CAMBIAR INVESTORS
Redefining Value Since 1973

September 2013

Emerging Markets: The Long View

The Cambiar Perspective

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The allure of Emerging Markets (EM) investing is ultimately rooted in superior economic performance and economic growth, translating to superior growth rates and stock market returns for businesses operating and domiciled in Emerging Markets. Recent Emerging Markets underperformance appears to represent something more than just a case of Developed Market (DM) equities "catching up" after years of lagging, with some notable red flags gaining visibility. Currencies have weakened, credit spreads have widened, civil unrest has materialized in (unexpected) places such as Brazil and India, and there is growing skepticism about the ability of the major Emerging Markets nations (the "BRICs" and a few others) to generate superior economic growth in coming years. Emerging Markets are notorious for enduring violent, wealth destructive currency weakness as a means of adjusting to comparatively weaker economic fundamentals and associated capital flight. Is history bound to be repeated? How should investors approach this asset class, not just in 2013 but on a longer term basis?

The Cambiar International Equities team believes that the sheer complexity of the asset class defies a formulaic answer to these questions. In a four part series, we seek to help investors find their own answers to these questions, alongside our conclusions.

Part 1 – Relative Value Investing in International and Emerging Markets, Historical Context

Brian Barish, President and CIO of Cambiar Investors, discusses Cambiar's relative value approach to stock selection and the applicability to EM equities. Cambiar believes that looking at historical valuation trends is of limited usefulness given the relatively short history of Emerging Stock Markets, with a bias towards cross-border valuation as a more relevant screening tool. Post-2009, this approach screened out most eligible EM stocks on valuation grounds in favor of DM counterparts, as the former had seen their valuation multiples vault to aggressive levels that could only be rationalized by very rapid and consistent growth rates. The avoidance of EM has been beneficial in the 2010s given the poor performance trends in EM as compared with very low expectations in DM. Brian also discusses the history of EM as a distinct asset class rising from the shadows of the Cold War, noting that the embrace of U.S.-styled capitalism was as much about a lack of successful alternatives than an affinity to the U.S. system. With reduced growth expectations and increased economic stresses, Brian believes that EM equities should be viewed as undergoing a valuation and ownership change that resembles a growth to value transition, with the caveat that these have historically been accompanied by currency crises and other capital market events.

Part 2 – The Unique Challenges of an Atypical Business Cycle

Todd Edwards, PhD, discusses the path of trade flows and monetary reserves between the emerging world and the developed world. Cambiar sees the pattern of excess reserve accumulation in EM over the 1999-2012 timeframe as being a logical consequence of the Asian crisis of 1998, a critical event in the Emerging Markets timeline. This caused most EM economies to structure their growth around a "reserves-first" development path as compared to one of attracting long term capital inflows. The offset was significant trade deficits in the U.S. as the primary excess-consumer. Following the Financial Crisis and subsequent Great Recession in Developed Markets, stronger economic growth in EM, coupled with higher bond yields, led to appreciating currencies and strong rallies in the EM debt markets. At the current juncture, with yields in DM poised to rise and the export-oriented, reserves-first development strategy having reached its logical limits, EM economies must transition to other more internally-focused forms of growth. This transition is likely to be made more challenging by rising yields in the face of declining growth rates and inflationary pressures. Given a remarkably high long term correlation between EM debt costs, EM equity performance, and U.S. interest rates, we expect investors to assign a higher cost of equity to EM than in the last few years, along some persistent currency pressures serving to elevate volatility.

Part 3 – China: Past Performance Is Not Necessarily Indicative of Future Returns

Jennifer Dunne, International Portfolio Manager and our resident China-expert, discusses the biggest of all EMs, China. Chinese per capita GDP presently stands around $6,000, an area known as the "middle income trap". Many other EM development paths have been challenged to advance sustainably beyond this point. The Chinese government is aware of the precedents and has focused national resources toward moving up the value-added chain and modernizing key areas of the nation's economy. Additional growth may be harvested by reforming or dismantling China's "hukuo" system of registering urban versus rural residents. Other areas of vital reform include modernizing China's financial system and providing more sustainable avenues for personal savings. The growth challenges are evident, but the direction of growth – toward less infrastructure

and more consumption – are clear enough. We have accordingly focused international investments toward meeting Chinese consumption demand, versus other alternatives.

Part 4 – A Differential Diagnosis of Pain

Alvaro Shiraishi, a Global Select Portfolio Manager, discusses the path of economic adjustment and accompanying stress as EMs adapt to higher interest rates and less potential for reserve accumulation. Based on our experience, many EM countries are likely to endure uncomfortable levels of inflation, which induces varied forms of economic and social stress. Moreover, higher inflation distorts economic decision making and discourages many other productive investments. Due to declining (and in some cases negative) labor force growth, along with a limited ability for capital to flow productively, higher EM inflation is inevitable in many countries. Among the major EMs, we expect Mexico, the Philippines, Eastern Europe, and the more technologically advanced EMs who are already further up the development curve in Asia to fare comparatively better as inflationary pressures build.

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Perspective 2013+

Late in the summer of 2013, Emerging Markets (EM) equities appear likely to register a fourth consecutive year of underperformance versus Developed Market (DM) equity indices, with most major EM indices declining in value by 5%-15% as compared to strong YTD gains for DM indices. The gap becomes more extreme when EM equity performance is measured against DM performance since the end of 2009; the former have declined by 6% in nominal terms measured in US$ while registering a very slight 3% cumulative gain with dividends (less than 1% annualized) this decade, while the latter have gained 38% including dividends, or better than 9% annualized in US$. This degree of underperformance by EM contrasts sharply with the experience of the last decade, when EM equities distinctly outperformed their DM counterparts in the 2000s. Emerging Market equities rose by over 100% and by over 160% including dividends, or a better than 10% annualized gain from 1999 through 2009. By comparison, Developed Market equities generated a 12% loss in simple price terms for the entire decade, and a 10% gain including dividends. The comparative degree of outperformance / underperformance is almost a mirror image at ~900 basis points annualized EM over DM in the 2000s, and likewise ~900 basis points annualized in DM over EM annualized (so far) in the 2010s.
(Source: Bloomberg)

The decade of the 2000s is commonly referred to as a “lost decade” for Developed Markets equity investors for good reasons. The dismal cumulative gain realized was exacerbated in most cases by ferocious bouts of volatility and risk-aversion, leading to acute and unpredictable shifts in the effectiveness of any particular style of investing, catastrophic losses in many (once-considered) blue chip stocks, and significant valuation-compression the result. Few investors made it through looking very smart. Emerging markets equities gained sharply and dramatically outperformed in almost all up-market periods globally from 2000-2009. Though EM equities fell just as sharply as their DM counterparts in the immediate wake of the Lehman-failure in 2008, they rapidly recovered over 75% of their net losses by the end of 2009 (DM equities only recently reached this threshold in 2013). Investors biased towards EM throughout the 2000s looked comparatively smarter.

