City National Rochdale®
AN RBC/CITY NATIONAL COMPANY

SPOTLIGHT ON

Emerging Market Equity Positioning

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Executive Summary

The traditional long-term investment case for Emerging Markets (EM) is based on their superior growth dynamics and diversification benefits. While the positive growth differential of EM in relation to Developed Markets (DM) is familiar, what is perhaps less well recognized is the divergence of potential opportunities between regions. As EM economies shift from their export-dependent, commodity-intensive models of the past and move toward more sustainable, services-led domestic drivers of growth, these markets are becoming increasingly diverse and sophisticated.

EM is often viewed as a monolithic asset class by investors, who refer to the growth and risk considerations within EM broadly even though levels of economic and financial market development may vary significantly in some cases. While a common set of factors may affect the broad-based universe in certain situations, we believe it is crucial to understand the fundamental differences in countries and regions that ultimately drive potential growth and returns.

In this paper, we outline the forces at work behind the shift underway in emerging economies and examine the allocation considerations investors now need to take into account within a globally diversified portfolio. Our analysis is based on the latest data, supplemented by research from the international financial and academic community, and incorporates our proprietary 4-Ps multifactor framework:

POLICIES to support economic growth and prosperity;

A **POPULATION** that is younger and growing more rapidly with higher levels of productivity;

The **POTENTIAL** for greater innovation in industries of high intellectual property that generate above average secular growth and returns;

A superior **PROFITABILITY** profile of the publicly traded companies.

Given Asia's rising economic importance and growing equity and fixed income markets, we conclude that the region presents a compelling opportunity for long-term investors searching for growth. The potential diversification benefits of EM Asia assets also underscore the investment case for including them as a core, strategic allocation in investor portfolios.

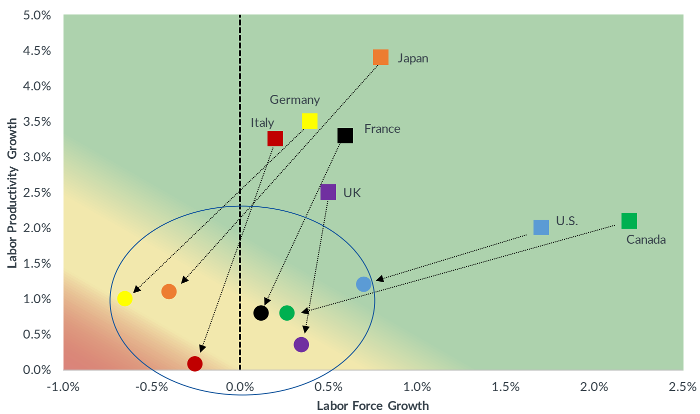
Dimming Global Growth Prospects

A key element of investment success is a long-term perspective. With it, investors can assess the long-term impact of fundamental, economic, and demographic changes on their portfolios. They can then allocate their portfolios more effectively, focusing on increasing returns over an extended time horizon. Unfortunately, global growth prospects for the next decade have dimmed, leaving investors with more muted return expectations than they have been accustomed to historically.

Some background is helpful. In the wake of the 2008-09 financial crisis, global potential output growth—the total economic output that nations can produce without generating damaging inflation—has fallen significantly. The causes of the slowdown are the subject of considerable debate within the economic community, with some arguing that a "secular stagnation" is to blame while others cite a "global savings glut." While an analysis of the specific forces behind the slowdown are beyond the scope of this paper, the fact is that the trend predates recent developments and was evident long before the crisis struck.

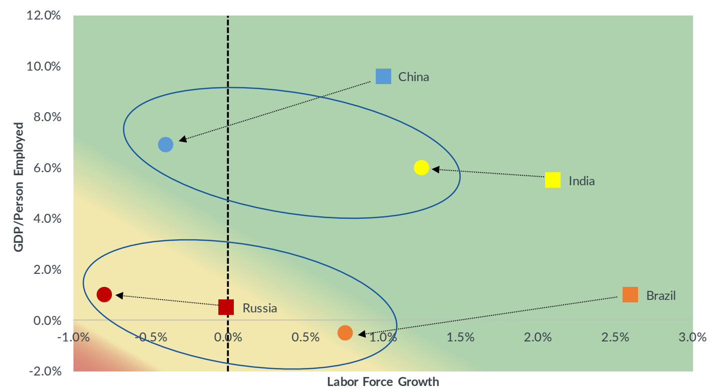
The charts below show the simple math of adding up productivity growth and labor force growth. For each G-7 economy, the starting coordinate is the 1957-2007 average for productivity growth and labor force growth. The same productivity data is not available for Brazil, Russia, India, China (BRIC) economies, so we substitute GDP per person employed as a proxy, and we use the 1991-2007 period as a starting coordinate. In the case of both cohorts, the ending coordinates near the arrowheads mark the average productivity growth over the past six years and potential labor force growth for the next six years.

