RESEARCH • RESOURCES • RESULTS

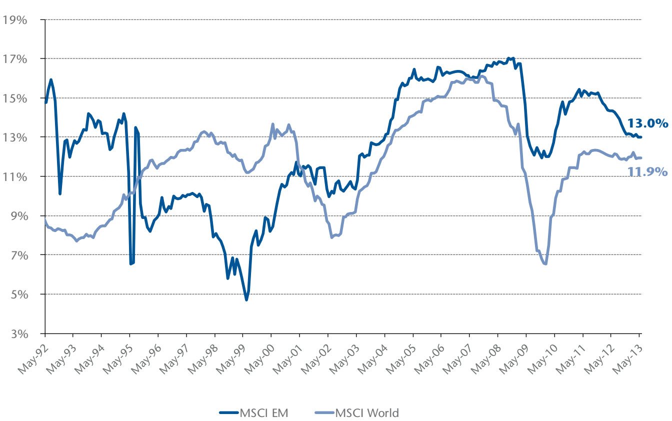
Q&A
Emerging Market Equities

Having shown their spirit in the years following the Global Financial Crisis, emerging market equities continue to have tremendous appeal amongst a broad range of investors. Mihail Dobrinov, CFA, portfolio manager and head of emerging markets equities at Principal Global Equities discusses the recent divergent results across developed markets and emerging markets and what he sees as themes that will drive the asset class going forward.

Developed market equities have recently seen some outperformance over emerging market equities. What's been driving this?

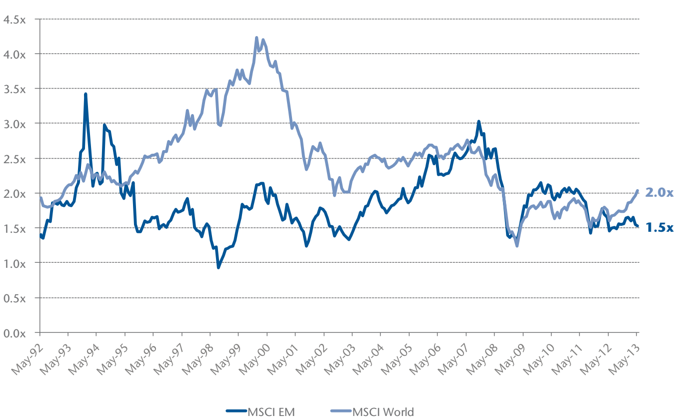
MD: The difference in performance over the past few years all comes down to earnings. On average, developed markets (DM) have seen positive earnings trends and upward revisions. In contrast, within emerging markets (EM), there have been more negative earnings surprises and downward revisions. The liquidity being generated by central banks' quantitative easing (QE) programs has been filtering into the EM economies, which are already operating at or above their economies' capacity. This massive inflow of capital has stoked inflation; as a result, rising wages and other input costs have put a squeeze on margins of many EM companies. This trend has been most pronounced since 2011 as we have seen declining EM return on equity (ROE), while DM ROE has remained flat. Accordingly, the market has rewarded DM with a price/book (P/B) multiple expansion.

EXHIBIT 1: TRAILING ROE



Source: Morgan Stanley Research

EXHIBIT 2: TRAILING PBV



Source: Morgan Stanley Research

Q&A

Emerging Market Equities

with Mihail Dobrinov

What are the three biggest themes that are currently driving emerging market equities?

MD: We believe that currently the three biggest themes are the slowdown in China, the appreciating U.S. dollar, and the ability of domestic demand to sustain GDP growth in EM countries. In China, the stimulus from 2009 and 2010 is wearing off and the government has yet to put anything in place to replace it. Further, the debt underlying that stimulus is now rather high and has become an overhang with the costs of servicing the debt syphoning off precious liquidity. Consequently, the Chinese economy is becoming more dependent on liquidity expansion and debt accumulation, but just like in the United States, there are diminishing returns to the accumulation of more debt.

The second theme we are seeing in EM is the strength of the U.S. dollar, particularly relative to the yen as of recently. Reversing a dollar-weakening trend that lasted ten years, the U.S. dollar has been strengthening since 2011. Historically, a strengthening U.S. dollar has been a headwind for EM. This is primarily because of the dollar's inverse relationship with commodity prices, as well as the availability and cost of dollar financing globally. Since many EM are dependent on commodities, lower prices hurt their economies. The weakening yen also puts direct pressure on emerging Asian nations. For example, if Japanese exporters decide to cut prices in an attempt to gain market share, this makes things more difficult for Korean exporters.

