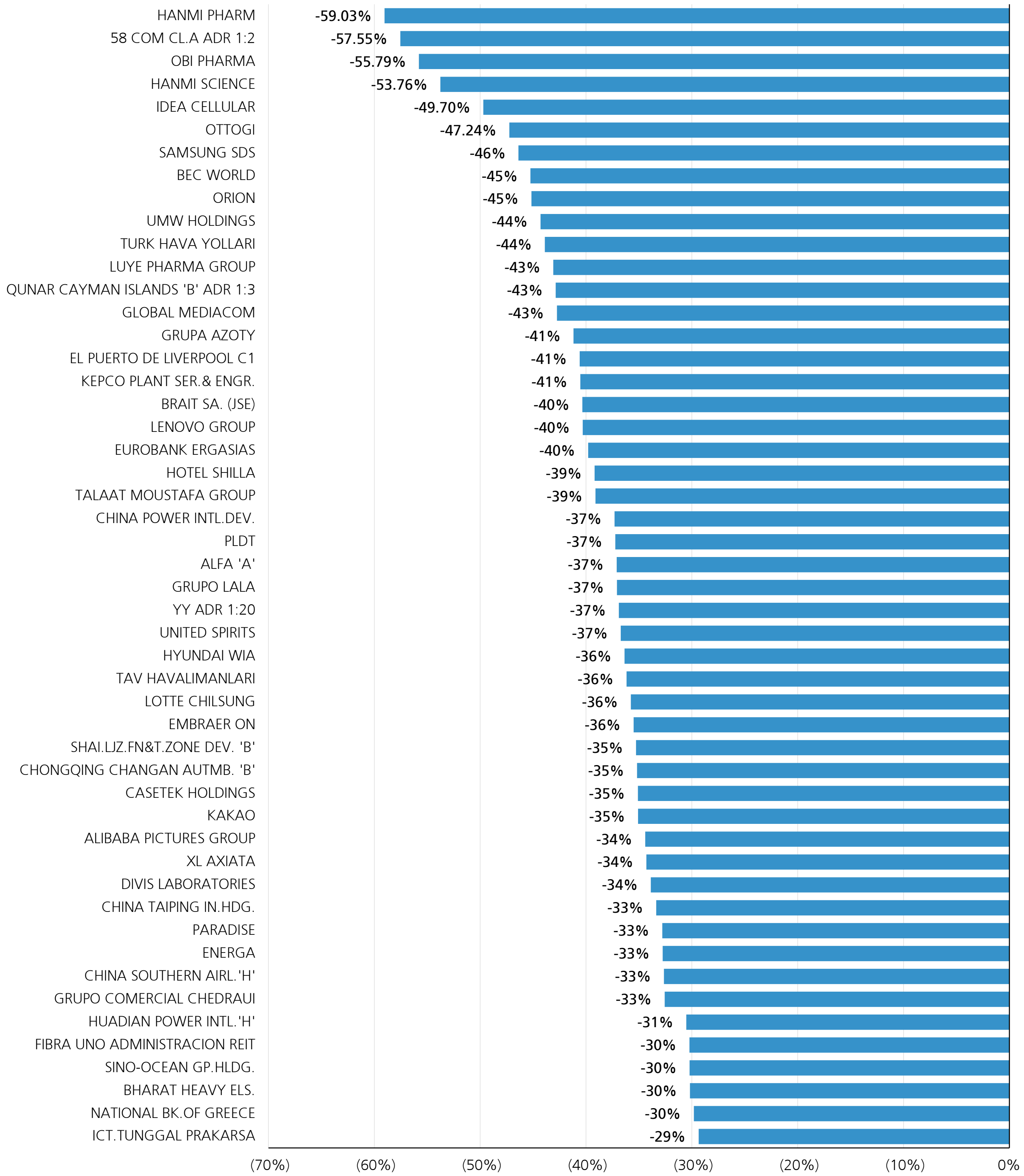
[36] Note that multiple share classes of a given company can appear on these lists.

Figure 81: MSCI GEMs: 50 Best Performing Stocks in 2016 (USD Performance)



Source: MSCI, Bloomberg, UBS.

Figure 82: MSCI GEMs: 50 Worst Performing Stocks in 2016 (USD Performance)



