Emerging markets are diverse and we see the growth prospects for certain countries as remaining excellent (and, in our view, sustainably so) irrespective of commodity prices and consequent global trade gyrations. We believe there are many heavily under-penetrated sectors providing growth opportunities, with the right companies to drive returns for many years to come.

EXECUTIVE SUMMARY

• The Newton Global Emerging Markets team thinks the outlook for emerging markets is selectively brighter, subject to whether protectionism spirals into a global trade war, which is not our central scenario but remains a possibility.

• There are some countries with economic reforms (e.g., India), many with low levels of debt and those with the potential for catch-up productivity (e.g., low factory automation levels in China). Our preference is to have low exposure to manufacturers and the more export-oriented economies and companies. We are wary about economic slowdown and the risk of a reversal in globalism; hence we currently have relatively little exposure to exporters among our holdings.

• A number of emerging markets are net exporters of oil and have had to adjust to a new lower-price reality, despite the recent rally. Most now let their currencies help the adjustment.

• India’s Prime Minister Narendra Modi’s economic reforms continue to impress us, but he is playing the long game, which may prove tiresome for the short-term speculator.

• China’s growing debt levels, albeit at a slower pace than previously, pose a concern, but we believe there remain opportunities in some sectors, particularly under-penetrated service areas and those that are consumer-related.
Shiller (10-year smoothed) price-to-earnings (PE) ratios suggest that emerging markets are still very inexpensive compared with developed markets. This is not universal, however, and there are always distortions in such imperfect analyses. Arguably, we think the political risk premium should now be higher for certain developed markets than for some emerging markets.

Stock selection can potentially outweigh geographic or sector allocation, which is something we think most strategists neglect as it is too difficult to fit into easily digestible high-level analysis. Hence, while thematic and macro analyses are important, they are merely inputs into our own stock-picking process.

Weak currencies have been a significant headwind to emerging-market equities over recent years. Given that most now appear, in our opinion, inexpensive, the prospect of continued steep devaluation seems far less plausible and appreciation is possible in coming years. This would allow underlying profit growth to be increasingly reflected in real hard-currency returns.

Here, we outline our views on emerging market (EM) opportunities and how we are addressing these in our strategy.

**SECTOR VARIANCE**

Sectoral returns from emerging-market equities have been close to the reverse of those witnessed in 2015, when commodity prices and related stock markets and currencies collapsed. Hence, to outperform in both years, a portfolio would have needed to change positioning aggressively from one year to the other.

Given a five-year investment horizon, we believe that, instead of trying to second-guess near-term market gyrations, we are better placed applying a longer-term investment approach in order to try to make rational investment decisions based on more enduring underlying fundamentals.

While we have recently been seeing a near-term rebound in some of the stocks and markets that were weak in 2015, this does not mean that one should extrapolate this as another commodity-driven super-cycle in EM, as in the mid-2000s. Quite the contrary—we think there are very good reasons to believe that the commodity rally will be short-lived, even if prices do not fall too much from here.

However, one should not conclude that EM equities as an asset class are unattractive; the underlying drivers are diverse. The argument about “value” can also be misleading—everything we do as managers of our clients’ investments is aimed at identifying stocks trading at a significant discount to their intrinsic value—but this does not necessarily mean we have to favor low price-to-earnings or price-to-book ratios. In fact, much of the recent “value” rally can be attributed to sharp price moves in highly leveraged commodity producers—either operationally or financially.

While, at an equity index level, emerging markets may have significant commodity-reliant components, we believe there are highly attractive opportunities available in emerging markets which are not commodity-driven, and which have what we view as far more sustainable growth pathways ahead.

Good examples of this are Indian, Indonesian and Philippine consumer service companies and, in some cases, Chinese consumer service companies. This includes firms in the Internet, education and health care sectors, which we believe can grow from here, even though the overall Chinese economy is likely to decelerate over time.
One advantage to us of a benchmark-agnostic approach is the ability to try to pick stocks that tap into the best future growth opportunities at valuations that provide significant return potential, which may not be obvious to the short-term market speculator.