The third trend we think is important for EM is the potential for consumer demand in EM countries to sustain GDP growth. This has been a key driver for many EM economies since the global financial crisis as policymakers sought to stimulate domestic demand. Credit became cheap and abundant; thereby, enabling people to buy houses, to buy automobiles, to buy almost anything. However, that growth has come at the expense of deteriorating current account balances within the EM universe meaning that these countries are increasingly dependent on foreign financing to sustain growth. On the positive side, global liquidity is currently plentiful, and the long-term demographic trends do favor the continuous rise of the EM consumer.

What is the tipping point that will either drive emerging market equities higher or force them lower?

MD: There could be several factors. For example, in China, the government is expected to announce several key economic reforms sometime in mid-2013. If the reforms are aggressive, the market could get excited about these changes. Conversely, we could see some disappointment in the market if the government fails to deliver. Chinese GDP numbers could be another trigger. If growth were to surprise on the positive side, that would serve as a tremendous boost to EM equities. As well, the movement of the U.S. dollar could be another driver for EM equities.

How has your investment process suited to the current environment?

MD: We have been very pleased with the way our process has worked for our clients through the recent turbulent times. We pick stocks using a disciplined, bottom-up process that balances fundamentally driven earnings trends with attractive relative valuations. Regardless of the overall market environment, we strive to separate the winners from the losers. Unlike the period 2003-2007 when "a rising tide lifted all boats," the market today is a lot more complex with wide divergences in returns among stocks. Therefore, we believe now, more than ever, it is a good time to be a stock picker.

ABOUT PRINCIPAL GLOBAL EQUITIES

Principal Global Equities is a specialized investment management group within Principal Global Investors. We are fundamental investors, focused on bottom-up stock selection, with capabilities and expertise encompassing large-cap, mid-cap, and small-cap stocks in developed and emerging markets worldwide.

Disclosures
The information in this document has been derived from sources believed to be accurate as of June 2013. Information derived from sources other than Principal Global Investors or its affiliates is believed to be reliable; however, we do not independently verify or guarantee its accuracy or validity.

The information in this document contains general information only on investment matters and should not be considered as a comprehensive statement on any matter and should not be relied upon as such. The general information it contains does not take account of any investor's investment objectives, particular needs or financial situation, nor should it be relied upon in any way as a forecast or guarantee of future events regarding a particular investment or the markets in general. All expressions of opinion and predictions in this document are subject to change without notice.

Subject to any contrary provisions of applicable law, no company in the Principal Financial Group nor any of their employees or directors gives any warranty of reliability or accuracy nor accepts any responsibility arising in any other way (including by reason of negligence) for errors or omissions in this document.

All figures shown in this document are in U.S. dollars unless otherwise noted.

This document is issued in:

- The United States by Principal Global Investors, LLC, which is regulated by the U.S. Securities and Exchange Commission.
- The United Kingdom by Principal Global Investors (Europe) Limited, Level 4, 10 Gresham Street, London, EC2V 7JD, registered in England, No. 03819986, which has approved its contents, and which is authorised and regulated by the Financial Conduct Authority.
- Singapore by Principal Global Investors (Singapore) Limited (ACRA Reg. No. 199603735H), which is regulated by the Monetary Authority of Singapore. In Singapore this document is directed exclusively at institutional investors [as defined by the Securities and Futures Act (Chapter 289)].
- Hong Kong by Principal Global Investors (Hong Kong) Limited, which is regulated by the Securities and Futures Commission.
- Australia by Principal Global Investors (Australia) Limited (ABN 45 102 488 068, AFS Licence No. 225385), which is regulated by the Australian Securities and Investments Commission.
- This document is issued by Principal Global Investors LLC, a branch registered in the Dubai International Financial Centre and authorized by the Dubai Financial Services Authority as a representative office and is delivered on an individual basis to the recipient and should not be passed on or otherwise distributed by the recipient to any other person or organisation. This document is intended for sophisticated institutional investors only.

In the United Kingdom this document is directed exclusively at persons who are eligible counterparties or professional investors (as defined by the rules of the Financial Conduct Authority). In connection with its management of client portfolios, Principal Global Investors (Europe) Limited may delegate management authority to affiliates that are not authorised and regulated by the Financial Conduct Authority. In any such case, the client may not benefit from all protections afforded by rules and regulations enacted under the Financial Services and Markets Act 2000.

Principal Global Investors is not a Brazilian financial institution and is not licensed to and does not operate as a financial institution in Brazil. Nothing in this document is, and shall not be considered as, an offer of financial products or services in Brazil.