Source: MSCI, Bloomberg, UBS

Appendix

Figure 83: Asset Price Changes in Falling and Rising Dollar Periods

	----- Falling Dollar -----		Flat Dollar	---------- Rising Dollar----------	
	(Annualized)			(Annualized)	
Period Start	Average (2002-08,	January 29, 2016	May 2, 2016	Average (2008-09,	August 23, 2016
Period End	2009, 2010-11, 2016)	May 2, 2016	August 23, 2016	2009-10, 2011-16)	December 28, 2016
Trade-Weighted US Dollar	-18.0%	-8.7%	0.0%	17.9%	10.4%
Period length (months)	24	3	3	24	4
Global Equities					
AC World	44.5%	7.8%	4.3%	-23.1%	-0.1%
DM	42.2%	7.3%	3.8%	-22.6%	0.7%
MSCI Indices (USD)					
Emerging Markets	66.0%	12.6%	8.5%	-26.6%	-6.1%
Asia	55.9%	8.0%	9.7%	-22.5%	-6.6%
EMEA	78.3%	20.0%	3.9%	-29.9%	-4.3%
Latin America	105.1%	29.5%	8.5%	-33.7%	-5.7%
GEMs Sectors (USD)					
Energy	90.6%	25.2%	0.6%	-35.7%	7.7%
Materials	107.9%	28.1%	5.9%	-35.9%	0.0%
Consumer Discretionary	87.3%	10.4%	7.6%	-21.0%	-11.1%
Consumer Staples	62.2%	10.7%	4.0%	-15.0%	-13.5%
Industrials	58.1%	8.8%	3.6%	-28.2%	-10.1%
Financials	78.9%	13.5%	8.7%	-28.3%	-3.5%
Health Care	26.5%	2.9%	5.8%	-1.2%	-13.4%
Information Technology	49.5%	8.1%	18.9%	-15.7%	-4.8%
Telecom	38.1%	8.1%	3.8%	-23.2%	-11.3%
Utilities	50.7%	13.4%	4.0%	-22.1%	-12.3%
EMBI+ Yield	9.2%-6.3%	6.4%-5.8%	5.8%-5.1%	6.3%-7.8%	5.1%-6.1%
Spread	575-305	445-380	380-340	310-490	340-360
Change in Yield (bps)	-290	-60	-70	150	100
Commodity Returns					
CRB	33.4%	36.0%	-0.8%	-14.9%	2.9%
Brent	108.2%	48.8%	7.2%	-32.7%	12.8%
Iron Ore	113.1%	8.4%	-6.6%	23.2%	40.4%
Performance (USD)					
China	52.1%	8.5%	10.0%	-22.9%	-6.5%
Korea	66.9%	10.0%	9.8%	-21.8%	-6.6%
Taiwan	43.7%	6.9%	11.9%	-23.8%	0.0%
India	76.8%	4.8%	8.2%	-23.7%	-10.2%
South Africa	80.7%	20.9%	10.7%	-23.5%	-12.8%
Brazil	156.2%	48.1%	17.5%	-38.6%	-1.4%
Mexico	72.5%	10.6%	-2.3%	-24.8%	-15.2%
Russia	102.7%	25.2%	0.8%	-37.2%	17.6%
Indonesia	90.8%	6.6%	14.2%	-17.1%	-9.6%
Turkey	85.3%	20.6%	-12.1%	-16.4%	-18.0%

Source: MSCI, Datastream, UBS

Figure 84: UBS Emerging Markets Macro Forecasts

	--------GDP y/y%--------			--------CPI y/y%--------			Current Acc Balance (% of GDP)			Budget Balance (% of GDP)		
	2016E	2017E	2018E	2016E	2017E	2018E	2016E	2017E	2018E	2016E	2017E	2018E
Emerging World	4.2	5.0	5.1	4.2	3.8	3.6	3.1	2.5	2.1	-3.4	-3.2	-3.0
Asia	5.7	5.9	5.8	2.5	2.8	2.7	3.5	2.9	2.6	-1.9	-1.9	-1.9
China	6.7	6.4	6.0	2.0	2.3	1.8	1.9	1.3	1.2	-4.0	-4.0	-4.0
Korea	2.8	2.6	2.5	0.9	1.8	1.7	7.0	6.1	5.5	-2.0	-2.0	-1.9
Taiwan	1.6	1.0	1.8	1.2	1.5	1.1	14.4	12.8	12.0	-0.2	-0.3	-0.4
India	6.0	8.0	7.8	4.7	4.1	4.9	-0.2	-1.0	-1.5	-3.5	-3.0	-3.5
Malaysia	3.8	3.4	3.7	2.1	2.7	2.8	1.3	1.3	1.6	-3.5	-3.0	-3.0
Indonesia	5.0	4.8	5.2	3.5	4.5	5.1	-2.0	-2.4	-2.7	-2.8	-2.8	-2.3
Thailand	3.1	2.5	3.1	0.2	1.4	1.7	10.7	8.9	8.0	-2.8	-3.0	-2.5
Philippines	6.8	6.0	6.5	1.7	2.9	3.2	0.8	0.2	-1.5	-2.6	-3.0	-2.9
Latin America	-1.0	1.6	2.3	6.5	4.2	4.3	-2.5	-2.3	-2.5	-7.6	-7.5	-6.3
Brazil	-3.6	1.3	2.6	8.8	4.5	4.6	-1.2	-1.4	-2.1	-9.1	-9.5	-8.7
Mexico	2.2	1.7	2.0	2.8	4.2	4.2	-2.7	-3.0	-3.3	-2.9	-2.5	-2.0
Chile	1.8	2.2	2.6	3.8	2.2	2.9	-2.0	-2.2	-1.8	-2.1	-1.8	-1.7
Colombia	2.2	2.4	3.2	6.4	5.0	3.8	-4.8	-4.4	-4.2	-4.1	-3.4	-3.0
Peru	3.8	4.4	4.3	3.3	2.8	2.6	-3.7	-3.2	-3.0	-3.0	-2.3	-2.3
EM EMEA	1.1	2.1	2.4	5.7	4.6	4.5	-1.1	-0.8	-1.0	-3.1	-2.5	-1.9
S Africa	0.6	1.2	1.6	6.3	5.7	5.6	-4.0	-3.6	-3.6	-3.4	-3.2	-2.8
Russia	-0.6	1.3	1.7	7.0	4.9	4.2	2.5	3.0	2.5	-3.7	-2.5	-1.6
Poland	3.1	3.3	3.3	-0.7	1.6	2.2	-0.7	-1.1	-1.3	-2.8	-2.8	-2.6
Turkey	3.2	3.0	3.1	7.8	7.0	6.5	-4.9	-5.8	-6.2	-1.8	-1.6	-1.5
Hungary	2.0	2.7	2.7	0.4	2.2	2.7	4.7	4.6	3.6	-1.6	-2.5	-2.5
Czech Rep	2.7	2.9	2.7	0.5	2.1	2.3	1.7	1.4	1.2	0.0	-0.5	-0.5
Greece	0.0	2.0	2.6	0.2	0.6	1.0	1.9	1.8	1.4	-3.4	-2.7	-1.7
UAE	2.6	2.9	3.0	1.4	1.2	4.4	3.4	4.6	5.0	-3.6	-0.2	2.4