FIGURE 1
G-7 Potential GDP



Square = 1957-2007 Average Circle = Post-Financial Crisis Trend

FIGURE 2
BRIC Potential GDP



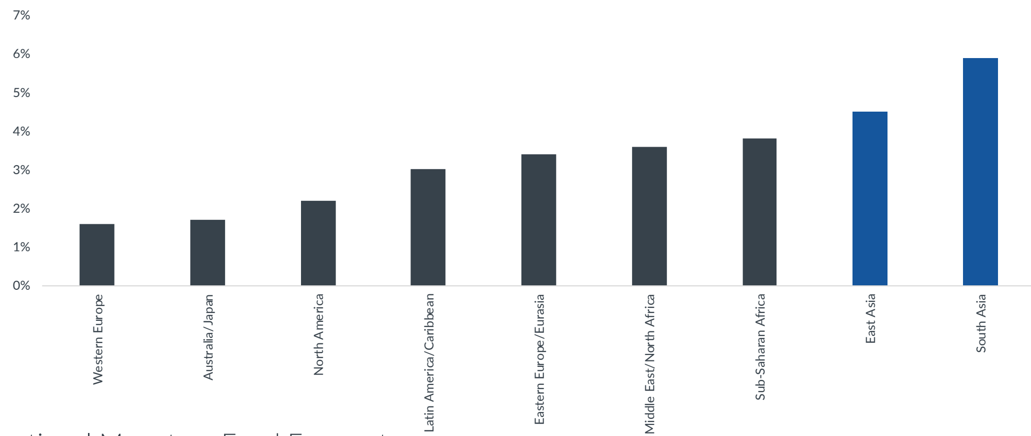
Square = 1957-2007 Average Circle = Post-Financial Crisis Trend

Source: International Monetary Fund.

The key here is the slanting lines. In terms of the basic building blocks of economic growth, every advanced economy is heading in the wrong direction. The story is more complicated with BRIC economies. While the trend is apparent, both India and China still enjoy significantly positive growth differentials relative to advanced economies. We think this relatively more positive outlook is representative of the Emerging Asia region as a whole.

Overall, the International Monetary Fund estimates potential growth in advanced economies over the next decade at 1.8%, well below the pre-crisis rate of 2.25%. In EM economies, potential growth is expected to decline from an average of about 6.5% to 5.2% a year between 2018 and 2027. However, there is considerable divergence between regions, with Asia expected to significantly outperform in the coming years.

FIGURE 3
Real GDP Growth Expectations (2018-2028)



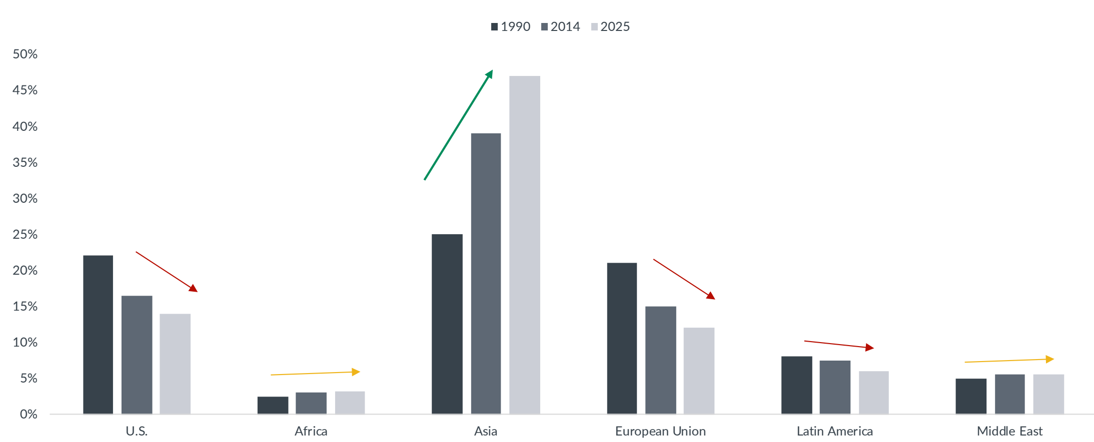
Source: International Monetary Fund Forecasts.

Look East for Growth

The lion's share of global growth today is being driven by Emerging Asia, and that percentage is only expected to grow over the next decade. Countries like China, India, Vietnam, and Indonesia sport growth rates that are large on both an absolute and relative basis, dwarfing those seen in developed markets like Europe and the United States, as well as in other non-Asian EM.

For investors with a long-term horizon, exposure to EM Asian equities would capture the bulk of these economies' incremental contribution to global growth. The investment opportunity set is broad-based—Financials, Consumer Discretionary, and Information Technology companies account for a significant and rising share of these markets, which are increasingly driven by technological innovation supported by an emergent young, affluent, and aspirational middle class.