China’s credit stimulus, which fueled the rebound in commodity markets, has already started to wane. We have also seen further policy signals from the Chinese authorities—of efforts to rein in the housing market, for example. Additionally, in 2016 we saw sharp restocking of supply chains, which is now largely complete. These factors, together with high levels of debt in the commodity-driven parts of the Chinese economy, point in our mind to the prospect of lower commodity demand in the future. We think trend growth could even turn negative for hard commodities such as iron ore, while supply keeps growing for now. We find a more attractive trade-off between risk and reward in other sectors, in preference to chasing this speculative gyration.

**VALUATIONS**

Through-cycle measures such as the Shiller (10-year smoothed) price-to-earnings (PE) ratio suggest emerging markets are still very inexpensive compared with developed markets. However, this is not universal and there are always distortions in such imperfect analyses. For example, we think the oil sector is unlikely to experience the levels of profits seen over the past decade in the coming years, and hence neither are most Russian companies.

We would certainly not suggest all emerging-market companies have an equally rosy outlook. While all backward-looking through-cycle measures may be flawed, so too are forward-looking measures, notably the one-year forward PE, which tends to neglect the detail of the economic and financial backdrop.

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**Shiller Cyclically Adjusted PE Ratio—MSCI Emerging Markets Index vs. MSCI World Index**

Source: Thomson Reuters Datastream, April 2017. Shiller PE (price/earnings) ratio: a cyclically adjusted price/earnings ratio, otherwise known as the CAPE, measures the real price of a company’s stock relative to real average earnings over the past 10 years. The Shiller PE aims to smooth out the economic and profit cycles to give a more informed view of a company’s price than the traditional price/earnings ratio, which uses only one year of profits.

Charts throughout are provided for illustrative purposes only and are not indicative of the past or future performance of any Dreyfus product.
Bearing in mind that the “terminal value” (often derived more than five years in the future) is typically a large component of equity valuations, we believe it is vital to consider prospects even further out than that. This requires scenario analysis, macroeconomic analysis, thematic perspective to understand the context, and a good understanding of the robustness of each business model.

In our experience, investors often largely ignore currencies in valuation discussions—owing to complexity, volatility and the tendency of currency markets to behave erratically for long periods. Real yields are currently very high in the likes of Brazil but there is also a continuing terms-of-trade correction, and fiscal tightening is still required to stabilize the budget; hence the currency and cost of capital are used as factors by the market to enforce “corrective” action. On the other hand, the devaluation of the peso makes the Mexican economy highly competitive, offsetting a significant tariff rise that the market currently fears. If the tariff rise does not materialize, it could fuel an export boom and, from an investment perspective, represent strong value.

U.S. interest rates are set to continue to shape the global cost of capital and currencies, but we have already seen big currency moves which forced economic changes and brought current-account deficits back into line. Weak currencies have been a significant headwind to emerging-market equities over recent years. Given that most now appear, in our opinion, inexpensive, the prospect of continued steep devaluation seems far less plausible and appreciation is possible in coming years. This would allow underlying profit growth to be increasingly reflected in real hard-currency returns, as we have started to see in 2017 with the dollar pausing for breath.

**FUTURE GROWTH PROSPECTS**

We believe we can break down the drivers of future economic growth into a few key constituent parts. The list is not exhaustive, but allows us to consider the most important criteria for emerging markets.

**Part 1 – Debt**

Debt levels are elevated in much of the world but there are stark differences by country, which shapes divergent growth prospects. Quantitative easing and near-zero interest rates did little to encourage the deleveraging of economies, although the location of debt appears to have shifted in many cases—from consumers to governments.