Source: UBS estimates

Figure 85: UBS Emerging Market Interest Rate Forecasts

	Change in 2016	end-2016	Change to end-2017	end-2017e
Brazil	-0.50%	13.75%	-3.25%	10.50%
Chile		3.50%	-0.50%	3.00%
China		1.50%		1.50%
Colombia	1.75%	7.50%	-1.20%	6.30%
Czech Rep		0.05%		0.05%
Greece	-0.05%	0.00%		0.00%
Hungary	-0.45%	0.90%		0.90%
India	-0.50%	6.25%	-0.50%	5.75%
Indonesia	-2.75%	4.75%	0.25%	5.00%
Korea	-0.25%	1.25%		1.25%
Malaysia	-0.25%	3.00%	-0.50%	2.50%
Mexico	2.50%	5.75%	0.75%	6.50%
Peru	0.50%	4.25%		4.25%
Philippines	-1.00%	3.00%		3.50%
Poland		1.50%	0.25%	1.75%
Qatar	0.25%	1.00%	0.50%	1.50%
Russia	-1.00%	10.00%	-2.00%	8.00%
S Africa	0.75%	7.00%		7.00%
Taiwan	-0.250%	1.375%	-0.250%	1.125%
Thailand		1.50%	-0.25%	1.25%
Turkey	0.30%	7.80%	2.00%	9.80%
UAE	0.25%	1.50%	0.50%	2.00%
US	0.25%	0.625%	0.50%	1.125%
Eurozone (ECB Refi Rate)	-0.05%	0.00%		0.00%
Japan	-0.20%	-0.10%		-0.10%

Source: Haver, UBS estimates

Figure 86: Currency Rates and UBS Forecasts

Currency	Change in 2016	end-2016	Change to end-2017	end-2017e
EUR/USD	-2.9%	1.05	7.1%	1.13
GBP/USD	-16.2%	1.24	-8.6%	1.13
AUD/USD	-0.5%	0.72	7.7%	0.78
USD/JPY	3.1%	116.6	6.0%	110.0
USD/CNY	-6.6%	6.95	-4.8%	7.30
USD/KRW	-2.9%	1,208	0.6%	1,200
USD/TWD	1.9%	32.2	-3.8%	33.5
USD/INR	-2.5%	67.9	-7.0%	73.0
USD/IDR	2.3%	13,473	-7.1%	14,500
USD/MYR	-4.3%	4.49	-2.5%	4.60
USD/THB	0.5%	35.81	-0.5%	36.00
USD/PHP	-5.3%	49.7	-2.5%	51.0
USD/RUB	19.6%	61.0	11.0%	55.0
USD/ZAR	13.3%	13.7	-10.3%	15.3
USD/TRY	-17.0%	3.52	2.0%	3.45
USD/AED	0.00%	3.67	0.1%	3.67
USD/QAR	0.00%	3.64	0.0%	3.64
EUR/PLN	-2.4%	4.40	3.6%	4.25
EUR/CZK	2.6%	27.02	3.9%	26.00
EUR/HUF	2.2%	309	-0.4%	310
USD/BRL	21.6%	3.25	8.5%	3.00
USD/MXN	-16.2%	20.60	-1.9%	21.00
USD/CLP	5.8%	670	0.0%	670
USD/COP	5.7%	3002	1.8%	2950
USD/PEN	1.7%	3.35	1.6%	3.30