But that was then, and this is now. The allure of Emerging Markets investing is ultimately rooted in superior economic performance and economic growth, translating to superior growth rates and stock market returns for businesses operating and domiciled in Emerging Markets. The recent EM underperformance appears to represent something more than just a case of DM equities “catching up” after years of lagging, with some notable red flags gaining visibility. Currencies have weakened, credit spreads have widened, civil unrest has materialized in unexpected places such as Brazil and India, and increasingly the ability of the major Emerging Markets nations (the “BRICs” and a few others) to generate superior economic growth is under scrutiny. Emerging Markets, whether individually or as an asset class, are notorious for enduring violent, wealth destructive currency weakness as a means of adjusting to comparatively weaker economic fundamentals and associated capital flight. Is history bound to be repeated?

Investors face a basic asset allocation question given the now rather substantial EM underperformance. Should investors:

1. **“Double down” and heavily increase EM allocations?**
2. **Stay the course with their existing portfolios?**
3. **Consider exposure to EM on a more “selective” basis as tidal economic forces roll through? Or,**
4. **Should cold turkey (as little EM exposure as possible) be an option on the table?**

All are fair questions to consider.

With these issues in mind, and with rather material financial consequences to getting the right answer, the Cambiar International equities research group undertook an effort at a different kind of white paper. It is a complex topic to be sure – we are talking about 3.5 billion persons, dozens of economies located in many geographies, and likely divergent longer term economic paths for the many nations in question. Fairly or unfairly as the case may be, there is a degree of correlation and interaction between different Emerging Markets, making a comprehensive conclusion unavoidable and yet unattainable. Our four senior team members, each possessing deep professional roots in Emerging Markets investing and capital market career paths, offer their own perspectives on facets of the issue.

Relative Value Investing in International Markets: E.M. Considerations

Brian M. Barish, CFA
President and CIO of Cambiar Investors LLC
Emerging Markets Experience: 25 Years

Cambiar Investors LLC employs a relative-value investment discipline in all of its portfolio management products. As the name implies, relative value investing means that all investments must be evaluated in relation to something, as valuations do not exist in a vacuum. That something is generally the valuation that the market places on securities with similar overall characteristics. This analysis can be within the same slice of time, which means that one looks at comparable company stock valuations in the same industry around the world, or alternatively over a longer time horizon, in which case the valuation range of the company in question and / or its peer group may be relevant over that time span. Just because a stock is cheap or expensive versus its history or peers does not predict future returns with much accuracy, but does yield some reasonable conclusions about the potential for re-rating or de-rating as the case may be. It is also fairly instructive in terms of what trade-offs may exist in the marketplace. There are always other instruments that investors could own at a particular point in time – so why not at least consider the less expensive ones? Alternatively, if a company has traded more cheaply or more expensively at other points in time, certainly one should ponder what is or is not different today versus those other points in time.

In many international markets however, relative value investors must often confine themselves to comparables analysis, as the usefulness of longer term valuation ranges is a good deal more questionable. For the uninitiated, there are but a handful of countries globally that could be considered as genuine equity-oriented capital market cultures as recently as the mid 1990s. These include the U.S., the U.K., the Scandinavian countries, the Netherlands, Canada, and possibly Switzerland. That's about it. Most of continental Europe, all of Asia including Japan, and all of what are today classified as "Emerging Markets" have had far less institutionalized capital markets, which means that historical valuation ranges (in terms of P/Es, P/BVs and so forth) are a good deal less usable outside in the small handful of equity-oriented cultures. Functionally, this has translated into poor financial disclosure, unclear and not generally shareholder-friendly corporate governance policies, heavy cross-ownership issues, and heavy government influence on key economic sectors. Consequently – we have emphasized relative value comps versus longer term valuation range comparisons throughout the 16-year history of our international activities in most nations.

By adhering to a relative value approach to stock selection, Cambiar's international portfolios have maintained a smaller than average EM weighting versus many peers in the past six years. That is no accident, but it is not because of a macro-based decision to run with a low weight either. It has been caused by the comparatively rich valuations of quality Emerging Market stocks versus Developed Market counterparts. Independently of the geographic jurisdiction of investment candidates, we aspire to populate our portfolios with companies possessed of quality management, reasonable minority shareholder oriented governance policies, clear financials, reasonable liquidity, and a business agenda not conjoined to a conflicting government agenda. While these qualitative characteristics may appear as no more than rudimentary filters, this combination constitutes a relatively restrictive subset of the EM equities universe. Cambiar Investors LLC furthermore is hardly alone in seeking these qualitative characteristics in stocks. Consequently, during the more ebullient phases of the EM equities boom of the 2000s, EM stocks possessed of these attributes became very richly valued, and especially so as measured against their DM counterparts.

A few examples in the consumer products space hammer this point home rather nicely. In early 2009, with stock markets deeply depressed, we considered the opportunity set in consumer product companies with broad global and Emerging Market penetration, rationalizing that given the nature of their products, demand was likely to hold up well despite the catastrophe in credit markets. To our surprise, we found Developed Markets-domiciled names with substantial Emerging Markets exposure to be orders of magnitude more attractively valued. In the realm of malted beverages, Dutch beer maker Heineken *(HEIA.NA)* was purchased by the Cambiar International strategy in March 2009, near the market lows. At the time it sported a then-forward PE of about 10x. By contrast, EM counterparts Modelo *(GMODELOC.MM)*, Ambev *(ABI.N)*, and Tsingtao *(168.HK)* traded at valuations in the high teens to mid 30s in simple PE terms. While these EM beer makers have generally retained their multiples since 2009, they have not seen any expansion. In sporting footwear, Cambiar International purchased a position in German manufacturer Adidas *(ADS.GR)* in May 2009. At the time it also sported a highly compressed

P/E multiple in the 8-9x P/E range on rather depressed earnings. The best Emerging Markets comparables, Chinese makers Li Ning *(2331.HK)* and Anta *(2020.HK)* traded at mid 30x P/E multiples (though these were down from figures in the 50-60x range pre-Lehman). Anta has risen by about 40% since early 2009, but its P/E multiple has been cut in half to a 16x level presently. Li Ning has lost most of its value. A more recent example of a seemingly outlandish EM valuation premium would include German carmaker Volkswagen *(VOW3.GR)*, purchased in the summer of 2010 at a P/E multiple in the 6s, as compared to Chinese pure-play Geely *(175.HK)* or India's Tata Motors *(TTM)* which traded in the ~20x P/E multiple range at that time – and have fallen to 9x currently and failed to appreciate. In another even more stark case, the valuation of Dutch consumer conglomerate Unilever *(UNA.NA)* compressed to the 11x level in 2006, at which point we initiated a purchase. Its 51%-owned Indian subsidiary, Hindustan Unilever *(HUVR.IN)* traded at the time at a mid 40s P/E. About half of Unilever's business resides in Asia, making the relative-value spread difficult to rationalize. Interestingly, in all these examples, the significant EM exposure of the European blue chips that we purchased in the 2009-10 time frame constituted a material component of our investment case and expected revenue / earnings growth.