FIGURE 4
Share of Global GDP (Real USD Purchasing Power Parity*)

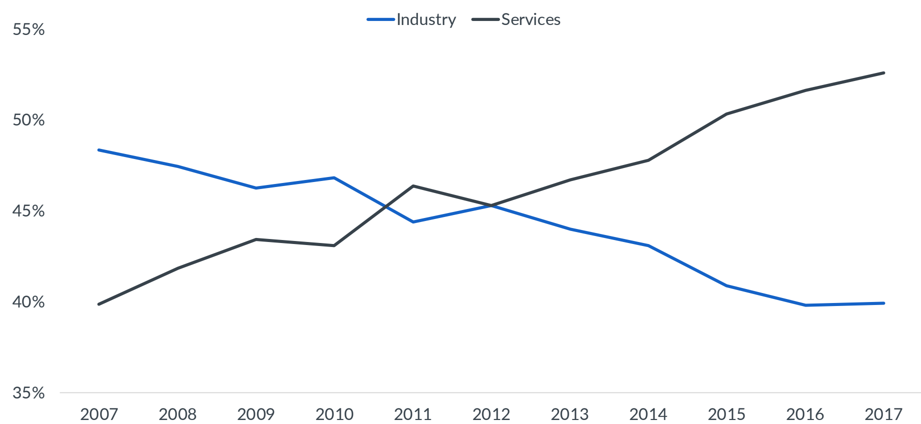


Source: International Monetary Fund Forecasts.

*Purchasing Power Parity (PPP) compares the purchasing power between two countries' currencies.

EM Asian countries have worked hard to diversify their economies. These nations are moving away from export-driven low-cost and labor-intensive manufacturing toward higher-paying value-added production and service-oriented industries. Improved government policy frameworks, structural reforms, technological innovation, and the growth of the middle class are all helping to build more sustainable sources of growth domestically. At the same time, there remains significant additional scope for long-term structural gains in productivity and competitiveness in relation to developed market nations.

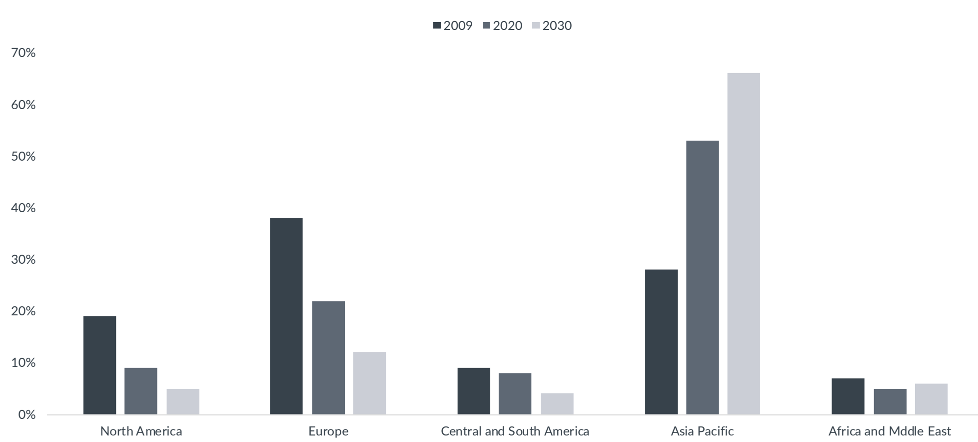
FIGURE 5
China's Economy Is Now Over 50% Service Driven



Source: National Bureau of Statistics of China.

The Asia story is driven fundamentally by favorable demographics, low debt and high savings/investment rates, competitive business environments, and strong integration in the global value chain. In terms of our key building blocks of economic growth, working age population growth, and productivity, Asia excels. Overall Asian population growth remains outsized, with the middle class alone expected to grow to 3,492 million by 2030 versus 525 million in 2009 and 1,380 million in 2015. Indeed, Asia's expected 153% middle class growth rate during the 2015-2030 period will dwarf almost every other region of the world.

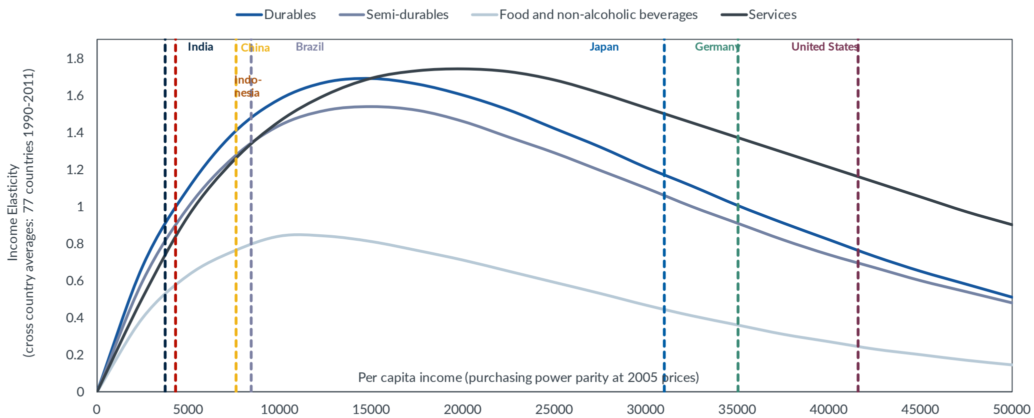
FIGURE 6
Asia's Share of Global Middle Class Set to Surge



Source: International Monetary Fund Forecasts.

