The Changing Face of Emerging Markets

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Change #1: The shifting investment landscape

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

Emerging Markets 1997

Emerging Markets 2017

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

Source: CIT, FactSet, Citi, and MSCI. Data as of December 2016. See disclosures on page 2.
Change #1: The shifting investment landscape

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

MSCI EM Index Holdings Over Time

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

Source: FactSet. Data as of December 2016.
See disclosures on page 2.
Change #2: Demographics – one change that you can count on

- According to J.P. Morgan, by 2099, 90% of the world population will live in emerging markets
- By 2037, most of the global population will live in EM cities
- By 2037, India will have added more workers than the U.S. currently has
- Nigeria uses more diapers in a month than western Europe does in a year

See disclosures on page 2.
Change #2: Demographics – one change that you can count on

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

Stellar growth in EM middle class

<table>
<thead>
<tr>
<th>Region</th>
<th>2015</th>
<th>2020</th>
<th>2025</th>
<th>2030</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>#</td>
<td>%</td>
<td>#</td>
<td>%</td>
</tr>
<tr>
<td>North America</td>
<td>335</td>
<td>11</td>
<td>344</td>
<td>9</td>
</tr>
<tr>
<td>Europe</td>
<td>724</td>
<td>24</td>
<td>736</td>
<td>20</td>
</tr>
<tr>
<td>Central and South America</td>
<td>285</td>
<td>9</td>
<td>303</td>
<td>8</td>
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<tr>
<td>Asia Pacific</td>
<td>1,380</td>
<td>46</td>
<td>2,023</td>
<td>54</td>
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<tr>
<td>Sub-Saharan Africa</td>
<td>114</td>
<td>4</td>
<td>132</td>
<td>4</td>
</tr>
<tr>
<td>Middle East and North Africa</td>
<td>192</td>
<td>6</td>
<td>228</td>
<td>6</td>
</tr>
<tr>
<td>World</td>
<td>1,030</td>
<td>100</td>
<td>3,766</td>
<td>100</td>
</tr>
</tbody>
</table>

Emerging Markets middle class a big winner

Change #3: The changing business model of emerging markets

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

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Change #3: The changing business model of emerging markets

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

**China exports as a % GDP**

**EM % exports by destination**

See disclosures on page 2.
Change #4: Less financial vulnerability

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

Source: Left: UBS. Right: Merrill Lynch. Top Right: Data as of December of 2016. See disclosures on page 2.
Change #5: Intra-country changes – China

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

Economic growth by province 2015

The changing face of China

Sector weights (%) over time in MSCI China

Number of engineering graduates in China and the US

Robot demand by country

Change #6: Micro changes – Free cash flow

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

See disclosures on page 2.
Change … that’s the problem with traditional passive in EM

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

See disclosures on page 2.