In the above examples, Cambiar analysts simply did not see a basis for paying three to five times as much in valuation terms to "go direct" with EM-domiciled names, with generally inferior brands to boot, financial crisis or not. Our "DM into EM" consumerism stocks have subsequently performed well and have enjoyed varying degrees of multiple expansion since markets bottomed out in the 2009-10 time period, while the direct EM stocks have exhibited more erratic performance. EM stocks have generally suffered from significant multiple compression this decade – as of today the spreads are narrowing between EM and DM valuations as growth rates are slowing and sovereign risk factors have begun to rise.

The point of the above examples is that relative valuations do matter a great deal to returns, to embedded risk, and in the context of truly global capital markets can be instrumental in leading one's geographic exposures (versus a top-down decision). As fundamentals unfold and capital markets undulate, it is quite plausible that we could be in a position to add some (or several) direct EM positions to the Cambiar International investment strategy, provided that valuations are particularly constructive. Should Emerging Markets continue to de-rate sharply, this time could come sooner versus later.

The Sweep of History

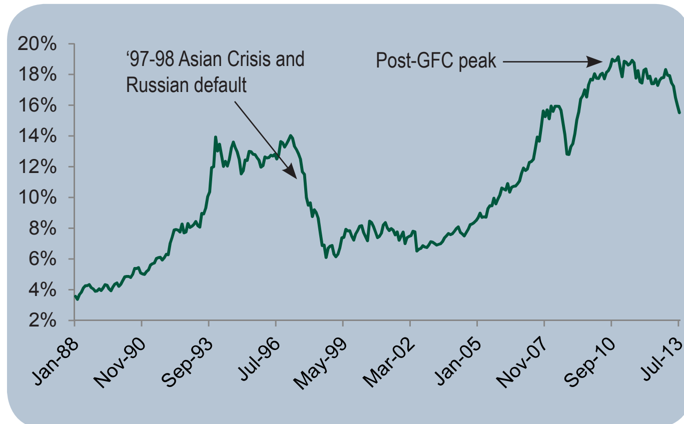
It is difficult to invest successfully in international markets, whether EM or DM in their classification, without some refined view of their history. International capital markets and stock exchanges are in the bulk of cases pretty new stuff in these nations. Some perspectives are in order.

In my view, it is impossible to appreciate the scope of the Emerging Markets investment phenomenon without going back to the very roots of it, at the end of the Cold War in 1989. It was just about a quarter century ago that the world had three classes of nations, the first world (the U.S., Japan, and Western Europe), the second / communist world comprised of the former Soviet Union and puppet states in Eastern Europe, and the third world comprised of very poor nations, many of which were former colonies of pre-World War Western European empires. The third world and the term "LDCs" (or "Less-Developed Countries") were synonymous in financial markets. Many of the LDC ex-colonies harbored deep antagonisms toward their former colonial masters and rebelled economically by pursuing some mix of isolationism, heavy state-led development, or full blown communism – in almost all cases local industry did not attempt to compete with developed market counterparts, leading to mostly commodity-based economies and limited access to capital, often available as an enticement to political-military alignment with either of the Cold War protagonists, the U.S. / NATO or the Soviet Union / Eastern Bloc.

With the fall of Soviet communism in Europe in 1989 and the subsequent fall of the Soviet Union itself in 1991, non-market based statism and anti-colonial economic models pursued by LDCs reached clear dead ends. American capitalism and its rewards, well-evangelized by Hollywood cinema and the visible wealth of the first world, was the shining and surviving beacon of credible economic development. In South America, Eastern Europe, and even communist China, the new / American paradigm was quickly embraced, with a burgeoning stock market as a key feature along with a repudiation of military-styled governments and at least the optics of representative democracy. In the major financial centers, money flooded out to the LDC hinterlands seeking higher yields and high growth rates for otherwise saturated product categories in richer first world nations. At just about that time, a clever asset management company in the Washington DC area coined the term "Emerging Markets" (this was far more marketable than the post-colonial "LDCs") and the phenomena was born. With per capita consumption of key consumer and industrial products at vastly

lower levels than in developed markets, many investors rightly concluded that it was only a matter of time and moving somewhat up the wealth curve before the penetration of beer, toothpaste, gasoline, tires, cell phones, etc… shot up to developed market levels.

Total Post-Cold War Market Capitalization of Emerging Markets Equities as % of Global Capitalization



Source: Bloomberg

The newly minted Emerging Markets quickly sought to replicate the more visible elements of the first world, in terms of consumption and infrastructure, and have been successful at this in varying degrees, albeit with a significant setback in the 1997-98 time period as external funding of current account deficits dried up. This episode led to aggressive "mercantilist" development strategies whereby Emerging Markets substituted their labor for DM home market labor, generating strongly positive current accounts, but also led to key global imbalances that were contributing factors to the financial crisis in Developed Markets in 2008-2012. As we enter the second quarter century after the end of the Cold War, these processes, industrial displacement, excess reserve accumulation, and consumer penetration, have already run quite far and show signs of trending in different directions. Clearly, many Emerging Market nations need to shift their development models, from export and infrastructure to domestic and services in the case of China, or from commodity to higher value-added in the case of Brazil and Russia. The next quarter century will likely feature winners and loser in these transitions. And these transitions won't be as easy as that of the traditional consumerism penetration of the last 20-25 years.