Source: UBS estimates

Figure 87: Earnings Growth and Valuation Table

	Trailing P/E			Forward P/E			Price/Book			Earnings Growth			ROE		Div Yield
	Latest	LTAvg	vs LTAvg	Latest	LTAvg	vs LTAvg	Latest	LTAvg	vs LTAvg	2015	2016	2017	Latest	LTAvg	Trailing
Developed World	18.4	17.5	6%	16.4	15.3	7%	2.24	2.27	-1%	-3.0%	0.9%	12.8%	10.2%	12.1%	2.5%
GEMs	13.5	13.2	2%	11.9	10.9	9%	1.51	1.83	-17%	-7.1%	8.3%	13.0%	10.6%	13.1%	2.6%
EM Asia	13.7	13.9	-2%	12.0	11.5	4%	1.53	1.82	-16%	2.6%	2.6%	14.0%	11.1%	12.4%	2.4%
EM Latin America	15.4	12.8	20%	14.1	10.9	29%	1.70	1.91	-11%	-36.7%	59.4%	9.6%	8.7%	13.2%	2.9%
EM EMEA	11.6	10.8	7%	10.3	9.6	7%	1.34	1.83	-27%	-22.2%	9.8%	11.5%	9.8%	14.4%	3.4%
Brazil	13.5	10.4	30%	12.8	8.9	44%	1.53	1.68	-9%	-50.0%	88.2%	6.1%	8.2%	13.6%	3.4%
Chile	15.8	19.0	-17%	15.3	15.4	-1%	1.57	1.90	-18%	-7.9%	12.5%	3.2%	8.6%	8.8%	2.7%
China	13.1	13.5	-3%	11.4	12.1	-6%	1.55	2.12	-27%	-3.2%	0.4%	15.1%	11.9%	13.9%	2.2%
Colombia	15.8	15.8	0%	12.4	13.9	-11%	1.26	1.58	-21%	-5.6%	4.6%	27.0%	5.3%	8.4%	3.2%
Czech Republic	12.3	13.3	-7%	14.0	12.6	11%	1.30	1.69	-23%	-0.3%	-6.2%	-12.1%	10.9%	12.0%	8.4%
Egypt	16.8	12.1	39%	11.8	9.8	20%	3.13	2.88	8%	NA	NA	NA	19.4%	17.6%	0.9%
Greece	15.7	13.9	13%	14.2	12.6	13%	0.51	1.75	-71%	-0.5%	1.6%	10.6%	-6.5%	7.0%	1.1%
Hungary	11.5	11.1	4%	11.8	9.8	21%	1.65	1.82	-9%	59.2%	50.7%	-2.3%	15.2%	15.1%	1.9%
India	18.8	17.5	8%	16.0	14.6	10%	2.93	3.21	-9%	6.1%	8.2%	19.3%	14.8%	17.7%	1.4%
Indonesia	17.9	13.0	37%	15.4	11.1	39%	2.80	3.17	-12%	-8.5%	4.8%	16.0%	15.1%	21.4%	2.1%
Korea	11.3	10.9	4%	10.0	9.2	8%	0.97	1.32	-27%	15.9%	7.0%	13.9%	8.9%	11.3%	1.7%
Malaysia	16.5	16.3	1%	15.6	14.6	7%	1.64	1.97	-17%	-1.2%	-3.2%	5.6%	9.9%	11.4%	3.0%
Mexico	19.4	16.7	17%	16.5	13.8	19%	2.43	2.64	-8%	-10.6%	36.8%	17.7%	11.2%	14.9%	2.0%
Peru	14.8	14.0	6%	12.1	11.8	3%	1.98	2.91	-32%	-11.3%	21.6%	22.5%	9.5%	19.3%	1.1%
Philippines	17.7	18.4	-3%	16.6	15.2	9%	2.35	2.22	6%	5.8%	7.3%	7.0%	12.6%	11.4%	1.7%
Poland	13.4	13.8	-3%	11.9	12.4	-4%	1.20	1.67	-28%	18.3%	-8.5%	12.6%	7.0%	12.0%	2.8%
Qatar	14.4	14.7	-2%	12.8	13.1	-2%	1.75	2.31	-24%	-4.7%	-5.8%	12.3%	12.0%	15.5%	3.9%
Russia	6.6	7.1	-7%	6.3	7.0	-10%	0.87	1.31	-34%	-42.0%	15.3%	4.9%	10.4%	14.5%	4.0%
South Africa	17.8	13.5	32%	14.3	11.2	27%	2.25	2.47	-9%	-3.8%	8.7%	20.6%	10.9%	16.2%	3.1%
Taiwan	14.3	17.3	-17%	12.9	14.2	-9%	1.76	1.93	-9%	1.4%	-1.8%	11.2%	11.5%	10.4%	4.0%
Thailand	15.9	13.2	21%	14.6	12.2	20%	2.04	2.06	-1%	-1.1%	10.9%	8.9%	12.9%	13.0%	2.9%
Turkey	9.0	11.9	-24%	7.8	9.5	-19%	1.16	2.14	-46%	12.2%	5.9%	16.3%	12.5%	15.9%	2.8%
UAE	13.3	14.3	-7%	11.8	12.7	-7%	1.63	1.64	0%	-4.6%	10.4%	12.8%	13.7%	10.6%	4.4%
Energy	10.8	8.1	33%	9.0	7.7	18%	0.87	1.54	-44%	-40.4%	-7.2%	19.8%	6.1%	16.7%	3.0%
Materials	13.4	12.4	8%	13.4	10.2	31%	1.29	1.70	-24%	-71.6%	NM	-0.3%	7.3%	12.9%	2.7%
Cons Disc	16.9	13.4	26%	14.1	11.3	25%	1.93	2.03	-5%	-0.8%	6.1%	17.1%	10.1%	13.9%	1.5%
Cons Staples	23.7	19.1	24%	19.9	16.3	22%	3.58	3.17	13%	7.5%	7.6%	18.7%	14.7%	15.3%	2.1%
Industrials	16.0	14.9	7%	13.1	11.9	10%	1.34	1.58	-15%	82.7%	-4.0%	21.4%	10.2%	9.3%	1.9%
Financials	9.6	12.2	-21%	9.0	9.9	-10%	1.15	1.70	-33%	5.4%	1.1%	8.0%	11.6%	12.7%	3.6%
Health Care	26.0	22.3	17%	21.2	18.3	16%	3.64	3.75	-3%	21.6%	9.0%	25.4%	14.7%	14.7%	1.1%
Info Tech	17.6	16.3	8%	14.3	13.5	6%	2.39	2.48	-4%	-4.7%	8.1%	22.2%	13.7%	14.4%	1.8%
Telecoms	17.0	15.0	14%	15.0	13.1	15%	1.92	2.45	-22%	-9.4%	-2.4%	13.4%	10.1%	15.7%	3.8%
Utilities	9.1	13.6	-33%	9.5	11.5	-18%	1.05	1.02	3%	33.9%	-2.2%	-4.4%	10.7%	7.5%	3.7%

