HERMES

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INVESTMENT NOTE

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The five GEM markets poised to outperform in 2014

Gary Greenberg, Head of Hermes Emerging Markets, outlines his team's five current overweight country allocations in the Hermes Global Emerging Markets Fund.

Many of the overweight countries trade significantly below historic levels and any positive surprises could lead to a sharp re-rating in 2014.

Here, Greenberg dissects the five overweight countries:

'China should trade at 12-14x earnings'
Since 2007, Chinese equities have de-rated from a P/E in the mid-20s to less than 9x. The country is undertaking a dramatic economic restructuring, which is intended to make Chinese economic growth sustainable over the long term. Despite current concerns over the shadow banking system, China's reasonable GDP growth and normalising interest rates point to a market that should eventually trade at levels of 12-14x.

Will implementation of the new policies outlined at the recent Third Party Plenum, combined with the current cash crunch, lead to a collapse of the Chinese economy? We do not think so. However, bank stocks trading at 0.8x book and discounting a 7 to 10% level of non-performing loans seem to be implying such an outcome.

China has nearly $4trn in reserves, low levels of loans to deposits, low overall central government indebtedness, high reserve ratio requirements, as well as virtually no foreign debt. Although the risks seem high right now, the cheapness of the market and the richness of tools available to stabilise the banking system gives us confidence this should be a good year for the Chinese market.

'Even small improvements should boost Russia'
The MSCI Russia closed 2013 at 787 in dollar terms, under its 2005 close and more than 50% lower than the end-2007 level. Russian equities have faced headwinds from the recent economic slump, while earnings growth this year is also expected to be lower. Recently the possibility of Russian military intervention has spooked the market and driven it down further. We have reduced our overweight into this uncertainty, looking to add should a market panic take place.

Despite the economy's sluggishness, inflation has remained stubbornly high and interest rates have stayed 200 basis points higher than the economy can handle. The 10% weakening of the ruble since May last year offset the dampening effect of the weak economy and administered price freezes on utilities. Nevertheless, these two factors should result in a lower CPI towards the end of 2014, allowing for cuts in interest rates and boosting an economic recovery.

In light of this, the prospects for growth in lending, car sales and retail should improve as the year goes on. Poor governance in Russia is largely expected, so even a small improvement in the economy, earnings, or in governance itself – through higher dividend payouts from the state owned enterprises – could result in a re-rating of the market. Sporting a dividend yield of over 4.5% and trading at 0.6 book, even small positive signs could result in a healthy revision.

'India is a tactical overweight ahead of elections'
The Indian market has been a good performer against the wider GEMs universe and is trading near its 2007 level in dollar terms. However, steady earnings growth means this elevated level is warranted.

We believe the market is fairly valued in light of current events, but we have moved to a tactical overweight, as an election victory for the BJP could add another 25% to the valuation. A recent trip confirmed the progress many Indian companies are making despite an ineffective government.

With the rupee falling 14% since last May, alongside restrictions on gold imports, India has started to see improvements in its current account. If the US becomes energy independent, as has been suggested, a lower oil price would benefit India significantly. Lower inflation, faster infrastructure development, as well as an opening to international direct investment would move GDP back into the 6-8% growth range. This would foster faster earnings growth and justify a multiple in the top half of the historical range.

'Turkish companies will find a way to grow profits'
The combination of tapering and political unrest has hit the Turkish market hard, resulting in a 30% drop in dollar terms from the peak in May 2013. Turkey's currency has lost more than 25% since May 2013, when tapering was first mentioned. Six month Turkish Libor has jumped from 5.1% to 9.4% over this period, and the economy duly slumped. Given these headwinds, the market has de-rated and is now looking cheap.

As most exports are directed to the Eurozone – primarily autos, textile, white goods and steel – Turkey stands to benefit from any European recovery. The country does not produce many commodities – it is an importer of oil, iron ore and coal. Therefore, any softening of Chinese growth could also have the knock-on effect of lowering further the costs of imports. This would have a significant impact, as the combination of electricity, gas, other fuels, and transportation account for another 22% of a typical Turkish consumer's overall expenditures.

The political situation is quite fluid and thus difficult to handicap, but on a tactical basis we believe a political solution will be found and companies will find a way to grow profits. Europe's recovery will help exports, China's slowdown should ease pressure on commodity prices, and the growing global interest in energy extraction from shale can only help Turkey's current account.

'Egypt could be a positive contrarian call'
While it is only a miniscule weighting in the benchmark, we have recently become more positive on Egypt. Recent political developments have established a certain level of stability, which has led foreign donors to send funds to help underwrite the country's debt repayment profile. A recent 70% rise in the minimum wage should also help ensure stability.

The Egyptian equity market has risen 40% in dollar terms since it troughed in early 2012, but it remains almost 50% below its 2008 peak. At just over 8x earnings, with a 4% yield, a return of stability post elections should allow the economy and market to begin to discount a more visible prospect of economic development and earnings growth. Foreign investors remain scarce, which may be interpreted as a positive sign from a contrarian point of view.
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Notes to Editors:

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- Our **Investment Office** is a crucial function, acting as a performance risk 'radar' for all boutiques' investment activity and is central to our mission to deliver Sustainable Risk-Adjusted Alpha to all our clients.

- Our commitment to behaving as a **Responsible Asset Manager**, not merely by being a 'Responsible Investor' in quoted companies but also by applying these principles across all asset classes and by behaving as a 'good fiduciary' on behalf of our clients.

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- **Alternatives**: Commodities, Hedge Fund Solutions, Real Estate, Private Equity, Infrastructure
- **Equities**: Global, Emerging Markets, Small & Mid Cap, Europe, Japan

Hermes manages assets on behalf of more than 170 clients* across these investment areas with £26.3 billion* assets under management. Additionally, we support pension funds and other global institutional investors worldwide in meeting their ESG responsibilities through our market leading Hermes Equity Ownership Services, which takes on a stewardship role engaging globally on more than £98 billion* of assets.

*Please note the total AuM figure includes £3.4bn of assets managed or under an advisory agreement by Hermes GPE LLP ("HGPE"), a joint venture between Hermes Fund Managers ("HFM") and GPE Partner Limited. HGPE is an independent entity and not part of the Hermes group. £0.4bn of total group AuM figure represents HFM mandates under advice. Source: Hermes as at 31 December 2013.