The point of the history lesson is that the embrace of American-style capitalism and governance is a very recent affair for many Emerging Markets, and not necessarily the result of longstanding admiration / emulation / cultural affinity with our economic and political system. Rather, the free markets economic development models that Emerging Markets have adopted stems more from expediency (all other models failed) in many cases. The history of free market capitalism is both brief and not all that well rooted in the culture, institutions, or legal frameworks of "Emerging Market" nations. This is a non-trivial risk factor to be mindful of as free market capitalism has a downside, namely that it does create winners and losers – sometimes very extreme ones at that. Our system (cultural, legal, institutional) is well adapted to these realities, and as key industries restructure, adapt, mutate, and often fail altogether within the creative-destruction that is free market capitalism – we don't really give it a second thought. In nations where the creative-destruction process is neither so well-understood nor institutionalized however, the process of adapting to change, particularly when the changes involve failure or dislocation in the near term, tends to generate unusual responses. These can include protectionism, state intervention, anti-foreigner sentiments, corporal punishments, capital flow restrictions, rapid changes in the law... responses that tend to interfere with the verdict that free markets might otherwise render, and that can protract or distort the necessary adjustment process. Part of the durability of the free markets system that we enjoy in the U.S. is that these kinds of reactions, while understandable under duress, are explicitly proscribed by our laws and Constitution. In our view, the value of these protections is not well appreciated by many investors.

Such limits on the reach or responsibilities of government are very different outside of the developed world, and arguably have had profound impacts on the ability of Emerging Markets to emerge to Developed Market status. Since the end of the Cold War, just four nations have made this transition successfully and durably: Hong Kong, Singapore, South Korea, and Israel. Intriguingly, all four of these nations share common characteristics not widely discussed among the more bullish of EM investors: they are smaller nations (two are city-states), all are former colonies of the U.K. or Japan, three of them endowed with a legal system resembling the UK / USA system, and all are well-possessed of intellectual capital versus commodity wealth and masses of population. Achieving Developed Market status is not easy. In the next quarter century, it is reasonable to expect some present day EMs to become DMs. But probably just a few.

Buying When Others Won't

The history of today's Emerging Markets, whether in Latin America, Asia, or Africa, has been one of irregular economic development, often scarred by calamitous steps backward, with chronically unstable capital markets tending to inflame already turbulent backdrops. Consequently, most truly successful Emerging Market investors have adhered to a deeper value / "blood in the streets" approach to stock selection and market timing. For about a 6-8 year span, EM stocks exhibited a growth to cult-like following among investors certainly not consistent with this longer term pattern of instability and volatility. Consequently a deeper value approach has not been an available option for many stocks. As a rule, we don't dedicate any specific component or percentage of our portfolio to EM. A dedicated EM allocation smacks of special treatment for an ideologically favored class of assets, versus a proper / objective financial analysis. If financially there is merit because of deeply discounted valuations and depressed fundamentals, we are happy to wade in. While few such circumstances have prevailed in the last 6-8 years, our hunch is that this may prove newly relevant. Accordingly, as elevated EM stock market multiples succumb to lowered growth expectations, increased sovereign debt costs, and an overall re-risking of the asset class, more and more names are dipping to levels that pique our interests. However, just as U.S.-oriented investors are well versed not to be overly hasty in buying "growth-to-value" transitions for individual stocks and sectors, we see a similar dynamic as being relevant for EM stocks as their ownership bases turn over. As Emerging Market economies move into this new phase, our game plan remains as it has been for many years. We look for the comparatively lower multiple names in global sectors, with some form of disconnect between their quoted valuation and how we view their underlying businesses to be developing. If Emerging Markets as an asset class continue to underperform, whether through slow liquidations of passive investors or due to rapid losses of value from currency crises, we will be keeping our eyes very open.

Our answer to the big allocation question would be #3:

Selectively hold or add exposure as tidal forces roll through. "Blood in the streets" approach to stock selection and market timing.

Emerging Markets—the Unique Challenges of an Atypical Business Cycle

Todd L. Edwards, PhD
Cambiar Global Select Portfolio Manager
Emerging Markets Experience: 18 years

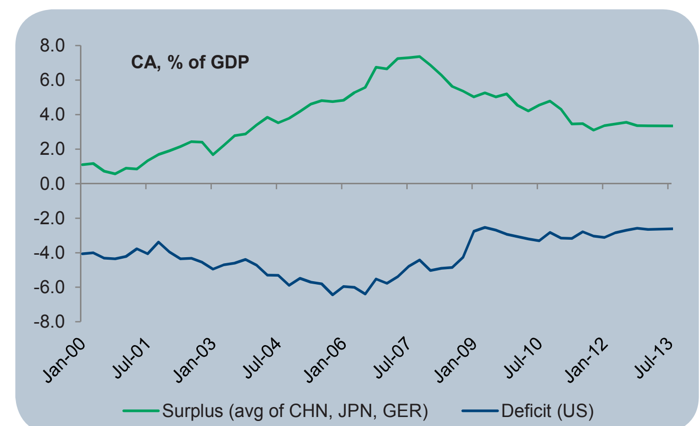
In July of 2009, Cambiar Investors wrote a white paper entitled "The Great Rebalancing" in which we examined both the near-term prospects for economic recovery in the United States and the longer- term need for a rebalancing of the global economy. Contrary to prevailing wisdom, the U.S. economy has continued its steady but subdued path forward, and is now entering its 5th consecutive year of growth. However, rebalancing remains a work in progress, and is currently something of a sore spot in the global economy. The biggest challenge in the rebalancing process is China's attempt to restructure its economy away from export and investment dependence, towards a more consumption-driven growth model. China is attempting to engineer this transformation at the same time that its economy is decelerating to a significantly lower growth trajectory. Partly as a consequence of this transition, many emerging market economies are also decelerating, particularly those that benefited from "the China boom" (and the related "commodity super-cycle"). Many of these same economies are also slowing due to domestic inflation issues and deliberate policy measures enacted to moderate domestic demand. Unfortunately, this economic deceleration and the larger rebalancing process are now becoming more complicated due to the Fed's "tapering" exercise, itself a move to normalize policy to reflect the improving growth dynamics of the U.S. economy. The taper represents a shock that is now reverberating throughout the developing world; ironically this normalization is now causing abnormal levels of stress in a variety of emerging economies and financial markets.

Rebalancing the Global Economy and the Dollar Bloc

Perhaps the best place to begin an examination of rebalancing is with the global financial crisis, and the Great Recession that followed in its wake, since these were precipitated by a series of dramatic imbalances in the global economy. The biggest imbalances were the huge current account surpluses being racked up by China (and other key emerging economies), and the corresponding, enormous current account deficits that were run by the United States and (a handful of other developed economies). Generally speaking, these trends began during the last global crisis, the Asian Crisis of 1997-98, which ultimately spread throughout the emerging world. The countries involved witnessed some combination of massive capital flight, huge currency devaluations, sovereign defaults, corporate bankruptcies and deep recessions. Capital essentially stopped flowing to emerging markets and as a group these countries were forced to run current account surpluses. At the same time, a number of the world's wealthier countries (particularly the U.S.) began to run larger and larger current account deficits. These deficits were funded by external credit; as a result, the poor surplus countries became creditors to the wealthy deficit countries. In effect, the U.S. became the "consumer of last resort" in the years after the Asian crisis, while key EM economies ramped up their export-driven growth models to feed this external demand. China became the biggest exporter of all; it was in turn an essential source of demand for other exporters. This global division of labor became a sort of "vendor-financing" operation in which export earnings and the enormous stockpiles of foreign reserves (mostly US$) these implied were recycled back to the deficit countries, thereby contributing to the super-easy credit conditions that ultimately led to financial catastrophe and the Great Recession.