Source: Datastream, IBES, MSCI, UBS GEMs Strategy. Data as of December 30, 2016

Figure 88: Emerging Markets Valuation Heat Map

Price/Book	Energy	Materials	Cons Disc	Cons Staples	Industrials	Financials	Health Care	Info Tech	Telecoms	Utilities	Aggregate
EM Asia	1.10	1.20	1.59	3.51	1.23	**1.02**	3.94	2.38	**1.77**	1.06	1.53
China	**0.88**	1.04	2.59	2.98	1.09	**0.93**	3.23	5.79	1.37	**1.41**	1.55
Korea	0.90	**0.75**	**0.77**	2.25	0.94	**0.59**	3.77	1.32	0.97	0.40	**0.97**
Taiwan	3.83	1.55	2.43	4.17	**0.93**	**1.04**	**8.07**	2.10	2.65		1.76
India	1.63	2.20	3.33	12.94	3.69	2.42	4.56	**4.45**	1.92	1.49	2.93
Malaysia	**1.19**	2.19	**1.23**	**2.12**	**1.54**	**1.40**	**2.55**		4.45	1.58	**1.64**
Indonesia	1.68	**2.09**	3.90	5.44	3.08	**2.14**	6.29		4.37	**1.57**	**2.80**
Thailand	1.38	1.79	5.10	5.20	**2.81**	**1.32**	7.66		4.27	1.82	2.04
Philippines			6.29	5.23	2.22	1.80			**2.78**	2.50	2.35
EM Latam	0.98	1.28	3.07	3.27	2.15	1.69	2.35	7.23	2.42	**1.26**	1.70
Brazil	0.95	1.07	3.14	3.68	**2.16**	1.64	**2.35**	**7.23**	1.09	**1.13**	1.53
Mexico		1.74	2.93	3.39	2.38	2.00	1.69		4.88		**2.43**
Chile		**1.10**	3.22	**1.66**	**1.33**	**1.94**			1.65	**1.45**	**1.57**
Colombia	**1.26**	1.33		**0.62**		1.24				**1.18**	**1.26**
Peru		**1.57**				2.24				1.27	**1.98**
EM EMEA	0.65	1.64	3.43	4.87	1.72	1.31	2.99		2.22	0.68	**1.34**
South Africa	**0.89**	**1.30**	3.66	4.59	**3.27**	1.88	3.60		**2.28**		2.25
Russia	0.59	**4.86**	0.44	7.18		1.40			2.14	0.66	0.87
Poland	1.27	1.09	3.30	5.23		**1.38**			**0.61**	**0.42**	1.20
Turkey	2.29	**1.65**	**3.19**	3.14	1.06	**0.81**			1.67		**1.16**
Hungary	1.44					1.69	1.77				1.65
Czech Rep						1.64			**4.77**	**0.88**	**1.30**
Egypt						**4.39**			5.29		3.13
Greece	0.80	1.13	1.84			0.29			1.89	0.12	0.51
UAE	0.60				1.70	1.38					1.63
Qatar	3.33				2.13	1.78			1.44	3.24	1.75
GEM	**0.87**	1.29	1.93	3.58	1.34	**1.15**	3.64	2.39	1.92	1.05	1.51

Source: MSCI, Datastream, UBS

Figure 89: Emerging Markets Valuation Heat Map

Forward P/E	Energy	Materials	Cons Disc	Cons Staples	Industrials	Financials	Health Care	Info Tech	Telecoms	Utilities	Aggregate
EM Asia	12.2	13.0	12.2	20.8	12.7	8.5	22.8	14.3	15.1	8.8	12.0
China	13.9	12.9	17.1	19.8	9.7	6.6	16.3	23.7	13.3	9.9	11.4
Korea	7.4	10.2	7.5	17.0	12.0	8.6	45.7	10.7	11.0	4.2	10.0
Taiwan	20.4	17.2	13.9	19.6	16.4	10.8		12.4	18.6		12.9
India	11.4	14.9	15.2	30.8	21.3	15.5	19.8	15.0	29.2	12.6	16.0
Malaysia	29.4	19.5	15.7	20.8	17.7	12.2	40.2		22.4	12.2	15.6
Indonesia	13.6	13.7	17.6	22.8	17.4	12.4	27.6		17.5	10.7	15.4
Thailand	11.9	11.5	24.7	22.6	28.3	10.1	36.2	17.0	22.4	12.3	14.6
Philippines			29.2	22.6	15.9	15.0			13.5	12.5	16.6
EM Latam	14.3	20.1	20.1	19.1	17.1	10.3	17.1	14.5	14.9	11.6	14.1
Brazil	13.8	24.2	15.2	17.2	22.1	9.3	16.5	14.0	14.2	10.7	12.8
Mexico		16.0	28.1	21.4	13.4	12.9			14.5	17.4	16.5
Chile	19.6	22.8	22.0	17.7	27.0	12.6			24.5	11.3	15.3
Colombia	9.0	26.7				11.1				13.6	12.4
Peru		14.7				11.2					12.1
EM EMEA	5.9	9.6	20.5	18.4	13.5	9.6	16.6		14.7	9.0	10.3
South Africa	7.4	9.6	20.6	17.6	14.7	11.2	15.7		14.5		14.3
Russia	5.4	8.6				7.4			10.6	6.9	6.3
Poland	10.2	8.9	20.9	21.5		13.3				7.2	11.9
Turkey	8.8	12.9	12.3	18.6	8.9	5.7			10.3		7.8
Hungary	9.4					11.1	18.7				11.8
Czech Rep						12.9			15.9	15.4	14.0
Egypt						11.9			10.5		11.8
Greece		17.4	12.9						15.2		14.2
GEM	9.0	13.4	14.1	19.9	13.1	9.0	21.2	14.3	15.0	9.5	11.9