It is interesting to bear in mind that many Western countries also have large off-balance-sheet liabilities, including unfunded pensions, which are estimated to be equivalent to 190% of GDP across the Organization for Economic Cooperation and Development (OECD), dwarfing apparent debt levels. Taking the UK as an example, it has large liabilities sitting under public-private partnership contracts—again, off balance sheet. We believe the Western world’s aging populations will increasingly want to tap into emerging-market growth to try to pay for these increasingly unaffordable commitments.
How does this impact security selection? Bank for International Settlements (BIS) figures for private debt-to-GDP ratios show the difference between the U.S. and UK (high but falling since 2009), Thailand and Malaysia (extended credit cycles have eased off) and Indonesia and India (rising from low levels, but flat over the past few years as they went through a down cycle). We think the key point to absorb is that there is much more scope for future credit penetration in the latter two economies, which should be highly growth-supportive. Most developed economies have high debt burdens, but so do some emerging markets. We emphasize the need to be selective.

**BIS Household and Non-Profit Institutions Serving Households (NPISH) Debt as % of GDP**

Sources: Newton, Thomson Reuters Datastream, March 2017.

**Part 2 – Politics**

Emerging markets have historically displayed a valuation discount, at least in part owing to political volatility. Now we have Donald Trump in the U.S., Britain’s exit from the EU and further potential challenges for the Eurozone up ahead. As such, we think the political risk premium should now be higher for certain developed markets than for some emerging markets.

The direction of travel is a key investment consideration when assessing politics and corruption. For example, the prevalence of corruption in the Nigerian economy is hardly a surprise, given the country’s stage of development. After all, the same applied to the UK and U.S. when they were at that level of GDP per capita.

Nigeria is not much of an outlier when you consider its perceived level of public-sector corruption versus the country’s income levels, but we believe Russia is far worse than it should be for its far higher income level per person. It is no surprise therefore that barely any Russian companies pass our corporate governance threshold. The key issues for our political analysis are, firstly, whether the situation is improving or deteriorating, and, secondly, whether we can find companies with sufficiently good corporate governance to be good stewards of our clients’ capital. We have found this with some multinational subsidiaries in Nigeria, for example, but have not currently found attractive opportunities in Russia.
Part 3 – Productivity

Most emerging markets have the potential for “catch-up” productivity, which contributes to raising trend GDP growth, as technology and governance lessons are learned from developed markets. Economic reforms are currently observable in a number of emerging markets, including India, Mexico and, to a certain extent, China and Indonesia. This is in stark contrast to the direction of travel in countries such as Turkey and South Africa. Brazil has had some political change to show the impetus for improvement, but there persists a painful correction to adjust consumption to the new, harsher reality of an extended credit cycle, fiscal profligacy and lower commodity export prices.

Part 4 – Population Dynamics

We have talked about the divergence that we see, and continue to expect, within emerging markets for a few years now. One of the key platforms of this argument relates to working-age populations. India and the Philippines continue to have rapid growth prospects ahead, with the workforce being the key GDP growth driver. Unfortunately, it is not the only consideration, and factors such as credit cycles, government policies and institutional support, as well as terms of trade, need to be overlain to provide an understanding of productivity growth (or contraction).

The West is aging rapidly, with the workforce likely to contract by about 20% over the next 25 years in most of Western Europe and Japan, but also South Korea, Thailand, and even China in due course (although the one-child policy impact is overstated and there is still plenty of scope for productivity catch-up).

The U.S. and UK are expected to see their workforces flat-line, but only if one takes into account an immigration assumption made by the United Nations, which may now be out of date, given recent policy shifts. The trend decline in working population growth of countries with aging populations needs to be offset by productivity growth if GDP growth is to be sustained. Given high starting debt levels, unfunded pensions, and the recent failure to drive productivity growth at the aggregate level, the outlook for productivity looks poor for most developed markets even with technological advancement. This could be amplified further if there is greater protectionism.

For emerging markets, there are some countries with economic reforms (e.g., India), many countries with low levels of debt, and many with the potential for catch-up productivity (e.g., low factory automation levels in China), so we think the outlook is selectively brighter. For others, the outlook could be overwhelmed by credit cycles, political intervention and commodity cycles. We would emphasize the need to understand the thematic backdrop in order to gauge the prospects and risks.