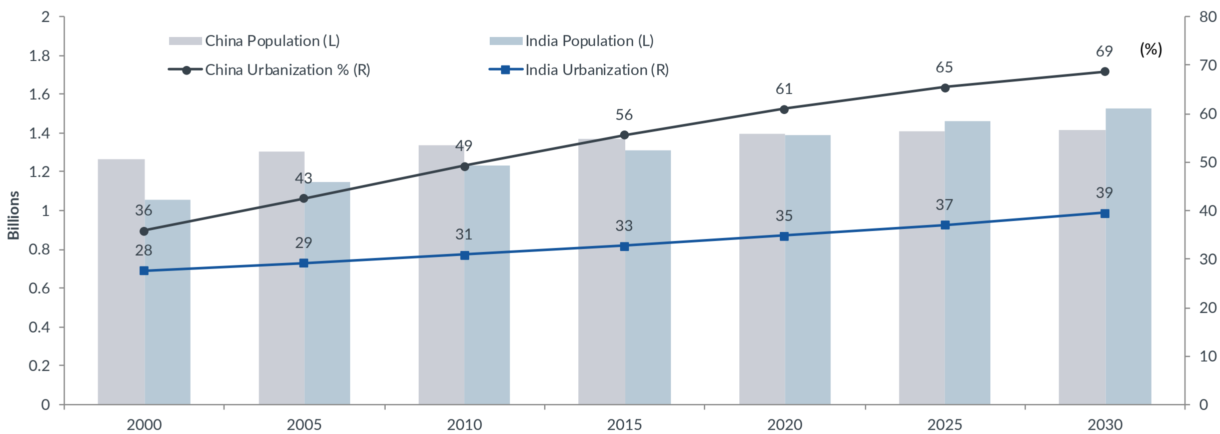
As the demographic dividends from a steady supply of young people entering the workface begin to kick in, this should help sustain growth rates, resources for investment, and consumption momentum. And, given that many Asian countries have not yet fully urbanized, there is considerable additional upside as more citizens shift from agriculture toward higher value-added manufacturing and service jobs. Greater urbanization is expected to further boost per capita incomes and productivity, which is what drives domestic consumption and demand and supports higher EPS growth and equity returns.

FIGURE 7
Asia Now Entering "Sweet Spot" of Demand x Income



Source: UNCTAD Research, December 2013. For Illustrative Purposes.

FIGURE 8
Population and Urbanization

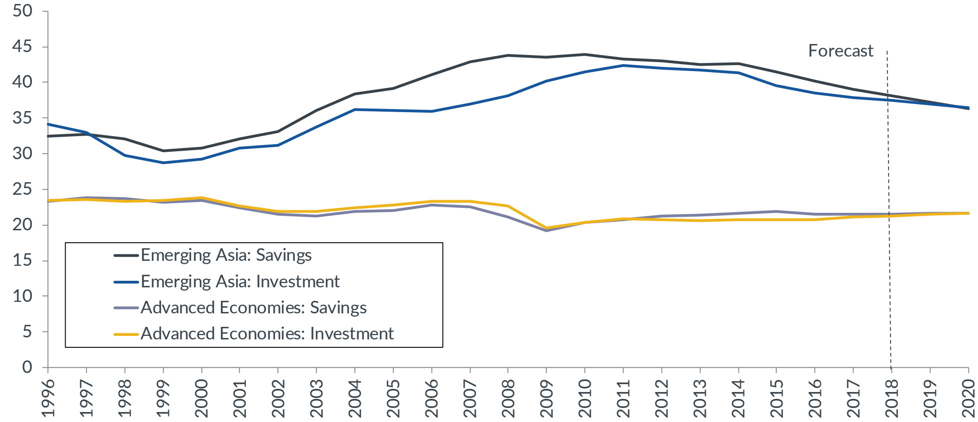


Source: Health Nutrition and Population Statistics (Population Estimates and Projections).

Similarly, overall productivity in the region remains substantially higher than in the rest of the world. Productivity growth is being boosted by strong investment rates as well as by competition within the business environment, which is incentivizing firms to evolve their processes or products to gain a competitive advantage. More than anything, Asia is marked by a growing culture of innovation and the region is quickly beginning to join the ranks of global leaders in technology research and development. For example, Asian investment contributed 40% of the record $154 billion in global venture financing in 2017, compared to just a 5% share 10 years ago.