Source: MSCI, IBES, Datastream, UBS

Figure 90: MSCI Emerging Markets Country and Sector Weights

		Energy	Materials	Cons Disc	Cons Staples	Industrials	Financials	Real Estate	Health Care	Info Tech	Telecoms	Utilities
GEM		7.93	7.37	10.33	7.11	5.74	24.43	2.59	2.50	23.26	5.89	2.86
EM Asia	70.01	3.76	3.81	6.82	3.76	4.55	15.17	1.51	1.98	23.04	3.88	1.72
EM EMEA	16.62	2.92	1.59	2.75	1.11	0.51	5.18	0.89	0.47	0.06	1.01	0.29
EM LatAm	13.37	1.28	2.01	0.78	2.29	0.77	4.08	0.19	0.16	0.22	0.87	0.81
Brazil	7.85	1.10	0.98	0.36	1.14	0.35	2.80	0.10	0.13	0.22	0.21	0.45
Chile	1.19	0.10	0.13	0.12	0.16	0.06	0.24		0.01		0.04	0.32
China	26.48	1.74	0.34	2.47	0.63	1.46	7.10	0.99	0.53	8.48	2.02	0.72
Colombia	0.47	0.06	0.09	0.00	0.02		0.28					0.03
Czech Rep	0.18		0.01	0.01	0.00	0.00	0.10		0.03	0.00	0.02	0.07
Egypt	0.14		0.01	0.01	0.02	0.07	0.10	0.01	0.00		0.03	
Greece	0.37		0.03	0.11			0.18				0.06	
Hungary	0.31	0.06	0.02	0.00	0.00	0.00	0.18		0.07		0.02	0.00
India	8.24	0.91	0.65	1.13	0.76	0.49	1.68		0.79	1.42	0.22	0.18
Indonesia	2.62	0.11	0.10	0.42	0.39	0.06	0.91	0.11	0.06		0.41	0.06
Korea	14.47	0.35	1.16	1.94	1.06	1.43	1.89		0.31	5.91	0.16	0.26
Malaysia	2.50	0.06	0.11	0.22	0.22	0.38	0.69	0.02	0.13	0.00	0.26	0.40
Mexico	3.45	0.01	0.67	0.30	0.96	0.36	0.48	0.09	0.02		0.53	
Peru	0.41		0.13		0.01	0.00	0.28				0.08	0.01
Philippines	1.23	0.00	0.00	0.04	0.07	0.31	0.36	0.29		0.00	0.10	0.06
Poland	1.16	0.25	0.13	0.11	0.02	0.01	0.56		0.00	0.02	0.02	0.07
Qatar	0.91	0.04				0.12	0.53	0.11	0.01		0.06	0.04
Russia	4.57	2.46	0.46	0.00	0.35	0.00	1.02		0.04		0.19	0.10
South Africa	7.11	0.02	0.86	2.42	0.58	0.10	1.81	0.46	0.31	0.03	0.55	
Taiwan	12.12	0.10	1.19	0.47	0.32	0.18	2.02	0.05	0.05	7.18	0.55	
Thailand	2.35	0.48	0.27	0.12	0.31	0.23	0.51	0.05	0.11	0.05	0.16	0.05
Turkey	0.99	0.06	0.06	0.07	0.14	0.11	0.43	0.04	0.00	0.00	0.08	0.00
UAE	0.87	0.02	0.01	0.03	0.00	0.08	0.27	0.27	0.01			

Source: Datastream, MSCI, UBS GEMs Strategy

Figure 91: Summary of EM Country Views

EM Asia	UBS Strategy View	Micro/Domestic Factors	Risks (key data points that we will track)
India (Overweight)	Structurally bullish given that we are deep into balance sheet repair and expect lower capex to lift utilisation ratios and returns on capital. Reforms continue to progress and RBI rhetoric suggests continued focus on lowering inflation and cost of capital too. But valuations look expensive and growth pick-up may take time to come through.	• When will economic & earnings growth turn around? • Is reform (lower rates) still on track?	• Inflation and implications for rate cuts. • Backtracking on the reform agenda. • Economic and Earnings growth. • Oil price rebound. • Well-owned.
China (Neutral)	Balance between faster credit growth supporting GDP and longer-term stability (debt/GDP is still rising rapidly). Valuations seem reasonable and we expect robust profit growth in 2017 on a cyclical recovery.	• Will FX concerns recede? • Reforms: when will they become visible? • Banking sector balance sheet health?	• FX fears return if US $ strengthens. • A more pronounced growth slowdown. • Commodity / inflation rebound may impede central bank's capacity to ease.
Korea (Overweight)	Korea benefits from an improving export-cyclical growth backdrop. Attractive valuations and earnings momentum remains strong.	• Will shareholder returns significantly improve? • Can the earnings picture improve other than for short-term cyclical reasons?	• Corporate governance reforms impress / disappoint • Global/US recovery fails to materialise • Domestic consumption falters.
Taiwan (Overweight)	Expect Taiwan to benefit from a cyclical pick-up, supported by inventory digestion. In a relative context, valuations seem reasonable and export orders are improving.	• What could drive tech earnings? • What's the outlook for China end-demand?	• Taiwan policy if Fed hikes rates • Success of iPhone product launches • Global/US recovery fails to materialize.
Thailand (Neutral)	Relatively expensive, however strong earnings growth outlook supported by recent government spending (but this may fade in 2017). We see scope for policy rates to be nudged lower to support growth in the near-term but policy close to bottoming.	• Does infrastructure spending continue to support growth? • When will we get more clarity on constitutional arrangements?	• Political risk. • Infrastructure spending and growth delivers.
Indonesia (Neutral)	Expensive valuations following strong inflows in 2016. Reform progress, slowing credit growth and improved current account balance are helpful for lowering the risk premium, but we think much of this improvement is already priced in. Risk that this could destabilise if BI cuts rates further too soon. Fed rate hikes in coming months may also pressure the IDR and Indonesian equities.	• Is the earnings improvement sustainable? • Are rate cuts compatible with currency and current account improvement?	• Current account improvement /deterioration • Fed rate hikes and higher US rates • Commodity prices (CPO and coal). • Reform disappointment
Philippines (Underweight)	Premium valuations already reflect the strong growth backdrop and current account surplus. High valuations could be at risk from Fed tightening which has historically been a negative.	• The impact on rates and FX from the Fed?	• Inflation and its impact on policy.
Malaysia (Underweight)	Weak earnings on the back of relatively low oil prices and domestic slowdown. FX reflects some of these risks, but equities are not obviously cheap given the fall in near-term earnings.	• Has the oil price slump come to an end? • Where does the currency go from here? • Does political noise recede?	• Oil price rebounds. • Politics. • Current account improvement. • Rebound in the currency.