While we do not construct a portfolio based on population dynamics, we do consider the impact on country and company-specific growth potential. This can consequently become visible in portfolio construction, as our stock selection tends to reflect this. By way of example, Turkey and Nigeria have very attractive working population growth profiles. This attraction has been overwhelmed by other factors, such as credit cycles and politics in Turkey, and terms of trade (oil) and weak institutions in Nigeria. However, the latter is very much on our radar for future stock ideas.
Part 5 – Protectionism

We perceive Donald Trump to be operating on a day-to-day basis at the moment. We know his apparent desires, but not yet what is feasible once the full consequences of his policies are considered. While the threat of a border tax adjustment remains, and would have negative consequences for exporters around the world, we believe it would potentially be just as damaging for the U.S. domestic economy by raising the cost of imported goods, leaving less disposable income for the consumer services that are the lifeblood of the U.S. economy. Protecting and growing a comparatively small number of relatively low-value manufacturing jobs could leave less money for service expenditure, precipitating misallocation of capital and a negative feedback loop. We see much of the recent border-tax analysis that we have read as adopting a head-in-the-sand approach to unintended consequences.

We think the U.S. consumer would bear the brunt of border-tax adjustments, and we would expect higher inflation (not as a consequence of healthy growth), and hence a higher cost of capital, leading to a dismantling of debt-funded structures that have driven economic “growth” and incomes across the economy.

What about U.S. manufacturing jobs? There are plenty of headlines, but we anticipate that this is more likely to be consistent with practices by companies like Apple, which announced a new US$150m assembly plant in the U.S. a few years ago to much publicity, while neatly overlooking its many billions being invested into the supply chain in Asia, particularly China. This investment of a whole supply-chain ecosystem, such as for smartphones, will not move back to the U.S. unless the economic advantages are stark. If they do move to the U.S., we would expect the new plants to be highly automated and that the cost of products in the U.S. would rise very significantly. It seems that Trump is lacking wider Republican support on the border adjustment tax, presumably for exactly the reason of such unintended consequences.

The cost of U.S. manufacturing labor is still multiples of the equivalents in Mexico and China, once payroll and other taxes are considered. To our mind, a manufacturing job renaissance is likely to disappoint. There are only about seven million manufacturing
jobs in the U.S., compared with well over 100 million non-manufacturing jobs. As such, while the aim to improve the prospects of the rust belt is admirable, the prospects of the other 100 million-plus is far more significant to the U.S. economy overall. In addition, raising the costs of imported goods will reduce consumer income available for other forms of spending, such as services, unless productivity rises overall.

History shows this is unlikely via protectionism. Brazil is a recent poster child of the failure of import tariffs to boost productivity or competitiveness. In the wake of its tariff imposition, the country’s domestic manufacturing became highly uncompetitive.

Another recent salutary lesson is former U.S. President Barack Obama’s tire import tariff, which was aimed at protecting U.S. jobs from Chinese dumping. Tariffs raised tire prices, protecting around 2,000 jobs and US$75m of wages, but at the expense of the wider consumer to the tune of over US$1bn in higher prices. Imagine what happens if this is applied on a wider scale across numerous products. We would hope Republicans are wise enough to think this through and hold President Trump back from irrational changes. Some milder border tax and tax restructuring is quite defensible, but would have less profound implications for global supply chains.

We are aware that the uncertainties are significant, hence our preference to have low exposure to manufacturers and the more export-oriented economies and companies. It is our contention that the strategy’s large Indian consumer exposure should be well insulated, for example, as this is a less mercantile economy than most emerging markets and has plenty of robust internal growth drivers.

THE SMART REVOLUTION

Newton has been thinking for some time about the implications of the confluence of a number of factors: greater automation (e.g., robotics and software as a service), connected devices, the interdependence of cloud computing, big data, greater computer power, far greater network connectedness (mobile and broadband), and rapidly developing artificial intelligence. We seek to invest in the beneficiary companies and avoid the disrupted, but we also need to be aware of the human aspect.