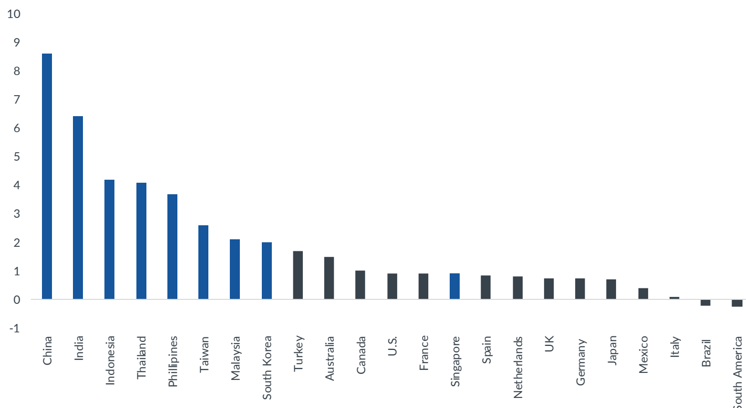
All of this is occurring against a largely favorable policy backdrop. Asia generally has sound fiscal policies, which have helped to support growth. Efficient investments in public infrastructure provide more capital stock for workers to use, thus improving labor productivity. Meanwhile, the adoption of more liberal economic policies in the region is contributing to the development of freer markets and the emergence of companies with more stable business models. Better corporate governance typically shows up on multiple fronts. Balance sheets improve, debt can be issued over longer maturities at lower rates, resilience in periods of shock increases, valuations rise, and equity prices become more reflective of fundamentals.

FIGURE 9
Savings and Investment as % of GDP



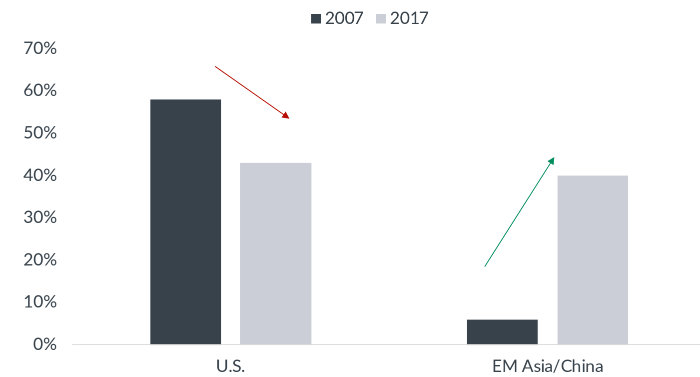
Source: City National Rochdale, International Monetary Fund, Asian Development Bank.

FIGURE 10
Average Annual Productivity Growth (2010-2017)



Source: International Monetary Fund.

FIGURE 11
% Total Global Venture Financing



Source: City National Rochdale, International Monetary Fund, Asian Development Bank.

Beyond strong internal demand, Emerging Asia has also been focused on strengthening interregional ties in order to expand into new markets and up the global value chain. Through trade agreements and cross-border infrastructure coordination, these efforts are helping improve efficiencies, connectivity, and investment flows throughout the pan-Asian economy. While in the past intra-Asian trade has been dominated by trade in components and materials that are assembled and then exported outside Asia, over the next 10 years, intra-Asian trade in final products and domestic demand is expected to drive growth. The U.S. decision to pull out of the Trans-Pacific Partnership (TPP) will only accelerate this trend. Indeed, while the U.S.-led TPP has faded into the background, the Chinese-led RCEP (Regional Comprehensive Economic Partnership) has gained momentum. Together with China's "One Belt, One Road" initiative, RCEP should further bolster greater regional connectivity—not only within Asia but also with Europe and the Middle East.

All Emerging Markets Are Not Created Equal

When identifying attractive global regions in which to invest, it is just as critical to determine which regions to avoid. Despite the growth of EM investing, many investors still carry some assumptions about EM assets that no longer hold true, one being that EM risk is singular and static. Recent struggles in Turkey and Argentina may have recalled painful memories from crises in the '80s and '90s, but over the last decade most EM Asian economies have dramatically improved their macroeconomic stability, possess fewer imbalances, and are less crisis-prone.

It is notable that EM Asian economies have had relatively few casualties since 2008, with sovereign defaults or currency crises limited to very specific cases. This speaks to the long-term resilience of these economies. Following the currency crises of the 1990s, EM Asian governments and central banks took steps to become more economically secure and build greater buffers. In general, these economies have an abundance of foreign exchange reserves, and relatively balanced fiscal positions and are able to employ sustainable fiscal packages as countercyclical tools.

Greater fiscal responsibility has resulted in lower public debt-to-GDP ratios relative to DM and other EM countries, and the transition from fixed to floating currencies in most countries over the past two decades has helped during periods of stress. Currency movements have been able to absorb the effect of a challenging global environment—a more favorable outcome than the immediate devaluations often seen with fixed currency arrangements that can lead to greater market shocks. Meanwhile, growth in domestic "onshore" funded assets, which can dampen volatility, has been helped by increased maturity, transparency, and breadth of local capital markets. Contractual savings institutions (e.g. national provident funds, life insurance companies, private pension funds, and funded social pension insurance systems) have created domestic demand for assets, smoothing currency fluctuations known to occur with more volatile cross-border flows.