Source: UBS

Figure 92: Summary of EM Country Views

Latin America	UBS Strategy View	Micro/Domestic Factors	Risks (key data points that we will track)
Brazil (Neutral)	FX pullback is opportunity to add some weight. Weak growth recovery in 2017 and political uncertainty remains high; valuations look stretched. The bull case is scope for lower rates in 2017 (-325bp) and further FX upside as the carry trade remains attractive.	• Structural reform progress. • Weak economic recovery. • How far can rates fall?	• Higher US yields, hawkish Fed and higher USD. • Temer mandate weakens on further scandal. • Major earnings downgrades.
Mexico (Underweight)	A laggard in 2016 that still looks risky and too expensive (16.5x). Weak growth, fiscal pressures, Peso risk, further rate hikes likely as the Fed tightens. Trade action by new US gov't/NAFTA revamp is a clear risk. Some good stocks.	• Oil price rebound helping fiscal balance. • Slowing consumer. • FX intervention v. rate hikes (+75bp in 2017)	• Weak peso and interest rate risk. • High valuations – where's the upside? • The EM most at risk from US trade action; will NAFTA be re-negotiated?
Chile (Underweight)	Least favoured Andean market. GDP growing c. 3% ex-copper; prices of the latter may rise in 2017. Investment is weak due to policy uncertainty. Rate cuts expected (-50bp in 2017) but wages are weak and fiscal tightening seems likely. Fair value to history (15.3x).	• Significant current account adjustment. • Expensive market v. GEMs, but cheap to history. • Election in November 2017.	• China slowdown hits copper prices. • Further fiscal retrenchment, and yet higher taxes on corporates. • The political merry-go-round – in November, does the country stay left or swing right again?
Colombia (Overweight)	Our top Andean market pick for 2017. Our positive view supported by: i) further gains in oil prices; ii) rate cuts (150bp in 2017); iii) cheap valuations below historical averages. Tax reform is vital to help curb twin deficits. A play on oil, but we think stock selection is challenging.	• Oil prices are key. • Investment exceeds savings = c/a deficit. • Hopes for a peace deal with FARC after all.	• Lower oil prices. • Peso risk on high external deficit. • Further economic weakness. • Peace process collapses again.
Peru (Overweight)	We see this as the best regional growth story (4.4% in 2017 boosted by higher copper prices, fiscal easing and positive sentiment towards new government. Valuations in line with long-term average despite huge 2016 rally. Market is led by bellwether: Credicorp.	• New mining and infrastructure projects. • Policy agenda of new president. • Copper (and gold) prices.	• China slowdown hurts metals prices. • Economy stalls. • Favoured/over-owned market.

Source: UBS

Figure 93: Summary of EM Country Views

EM EMEA	UBS Strategy View	Micro/Domestic Factors	Risks (key data points that we will track)
South Africa (Underweight)	The ZAR and equity market look expensive. Reform proposals have broad scope but implementation is challenging. The economy is weak and fiscal pressures great. However, downgrade risk has receded although political uncertainty is still high. Expect flat rates in 2017.	• Structural reform and downgrade risk. • Quality domestic companies. • Is political change coming?	• Ratings cut. • Further slowdown in China. • Strong dollar pulls ZAR sharply lower.
Russia (Overweight)	Top EM pick in 2017, supported by rising oil prices and economic recovery, underpinned by consumption rebound. Ruble has upside. Rates to continue to fall (-200bp in 2017). Cheap valuations even on modest earnings forecasts. Is political risk priced in?	• One of the best interest rate stories in EM. • Oil price rally boosts economy and budget. • The outlook for sanctions.	• Oil prices and Ruble fall back again. • Economic recovery disappoints. • Further political tension v. the West.
Turkey (Underweight)	Macro events and weak monetary policy have affected the market, FX and the economy. The Lira remains exposed to Fed and bond market risk, given wider current account deficit; higher oil prices are a big negative. The market is cheap, but should be.	• Slowing economy in 2016 H2. • Rates, yields and the dollar. • Strong corporate sector.	• Higher US yields, hawkish Fed, higher USD lead to further Lira weakness. • Further rally in oil prices. • Any further macro turbulence in the region.
Czech (Underweight)	Least preferred of CE3 markets, given lack of attractive stocks. The macro is good, inflation/interest rates are rock-bottom. Interest rates flat in 2017. Market is expensive with defensive (high-yield) stocks.	• Limited currency risk on strong EUR/USD outlook. • Rich, defensive stocks. • How long will rates be at zero?	• Rich valuations, less interesting in rising markets. • Risk of slower growth. • Stronger dollar/weak Euro.
Hungary (Overweight)	Retain single-stock Overweight in market outperformer in 2016. Growth to pick up to 2.7% this year, with upside risk. External balance is strong. No rate hikes until 2018. Rich market v history, but not v. GEMs. Switch stock preference from OTP to MOL.	• Upside risk to growth. • Rates close to zero and on hold. • Limited currency risk on strong EUR/USD outlook.	• Growth pick-up fails to come through. • Stronger dollar/weak Euro. • Higher rates in 2017?
Poland (Neutral)	Upgrade to Neutral after lagging in 2016. Solid growth c 3% pa, although risk of fiscal adjustment. Internal political cohesion is not strong. Low inflation means only a 25bp rise in rates in 2017. Market is cheap v its history.	• Will growth pick up? • Limited currency risk on strong EUR/USD outlook. • Politics remain a 'wild card'.	• Stronger dollar/weak Euro. • Fiscal tightening to put growth at risk. • Sector impact of any new policy moves.
Greece (Underweight)	Macro risk remains high despite pick-up to 2% growth in 2017. Second review of third bailout package is a key uncertainty, including debt relief, IMF participation and Greece's possible inclusion in ECB QE. Worst EM performer for two years – but, still an Underweight.	• Weak economy still, with a heavy debt burden. Reforms to complete latest review of bailout deal. Waiting for a full IMF response.	• Can further fiscal adjustment be achieved? • Growth fails to pick up. • Further tension with EU leaders on immigration.