While there are a few exceptions to the general pattern (e.g. rich nations Japan and Germany have traditionally run huge current account surpluses) it has held up generally and has been defined by the two extremes: the United States as the largest deficit/debtor country and China as the largest surplus/creditor nation. As the graph below illustrates, these imbalances peaked in the run-up to the global financial crisis; the "Great Recession" also marks the beginning of what we think will be a long period of global rebalancing.

External Imbalance - Current Account



Source: Goldman Sachs

The first phase of global rebalancing was led primarily by the collapse in imports in the United States and other wealthy nations during the deep recession of 2008-09. Emerging economies were certainly impacted by the crisis and ensuing recession, but the relative scarcity of financial excesses in these countries, coupled with enormous domestic stimulus efforts, meant that their economies performed much better; as a result, their imports (and therefore DM exports) held up better.

The driving forces of rebalancing are now shifting, from these demand-side issues in DM to supply and demand side issues in EM. China is the 800 pound gorilla in this process and is leading the way. Both structural and cyclical issues matter. Cyclically, EM as a group unleashed aggressive stimulus policies to counteract the DM economic collapse. Many of these countries stoked internal demand to the point of reviving inflationary pressures, and then had to respond with countercyclical policy measures in 2010 and 2011 to cool things off. Structurally, many of these same countries recognized in the depths of the crisis that excessive dependence on exports (and therefore the demand conditions of other countries) can be perilous. China in particular appears to have recognized the need for more balanced growth and a higher proportion of consumption to GDP. This will be a long-term project as the country deals with excess capacity in export-oriented sectors, at the same time that it faces insufficient capacity in sectors geared to domestic consumption. Other big EMs (such as Indonesia and Brazil) have already moved to current account deficits. While this is helpful to the long-term process of rebalancing, it has suddenly become problematic as global financial markets contemplate the removal of quantitative easing in the U.S.

Normalizing US Monetary Policy

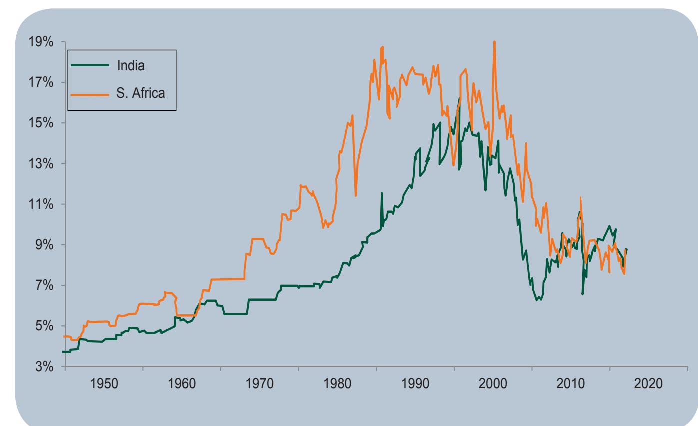
The tapering of QE in the United States and more generally the normalization of interest rates in the developed world now stands to complicate the already-complicated process of global rebalancing. Not only must EMs think hard about their growth models in a world of much lower (and different) Chinese growth, they must now contemplate a world with less capital available to finance their investment.

The basic problem starts with QE and what must be called a bubble in high quality fixed income instruments (U.S. Treasuries, German Bunds, etc.). Astonishingly low interest rates in DM government bonds drove a search for yield that often ended in the purchase of large quantities of EM debt. These securities became high beta plays on low and declining “risk-free” yields.

Unfortunately, the sharp back-up in longer-term Treasury yields has driven a stampede out of these high beta markets and has set off a sort of negative feedback loop between financial markets and the real economies. As such, normalization in DM has induced a sort of volatile abnormality in EM. Bond and currency markets have witnessed sharp sell-offs, causing interest rates to rise and equities to fall in the process. Destabilized financial markets (and the risk of pass-through inflation from weaker currencies/higher import prices) increase the need for pro-cyclical policies from EM policymakers. In other words, despite slowing growth, many EM countries are now being forced to hike interest rates to defend their currencies and stabilize their domestic market. The result is that the slowing economies will slow further, raising questions about the underlying economic fundamentals that supported previous investments in these countries. And so a vicious cycle has developed.

So far markets have focused their “punishment” on a few countries, particularly those with current account deficits and currencies deemed to be expensive. Market participants have even dubbed a group of these countries “the fragile five” to include India, Indonesia, South Africa, Turkey and Brazil. It should not go unnoticed that these same countries have been among the most popular destinations for foreign investors during the boom years for emerging markets, resulting in dramatic declines in the cost of capital *(see graph below)*.

10 Year Government Bond Yields



Source: Bloomberg

Market Implications

The two trends described above—China's restructuring/deceleration as the latest phase in global rebalancing and U.S. rate normalization as a destabilizing shock to EM—have significant implications to successful investment positioning, particularly as it relates to EM vs. DM exposure. As discussed, Cambiar has had relatively low exposure to EM for several years, a position driven by what we felt were the prohibitively expensive valuations attached to the higher quality companies in which we look to invest. As we see it, investment opportunities in EM should begin to present themselves in the coming months. However, we think the road ahead for EM will remain relatively complicated, and that it would be a mistake to think the tide will somehow quickly turn back in favor of EMs. Four key points stand out:

1. Fixed income tends to lead the way in emerging financial markets, and there is no reason to believe the process of interest rate normalization in the U.S. will end soon. This view suggests ongoing upward pressure on emerging bond yields, a higher overall cost of capital in EM and downward pressure on EM stocks.

2. Falling currencies, tight labor markets and domestic capacity constraints suggest higher levels of inflation for many EMs. Higher inflation implies higher rates, a higher cost of capital and a headwind for profits and equities in general.

3. Countries forced into pro-cyclical policy measures to stabilize currency and bond markets have a difficult road ahead—despite slowing economic growth many will be forced to tighten policy further, ensuring even slower economic growth in the months ahead.