Indicator	Turkey	Argentina	Colombia	South Africa	Mexico	Poland	Indonesia	Brazil	Chile	Peru	Russia	India	Philip-pines	Malaysia	China	Thailand	Taiwan	South Korea
Current Account Balance, 2018 (% GDP)	-5.4%	-5.1%	-2.0%	-2.9%	-1.9%	-0.9%	-1.9%	-1.6%	-1.8%	-0.7%	2.2%	-1.9%	-0.5%	2.4%	1.2%	9.3%	13.0%	5.5%
External Debt, 2017 (% GDP)	53.5%	36.8%	40.3%	49.6%	38.2%	72.3%	34.8%	32.5%	65.5%	31.4%	33.9%	19.60%	23.3%	68.9%	13.0%	32.8%	31.4%	27.2%
CPI Inflation Q2 2018 (Y/Y)	12.8%	27.6%	3.20%	4.5%	4.6%	1.8%	3.3%	3.3%	2.1%	1.0%	2.4%	4.1%	4.8%	1.3%	1.8%	1.3%	1.7%	1.5%
Protectionism Vulnerability (Exports % GDP)	18.5%	9.1%	11.7%	25.6%	35.6%	44.0%	16.6%	10.6%	28.6%	19.2%	23.3%	11.3%	25.7%	69.1%	19.0%	51.9%	54.8%	36.5%
Oil Vulnerability (Est. Net Oil Production % GDP)	-1.6%	-0.2%	2.2%	-3.0%	0.9%	-2.0%	-1.3%	-0.4%	0.1%	0.5%	10.0%	-2.6%	0.1%	-0.7%	-1.2%	3.5%	-3.1%	-3.1%
Government Policy	0.05	0.18	0.02	0.27	0.14	0.69	0.01	-0.18	1.02	-0.17	-0.22	0.10	-0.01	0.88	0.36	0.34	1.37	1.07
Vulnerability Ranking																		

Source: Source: Bloomberg, International Monetary Fund, World Trade Organization, Bank of International Settlements, City National Rochdale. As of September 2018.

The Four Ps:
Policies, Population, Potential, Profitability

Investors tend to lump emerging markets together, sometimes failing to recognize fundamental differences between countries and regions. Using the top 10 country constituents of the MSCI EM Index, our approach is represented by our multifactor 4-Ps framework. We have reviewed the data and ranked each country versus this cohort, adding together the relative positioning to arrive at a total unweighted score. In our approach, the lower the score is the better the rank.

For each factor, our conclusion is that when considering the EM asset class, Asian economies offer investors the best opportunity in terms of the economic and profit growth that ultimately drives stock returns.

Our final scores:

CITY NATIONAL ROCHDALE 4PS FACTOR ANALYSIS EMERGING MARKETS

CHINA	104	BRAZIL	184
SOUTH KOREA	98	SOUTH AFRICA	181
TAIWAN	117	RUSSIA	157
INDIA	136	MEXICO	162
MALAYSIA	125	POLAND	163
EM ASIA	116	EM NON ASIA	169

See sources on the final page.

POLICIES

Monetary, regulatory, trade-related—the ease of creating and sustaining economic growth, infrastructure investment

As it relates to policy, we include eight factors. We have examined the effectiveness a government provides to its country via the World Bank's Governance Indicators, as well as the degree of support an economy receives from its monetary and fiscal authorities. We also access real GDP growth over a 10-year period, government spending and debt levels as a percentage of GDP, as well as a country's position in the global economy as indicated by its current account balance and debt held by foreigners.

When pursuing investments on a global basis, it is vitally important to consider the manner in which countries are organized and run. The World Bank has an index based on its worldwide governance indicators, which include political stability, rule of law, and regulatory quality, among others.

Other important measures we have included in the policy framework are the Economic Freedom Index produced by the Heritage Foundation and the Ease of Doing Business Index created by the World Bank. These indices generally reflect favorable regulations for business and stronger protections of property rights, foundations for strong economic framework and growth.

POLICIES

	GOVERNANCE INDEX	SUPPORTIVE FISCAL POLICY	SUPPORTIVE MONETARY POLICY	DEBT AS % GDP	GOV'T SPENDING % OF GDP	CURRENT ACCOUNT BALANCE % GDP	DEBT HELD BY FOREIGNERS	REAL GDP GROWTH 10-YEAR ANNUALIZED	TOTAL
CHINA	9	3	3	5	6	5	1	1	33
SOUTH KOREA	2	2	2	3	2	2	4	5	22
TAIWAN	1	1	1	2	1	1	2	6	15
INDIA	7	6	9	9	5	7	3	2	48
MALAYSIA	4	7	7	7	3	3	7	3	41
EM ASIA	**5**	**4**	**4**	**5**	**3**	**4**	**3**	**3**	**32**
BRAZIL	6	10	10	10	9	8	5	9	67
SOUTH AFRICA	5	9	8	8	7	10	10	8	65
RUSSIA	10	5	5	1	8	4	9	10	52
MEXICO	8	8	6	4	4	9	6	7	52
POLAND	3	4	4	6	10	6	8	4	45
EM NON ASIA	**6**	**7**	**7**	**6**	**8**	**7**	**8**	**8**	**56**

See sources on the final page.

POPULATION

The demographic profile that is the foundational building block for economic growth

We use six components in this factor. Total population growth is often a leading indicator for growth in the working age population. This is important because there is a high correlation between growth in individuals in the 20-65 age group and the demand from this cohort for goods and services as individuals marry, raise children, and buy and furnish a home, all of which help to drive economic growth.