Source: UBS

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Neutral	FSR is between -6% and 6% of the MRA.	39%	27%
Sell	FSR is > 6% below the MRA.	15%	16%
Short-Term Rating	**Definition**	**Coverage[3]**	**IB Services[4]**
Buy	Stock price expected to rise within three months from the time the rating was assigned because of a specific catalyst or event.	<1%	<1%
Sell	Stock price expected to fall within three months from the time the rating was assigned because of a specific catalyst or event.	<1%	<1%

Source: UBS. Rating allocations are as of 31 December 2016.
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ASE[16b]	2311.TW	Buy	N/A	NT$34.20	09 Jan 2017
Banco Davivienda[5, 6a, 6b, 7]	DVI_p.CN	Buy	N/A	P31,300.00	06 Jan 2017
Bank Rakyat Indonesia[7]	BBRI.JK	Buy	N/A	Rp11,750	09 Jan 2017
Banorte[2, 4, 7]	GFNORTEO.MX	Buy	N/A	P97.39	06 Jan 2017
China Construction Bank[2, 4, 5, 6a, 6b, 7, 16a]	0939.HK	Buy	N/A	HK$5.83	09 Jan 2017
China Railway Construction[2, 4, 16a]	1186.HK	Buy	N/A	HK$10.22	09 Jan 2017
China Shenhua Energy[4, 5, 16a]	1088.HK	Buy	N/A	HK$15.40	09 Jan 2017
Credicorp[7, 16b]	BAP.N	Buy	N/A	US$164.69	06 Jan 2017
CSPC Pharmaceutical Group	1093.HK	Buy	N/A	HK$8.28	09 Jan 2017
Delta Electronics	2308.TW	Buy	N/A	NT$161.50	09 Jan 2017
Discovery Ltd	DSYJ.J	Buy	N/A	RCnt11,475	09 Jan 2017
Fosun International[2, 4, 5, 7, 16a]	0656.HK	Buy	N/A	HK$11.04	09 Jan 2017
Guangzhou Automobile	2238.HK	Buy	N/A	HK$9.69	09 Jan 2017
HDFC Bank[6a, 6b, 7, 16b]	HDBK.BO	Buy	N/A	Rs1,194.90	09 Jan 2017
Hindustan Unilever	HLL.BO	Buy	N/A	Rs830.85	09 Jan 2017
Hon Hai Precision	2317.TW	Buy	N/A	NT$83.50	09 Jan 2017
Hyundai Glovis	086280.KS	Buy	N/A	Won158,000	09 Jan 2017
Hyundai Mobis	012330.KS	Buy	N/A	Won275,000	09 Jan 2017
Itau Unibanco[7, 16b]	ITUB4.SA	Buy	N/A	R$35.70	06 Jan 2017
Kasikornbank[7]	KBANK.BK	Buy	N/A	Bt186.00	09 Jan 2017
LG Chemical	051910.KS	Buy	N/A	Won264,500	09 Jan 2017
LG Display[7, 16b]	034220.KS	Buy	N/A	Won32,100	09 Jan 2017
MOL Group	MOLB.BU	Buy	N/A	HUF21,000.00	09 Jan 2017
Naspers[22]	NPNJn.J	Buy	N/A	RCnt212,459	09 Jan 2017
NCsoft	036570.KS	Buy	N/A	Won262,000	09 Jan 2017
Nine Dragons Paper	2689.HK	Buy	N/A	HK$7.80	09 Jan 2017
OTP Bank Nyrt[7]	OTPB.BU	Neutral	N/A	HUF8,650.00	09 Jan 2017
Petrobras (PN)[16b]	PETR4.SA	Buy	N/A	R$15.66	06 Jan 2017
PetroChina[16a, 16b]	0857.HK	Buy	N/A	HK$6.18	09 Jan 2017
PZU[3, 4, 5, 7]	PZU.WA	Buy	N/A	PLN33.75	09 Jan 2017
SABESP[16b]	SBSP3.SA	Buy	N/A	R$29.18	06 Jan 2017
Samsung Fire & Marine Insurance[7, 22]	000810.KS	Buy	N/A	Won269,500	09 Jan 2017
Sberbank[4, 5, 6a, 6b, 7, 18a, 18b]	SBER.MM	Buy	N/A	RBL168.35	09 Jan 2017
State Bank of India[6a, 6b, 7]	SBI.BO	Buy	N/A	Rs247.00	09 Jan 2017
Taiwan Mobile	3045.TW	Buy	N/A	NT$105.50	09 Jan 2017
Taiwan Semiconductor Manufacturing[16b]	2330.TW	Buy	N/A	NT$184.00	09 Jan 2017
Tata Motors Ltd.[16b, 18b]	TAMO.BO	Buy	N/A	Rs500.35	09 Jan 2017
Tencent Holdings[16a, 22]	0700.HK	Buy	N/A	HK$195.60	09 Jan 2017
WH Group	0288.HK	Buy	N/A	HK$6.13	09 Jan 2017
X5 Retail Group	PJPq.L	Buy	N/A	US$32.13	09 Jan 2017
Yandex N.V.[16b]	YNDX.O	Buy	N/A	US$22.04	09 Jan 2017

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