4. EM valuations embed both the long-term decline in the cost of capital shown in the graph above and considerable optimism surrounding higher economic growth levels in EM (higher growth is assumed to imply higher earnings). Chinese deceleration, domestic capacity constraints, pro-cyclical policy measures and rising DM interest rates put the foundations of the "buy EM" thesis at risk. The valuation multiples assigned to EM equities will have to adjust accordingly.

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China - Past Performance is Not Necessarily Indicative of Future Results

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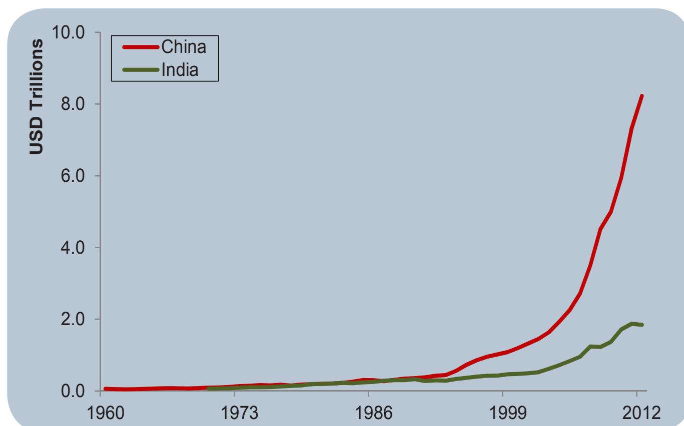
Emerging Markets Experience: 18 years

The Long Term View

The Chinese economy finds itself at a crossroads after decades of robust economic growth brought forth in the seventies by Deng Xiaoping, the late leader of the Communist Party of China. Deng's "Socialism with Chinese characteristics" has transformed the economy from an agrarian society to the second largest economy in the world, with an average annual GDP growth rate of almost 10% over the last 34 years. Nominal GDP per capita has grown from $180 in 1978 to approximately $6,000 in 2011. Millions of people a year enter the middle class, a group that numbered 40 million at the turn of the century and today stands at approximately 250 million (18% of the population). Such impressive growth relied on increasing the number of workers involved in production, a situation that is no longer sustainable, given that the working age population has peaked. This so-called 'demographic dividend' has run its course, making double digit GDP growth neither necessary nor desirable, given the inflation implications, something that is anathema to the Chinese government. It is this dynamic that is forcing the government to focus on the composition and quality of growth, versus the quantity.

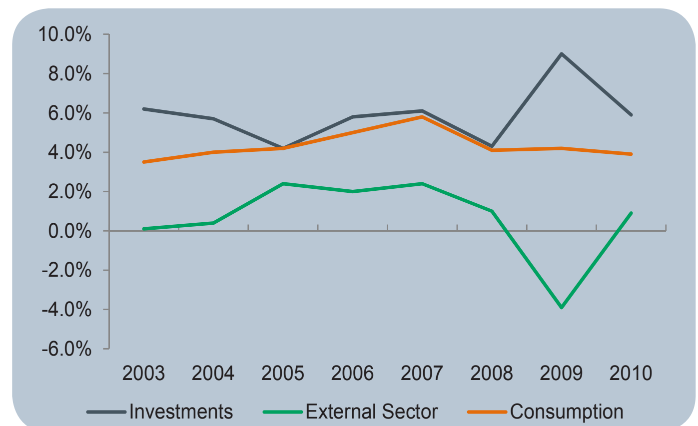
Making the transition from investment-led to consumption-led and higher-value added economic growth is central to the transformation that must take place if China is to escape the "middle-income trap." This concept is certainly not lost on current leadership. The 12th Five-Year Plan outlines certain elements of the transformation. For example seven strategic industries (energy-saving/environmental protection, next generation information technology, bio-tech, advanced equipment manufacturing, new energy, new materials and new-energy vehicles) have been identified as key to high-grading the economy. Instrumental to success will be an increase in state-owned bank lending to the private sector. As well, hukou reform has become one of the government's top priorities, as it has the potential to significantly drive consumption in future years. In a nutshell, the hukuo system is a decades old household registration system that gives each Chinese citizen rural or urban status. Rural hukuo holders have no access to public services such as education, healthcare and housing if they move to urban areas. Currently, over 200 million workers living in the cities do not possess an urban hukuo. Even though these workers may earn enough to buy a home, they are saving most of what they earn and using disposable income to pay for services such as education and healthcare. This is an increasingly untenable situation, the dismantling of which would unleash a wave of consumption. The costs of hukuo reform are enormous for both governments and corporations; reform is inevitable.