Another important demographic component is the percentage of the population that is over 65. Wage growth declines in this age bracket while the need for health care and other services increases and must be supported by the rest of the population, which constrains the ability of an economy to grow.

Crucial in evaluating a country's population and its impact on the economy is how productive the workforce is. It is also vital to assess the savings rate of a country, as that has an influence not only on the willingness to spend, which benefits economic activity, but also the ability to fund overall debt levels from internal sources.

POPULATION AND PRODUCTIVITY

	GROWTH RATE	WORKING AGE RATE	PRODUCTIVITY OF WORKERS	OVER 65 %	SAVINGS % INCOME	ECONOMIC FREEDOM INDEX	TOTAL
CHINA	6	7	1	6	1	8	29
SOUTH KOREA	6	6	6	7	6	3	34
TAIWAN	8	8	5	9	2	1	33
INDIA	4	3	2	2	5	9	25
MALAYSIA	1	1	4	3	9	2	20
EM ASIA	**5**	**5**	**4**	**5**	**5**	**5**	**29**
BRAZIL	5	5	7	5	4	10	36
SOUTH AFRICA	2	4	10	1	10	6	33
RUSSIA	9	10	8	8	7	7	49
MEXICO	2	2	9	4	3	5	25
POLAND	10	9	3	10	8	4	44
EM NON ASIA	**6**	**6**	**7**	**6**	**6**	**6**	**37**

See sources on the final page.

POTENTIAL

Assess the relative and absolute drivers of innovation

The potential for innovation in industries of high intellectual property within a country is important, as these industries tend to have higher growth, and higher profitability and provide higher wages to their employees. To evaluate this, we look at a number of variables. One is Cornell University's Global Innovation Index, which includes items such as venture capital deals, online creativity, R&D, patents and knowledge creation.

All innovation does not come from government policy and spending. A country's venture capital community and technology-focused universities, combined with the creative spirit of innovation, are also important factors. We also include the Ease of Doing Business Index developed by the World Bank as a measure to determine the ability of great ideas to be translated into business success.

POTENTIAL FOR INNOVATION

	GLOBAL INNOVATION INDEX	R&D % GDP	PATENTS	VENTURE CAPITAL	UNIVERSITIES	EASE OF BUSINESS INDEX	TOTAL
CHINA	2	3	1	1	1	7	15
SOUTH KOREA	1	1	2	6	2	1	13
TAIWAN	4	2	9	8	3	4	30
INDIA	9	9	4	2	5	9	38
MALAYSIA	3	4	8	7	4	2	28
EM ASIA	**4**	**4**	**5**	**5**	**3**	**5**	**26**
BRAZIL	10	5	5	4	8	10	42
SOUTH AFRICA	7	8	7	5	10	8	45
RUSSIA	6	6	3	10	6	5	36
MEXICO	8	9	10	9	7	6	49
POLAND	5	7	6	3	9	3	33
EM NON ASIA	**7**	**7**	**6**	**6**	**8**	**6**	**40**

See sources on the final page.

PROFITABILITY

The ability to convert growth into shareholder returns by assessing the divergence of GDP and corporate growth among regions

An important consideration is the overall profitability of companies that are available to investors. We utilize the DuPont model, which evaluates the financial performance of companies on measures such as Asset Turnover, Pretax Margins, Debt Levels, and ultimately, Return on Equity. For this measure we use recent returns as well as long-term averages. Asset turnover is a ratio of a company's sales to assets. Pretax margins are a proxy for how much money a company makes per dollar of sales, before taxes. We also include in our profitability discussion the outlook for sales growth and earnings over the next 12 months.

PROFITABILITY

					2018 EST		
	ASSET TURNOVER	PRETAX MARGIN	DEBT % CAPITAL	ROE	SALES GROWTH	EPS GROWTH	TOTAL
CHINA	9	2	8	4	1	3	27
SOUTH KOREA	5	6	4	8	5	1	29
TAIWAN	4	10	3	6	7	9	39
INDIA	2	5	7	1	3	7	25
MALAYSIA	10	1	6	10	4	5	36
EM ASIA	**6**	**5**	**6**	**6**	**4**	**5**	**32**
BRAZIL	7	9	9	3	9	2	39
SOUTH AFRICA	6	7	5	2	10	8	38
RUSSIA	3	3	1	7	2	4	20
MEXICO	1	8	10	5	6	6	36
POLAND	8	4	2	9	8	10	41
EM NON ASIA	**5**	**6**	**5**	**5**	**7**	**6**	**34**

See sources on the final page.

Attractive Long-term Valuations

We see compelling long-term valuation opportunities in this asset class at a time when many countries have improved their economic standing and companies are making meaningful, positive changes to their operating models. Despite offering a significant growth premium and improving fundamentals, Emerging Asia equity markets still trade at a long-term historical 25-30% discount to those in developed markets.

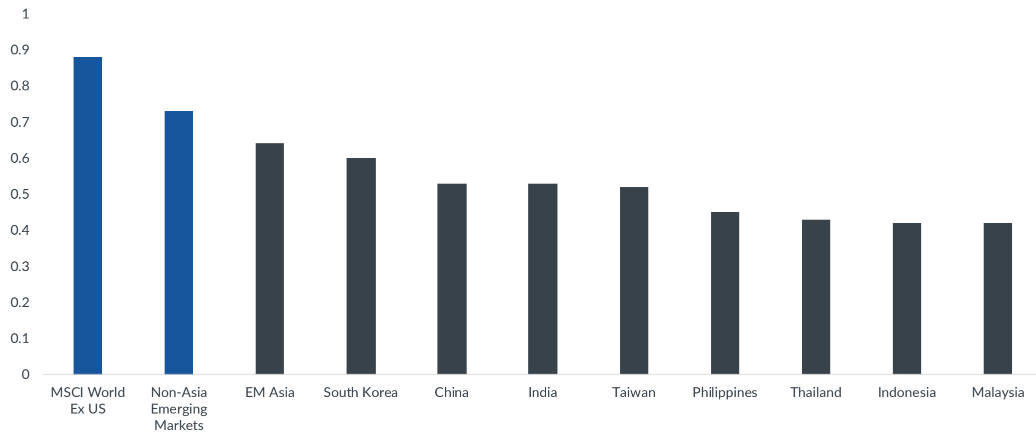
Over time, rising global weightings should also continue to push funds into Asia. Although the contribution of EM to global growth continues to increase, the asset class remains vastly underrepresented in global indices in relation to its economic significance. Emerging Markets currently account for just 17% of total global market capitalization, a number we expect to change profoundly between now and 2030. As underlying economies mature, capital markets deepen and domestic savings pools become institutionalized, the proportionate share of EM equity is predicted to account for up to 40% of a global asset pool that is projected to grow from $80 trillion today to $515 trillion.

Changes in regulation vary significantly from country to country, but the trend has been toward higher international participation. Relaxation of borrowing market rules in some EM Asia countries should contribute to increased liquidity in local equity markets. The introduction and rapid growth of readily available, efficient financial instruments and vehicles has also contributed to the democratization of investing in these markets, thus enabling investors to better express their convictions.

Diversification Benefits

Exposure to Emerging Asia equities not only offer investors in developed nations the potential of higher returns, but also risk reduction benefits through portfolio diversification. The rising degree of global financial market integration has prompted some to question whether EM can still provide meaningful diversification in portfolios. It's true that a renewed bout of global risk aversion would likely pose headwinds for EM, which continues to trade with a heightened beta to global markets. Emerging Markets are, after all, part of the global economy and thus not immune to the impact of global shocks from both fundamental and technical perspectives. Still, our analysis indicates that significant diversification benefits, from Asian markets specifically, have persisted in the long term, making a strategic allocation to EM Asia equities an effective diversifier for clients from DM risk.

FIGURE 12
Correlation to S&P 500



Source: Bloomberg; 15-Year Correlation (Weekly, USD), MSCI Indices.

Conclusion

The "free lunch" of naïve diversification is over, and the most important decision an investor can make when constructing a globally equity portfolio is where to invest regionally. Not all economies and markets are created equal, and opportunities (and risks) across the globe are growing increasingly divergent. However, client goals of higher returns and diversification are still possible with a targeted, intelligent approach to global equity investing.

In a world largely starved for structural growth, we believe that Asian equities and credits represent some of the best long-term values we see across global capital markets. Profound structural changes are redefining long-term investment opportunities in Emerging Asia. The convergence of demographics, innovative technology, and government reform is leading to stronger and more resilient domestic economies in which a dynamic private sector is playing an increasingly significant competitive role.

Asia's surging middle class, coupled with strong productivity trends, signal robust structural growth for the foreseeable future. Having the two key components of GDP—labor force growth and productivity—trending so strongly is an important differentiator for the Asian region at a time when many parts of the global economy are facing demographic and/or productivity challenges. Compelling urbanization patterns across the region are helping, too. As a result, overall GDP per capita in Asia is growing significantly faster than in many other parts of the world.

From an investment standpoint, we think that these drivers of strong structural growth across a variety of industries, including technology, consumer and financial services, education, and health care delivery, will be constructive for the trajectory of Emerging Asia equity earnings and multiples in the coming years. There are current risks associated with our positive outlook, but our base view is that over time the investment profile of EM is compelling enough to overcome short-term gyrations that could be caused over such recent concerns above excess debt in China, currency devaluations, and slowing global trade. As such, we continue to recommend a long-term strategic overweight to Asian equities for investors looking to capture enhanced return and diversification benefits.

Sources for 4P Data

BCA Research

Bloomberg

Bureau of Labor and Statistics

CEIC Data

CIA World Factbook

Cornell University

FactSet

Global Innovation Index

Goldman Sachs

Heritage Foundation

Insead

International Monetary Fund

Ned Davis Research

OECD

SC Johnson College of Business

St. Louis Federal Reserve

tradingeconomics.com

WIPO

World Bank

Important Disclosures

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