Gross Domestic Product



Source: World Bank

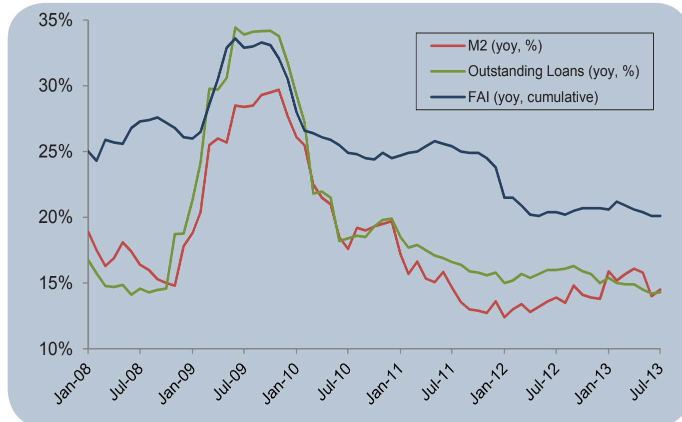
Contribution To Growth



Source: Bloomberg

Near Term Issues

Stabilization

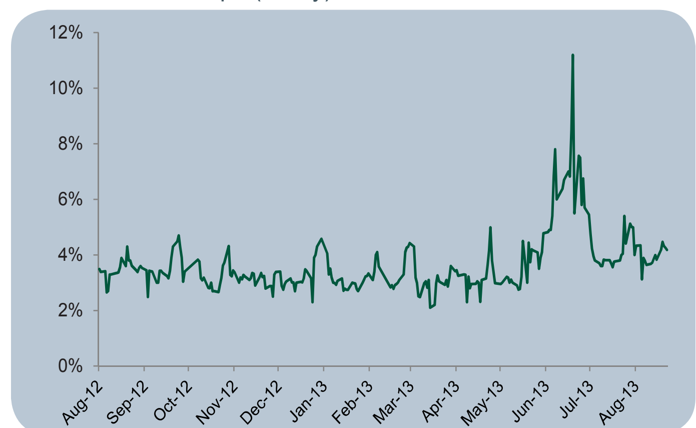


Source: Bloomberg

It is widely acknowledged that Beijing's response to the US financial crisis was excessive and resulted in large scale misallocation of capital and consequent diminishing returns to credit growth. The 4 trillion yuan stimulus package implemented in 2009-2010, equivalent 12% of 2009 GDP, sent loan and fixed asset investment into the stratosphere, as can be seen in the chart above. While government's efforts to avert disaster were successful, the massive stimulus has created some fairly serious worries - specifically as it relates to the property market, the shadow banking system, local government finance vehicles and excess industrial capacity. The real estate market, both residential and commercial is viewed by many in China as an avenue for savings and investment due to the fact that deposit rates are capped, the stock market is not viewed as attractive and foreign investment is restricted. While there is certainly real demand for housing and the government implemented a number of measures in 2010/11 and again in 2013 to rein in the property market, many investors remain wary of a housing bubble. The most recent restrictive measures put in place include a 20% capital gains tax, higher down payments and mortgage rates for second homes in certain cities and more thorough checking of eligibility. Property taxes are also being implemented on a pilot basis in select cities. Despite efforts to dampen price increases, the latest 100-city data released by SouFun Holdings Ltd *(SFUN)*, China's largest online real estate information provider, shows an 8.6% price increase in August versus one year ago, with much larger increases in tier one cities such as Beijing (22%) and Guangzhou (24%). While some of the speculative excess has been driven out of the property market by the policies mentioned above, it remains difficult to ascertain just how much of the existing stock is held by speculators and what portion of current transactions are a reflection of real demand. The higher the speculative ownership is, the more vulnerable the property market is to a negative shock.

Rapid growth in shadow banking has also become an area of concern. Estimated at 40% of GDP, shadow banking is loosely defined as any non-bank credit intermediation such as trust loans, entrusted loans, wealth management products (WMP) and bank acceptances. (Note: banks actually control about 75% of the shadow bank lending although it is off balance sheet.) While the shadow banking system in China is still small relative to the size of the economy (US is 160% of GDP, Europe 170%), the fact that the market has essentially doubled over the past two years is enough to give one pause. The main risks are associated with WMPs and trust loans which have been used by investors to achieve higher returns than can be obtained from bank deposits. The risks associated with these products stem from duration mismatch and the potential for default, given that much of the money raised is lent to local governments to fund projects with questionable returns. None of this is lost on the central government, who has stepped up regulatory oversight of these trust companies; in June, the government fired a shot across the bow by not stepping into the interbank market to provide liquidity *(see below)*. In order to avoid more serious problems, the government must reign in growth, tighten regulation and increase transparency in the shadow banking system.

China Interbank Repo (7 Day)



Source: Bloomberg

China possesses some unique features that mitigate some of the risks associated with the financial sector. Not least important is the fact that banks are state owned and funded primarily by domestic deposits. It is also important to point out that the government at the turn of the century successfully orchestrated massive financial sector restructuring in order to list the four largest policy banks whose NPLs at the time accounted for approximately one quarter of total lending. We are cautiously optimistic that the government is aggressively focused on improving the allocation of credit, as well as increasing oversight of the shadow banking system. The best case scenario is that credit losses will gradually be absorbed over the coming years, with no need for another round of restructuring.

Cambiar Investors International Portfolio - Exposure to China

Cambiar's bottom-up fundamental research has allowed us to identify franchises that are both defensible in the highly competitive Chinese marketplace and exposed to structural growth drivers that include the rebalancing of economic growth toward consumption, continued real income growth, the rising middle class and the aging demographic. One of the more defensible franchises in China is an aspirational Western brand. We own several such companies. Daimler *(DAI.GR)*, the maker of Mercedes Benz, is one such example. While the investment thesis is primarily predicated on a new product cycle and improved efficiency of overall production, Daimler derives over 10% of sales from China, and as such are a clear beneficiary of the rising middle class. Demand for more and better healthcare is another driver for growth in China. Rising wealth, an aging population and increased government commitment to expand access should help drive sales at companies such as Roche *(ROG.VX)*, Novartis *(NVS)* and Philips *(PHG)*. DSM *(RDSMY)* and Gea Group *(GEAGY)* are exposed to increased demand for more processed food and beverage products. While DSM is a manufacturer of human and animal nutritional ingredients, Gea Group manufactures equipment for large food companies who are selling increasingly sophisticated products in China. While we realize that China's transition from an investment-led to a consumption-led economy will likely be lengthy, involve slower rates of economic growth and not be entirely devoid of setbacks, we do believe that companies such as those described above will fare well in this environment.

A Differential Diagnosis of Pain

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While Emerging Economies as a group face the headwinds we describe, the level of pain that each individual country faces will vary. Some are likely to fare better than others as the rebalancing continues. In the table below, we have compiled a sample of some of the more significant Emerging Countries, looking at the year to date moves in their currencies and equity markets as indicators of the pain they have endured. Some of the common threads to those markets faring better are:

D.M. of E.M.	GDP (per Capita)	Inflation (YoY)	Currency (YTD)	Equities (YTD)
Hong Kong	51,494	6.9	-0.1%	-3.0%
Israel	32,312	2.2	5.2%	1.9%
Singapore	60,410	1.8	-4.2%	-1.2%
South Korea	32,272	1.4	-5.1%	-5.5%
Taiwan	38,749	0.6	-2.9%	1.7%
BRICs	**GDP (per Capita)**	**Inflation (YoY)**	**Currency (YTD)**	**Equities (YTD)**
Brazil	11,875	6.4	-14.4%	-17.1%
China	9,162	2.7	1.7%	-8.3%
India	3,830	9.6	-13.3%	-6.1%
Russia	17,709	6.5	-7.2%	-6.5%
Other Emerging	**GDP (per Capita)**	**Inflation (YoY)**	**Currency (YTD)**	**Equities (YTD)**
Chile	18,419	2.2	-6.9%	-14.3%
Colombia	10,792	2.2	-8.1%	-6.8%
Hungary	19,638	1.8	-1.0%	1.3%
Indonesia	4,977	8.6	-9.8%	-3.3%
Mexico	15,312	2.5	-1.0%	-4.3%
Philippines	4,430	2.5	-6.2%	12.3%
Poland	20,592	1.1	-1.9%	3.6%
South Africa	11,375	5.5	-16.8%	9.0%
Thailand	10,126	2.0	-3.4%	-1.5%
Turkey	14,543	8.9	-8.5%	-7.7%

Source: Bloomberg

- Countries who relied heavily on Chinese growth as a driver for their own economic dynamics (i.e. China and Friends) as suppliers and/or partners of the investment driven boom are facing a more complicated and longer adjustment process; examples include Brazil, Indonesia, South Africa and Chile. By contrast, Eastern European emerging economies which benefited from global growth, but engaged on the transformation of their local economies (Poland, Hungary), are removed from this exposure and faring better through the adjustment.

- Not surprisingly, inflation is amongst the most significant variables determining relative pain. Countries with tougher inflation battles (5% or above) have suffered the most through the adjustment. Price increases are more often than not the consequence of tight labor markets and rising wages. Brazil, India, Turkey and Indonesia have experienced the greater difficulties. EMs with less inflationary pressure (e.g. Poland, Hungary, Thailand, the Philippines and Mexico) are on a more manageable path.

- While the pain in EM has yet to escalate into double digit inflation as has been the case in the past, the persistence of inflation puts a number of countries at risk of this happening, with all the negative effects it has on the economy and society. It is no coincidence that social unrest has erupted in Brazil and Turkey, where inflation has remained high. The spark that drove people to protest in Brazil was the annual increase in public transportation fares, a relatively minor event that nonetheless became the "no mas" tipping point of economic deterioration for the country's masses.

- The vicious circle of wage pressures-inflation-devaluation also creates distortions on investment decisions and capital markets, complicating the adjustment process. Inflation increases the opportunity cost of holding money and discourages productive investments which require higher rates of return to materialize. On the flip side, savings are discouraged and poorly developed capital and currency markets see increased volatility. Frequently, as individuals seek refuge in hard assets, real estate bubbles emerge. Precious metals and hard currencies are additional shelters. Persistent inflation increases demands on more frequent wage revisions and induces spending distortions via hoarding and undue shortages of staples, pushing

costs even higher. Occasionally, EM Governments react by introducing price controls or rationing, which only exacerbates the distortions and adds to fiscal pressures.

- Given the above dynamics, the fight against inflation is often characterized by episodes of extreme pain and volatility. The charts below show the year-over-year inflation for leading EM economies and the respective exchange rates for the past 10 years. As can be seen, periodic flare ups are the norm. It is only after extreme pain that the right policy prescription is administered.

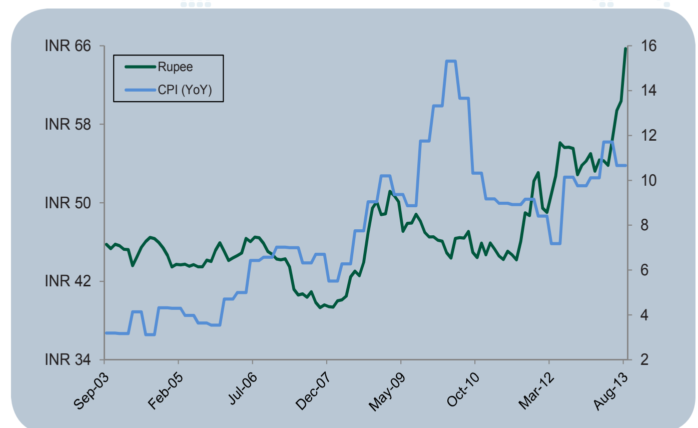
Indonesia - YoY Inflation and Exchange Rate

Source: Bloomberg

Brazil - YoY Inflation and Exchange Rate

Source: Bloomberg

India - YoY Inflation and Exchange Rate



Source: Bloomberg

- Mexico stands out as a potential beneficiary of the adjustment process. As China moves to a consumption driven economy and its labor costs edge higher, Mexico's proximity to the US market works to its advantage. As the recently elected Mexican government embarks on efforts to reform its labor markets and the energy sector, the outlook for investments in general (and foreign capital in particular), is promising. The much needed investments in the oil sector will take multiple years to be implemented and will support economic activity moving forward.

- In Asia, the Philippines stand out as enjoying a stronger position relative to its neighbors. The country did not see the same exuberance in its credit markets (its Credit to GDP gap ratio only grew by 5% from 2008 to 2012). By enjoying reduced reliance on credit and the China pull, the return on investment has remained relatively stable (still in double digit territory). Population growth supports consumer demand, but also alleviates pressure on labor costs. As investors have sought a safe haven, Philippine equities have vastly outperformed its regional peers in 2013.

	Domestic Credit to GDP	Credit/ GDP Gap	Change % (2008-2012)	ROIC % (2012)	ROIC % (10 Yr Avg)	Population Growth
China	155.1	14	53	8.0	10.4	0.2
India	76.6	-2	4	9.2	12.9	1.6
Indonesia	42.6	5	6	16.2	13.8	1.2
Malaysia	133.8	15	19	8.8	8.1	1.8
Philippines	50.9	9	5	10.6	10.8	2.1
Thailand	169.3	16	21	9.7	11.1	0.4
S. Korea	168.7	8	10	8.4	9.3	-

Source: BIS, Credit Suisse

- From a structural perspective, we note that the extent to which market driven policies facilitate capital allocation decisions plays a part, not only in isolating emerging economies from external/rebalancing shocks but also, ultimately, in allowing them to reach "developed" status or characteristics. The table below shows the Global Competitiveness Index (2012) and ranking for selected EM and Developed economies. The lower ranked economies, are viewed as "factor driven", i.e. highly vulnerable to cycles and commodities prices while the higher ranked are considered as "innovation driven" economies, where the economy is less vulnerable to cycles by its concentration in services and product innovation.

	GCI	Rank
Switzerland	5.72	1
Singapore	5.67	2
Finland	5.55	3
Sweden	5.53	4
Netherlands	5.50	5
Germany	5.48	6
United States	5.47	7
United Kingdom	5.45	8
Hong Kong	5.41	9
Japan	5.40	10
Taiwan	5.28	13
South Korea	5.12	19
Israel	5.06	26
China	4.83	29
Brazil	4.40	48
Indonesia	4.40	50
India	4.32	59
Philippines	4.23	65
Russia	4.20	67

Source: World Economic Forum

- The Asian Tigers (Singapore, South Korea, Taiwan and Hong Kong) have transitioned to "innovation driven" status and achieved high GDP per capita levels (in the case of Singapore, even higher than "older" Developed economies) by establishing a predictable legal and regulatory framework where economic agents can make more effective capital allocation decisions. Their Governments also provided clear incentives for the development of innovation/service driven sectors (IT, electronics, shipping) and opened their markets to foreign trade and investments. Another important aspect to note is that all of the countries that have moved from "emerging" to "developed" since the 1990's have populations smaller than 50 million. The challenges of emerging are much greater when trying to lift the standard of living for a larger number of people.

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