We believe the recent populism espoused by the Brexit and Trump outcomes represents protest votes which are a cry for help from the “losers” in this shift to cloud and automation. It has not only displaced manufacturing jobs but, increasingly, clerical jobs too. In the future, it could well threaten value-added white-collar jobs. This is a profound challenge to traditional middle-class aspirations and is visible in wage trends and the gap between capital owners and labor.

The UK Independence Party and Donald Trump have blamed Eastern Europeans and Mexicans, respectively, for taking jobs, but technology is the far more plausible cause of job losses. The wealth gap has been accentuated by loose monetary policy, which has stoked asset prices—to the benefit of the rich, not the poor, in our view.

To our mind, this means that many of the supposed solutions being reflected in anti-trade policies are likely to be self-defeating, in further lowering already tepid long-term growth potential on a possibly global scale. The march of technology is likely to continue its acceleration, underpinned by Moore’s Law and by the cross-fertilization of technological developments. In light of this, policy seems to be focused in the wrong direction, and should instead, we suggest, be aimed at the reskilling of workforces, redistributive tax policy, and measures aimed at helping the transition, which may be very rapid (as it was for the rust-belt communities hit by the exodus of manufacturing).
Does Donald Trump need to drive down the U.S. dollar to spark a manufacturing renaissance? Quite possibly; but recent policy postulations have had the opposite effect, driving up the dollar on border-tax speculation and hence reducing competitiveness. What about so-called Chinese currency manipulation? China has clearly been taking a diversified “basket” approach to managing its currency, having allowed it to strengthen in recent years. However, the accusation of currency manipulation has been leveled at China because it is still not a fully open free-market economy—it has a closed, but leaky, capital account for example.

The Westpac real effective trade-weighted index for the Chinese yuan shows appreciation over the past 10 years to have reflected increasing competitiveness and to have allowed the current-account surplus to narrow to the current 1.89% from a peak of over 10% in 2007. While the currency is still managed, branding China a “currency manipulator” is quite harsh, given that China’s approach has been rational and it has been in China’s interest to maintain a stronger currency in order to drive the rebalancing towards consumption that it desires in its economy.

We are wary about economic slowdown and the risk of a reversal in globalism; hence we have relatively little exposure to exporters among our holdings. On the other hand, we find significant value in certain more defensive Mexican companies, such as an airport operator and a consumer company, both of which have been caught up in the flight from all things Mexican, as has been the case with the currency, which has been sold off on protectionist fears.

Having just returned from visiting companies in China, it is very clear to us that automation of production lines is happening fast and is coming from low levels, which leads to investment opportunities as well as threats.
CURRENT GLOBAL ECONOMIC ENVIRONMENT

Global economic activity has been reaccelerating, with a pickup in global trade growth. This has probably been helped by the rebound in oil prices, which leads to an expectation of price increases and hence restocking, reversing the situation in which the opposite was the case in 2016. As a result, we have moved from a period characterized by deflation fears to one marked by the prospect of reflation, which has led to a sector rotation into banks and commodities as expectations of interest-rate increases have been priced into markets.

While we believe that there is a greater inflation tail risk under President Trump, the effects of the Chinese credit stimulus are likely to ease from here. Furthermore, the year-over-year oil price rebound and its impact on other goods and services are probably at a peak and are likely to ease as we move into the summer, unless we see a further surge in the oil price, which seems unlikely given fundamental supply-and-demand characteristics (not least U.S. oil shale economics and dynamism).

As a consequence of this recovery, we have seen global trade growth resuming in both volume and U.S.-dollar terms after a fall in 2016.\textsuperscript{5}

\begin{figure}
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\caption{Morgan Stanley Global Trade Leading Indicator}
\end{figure}

\begin{itemize}
\item Oil is still the critical swing factor in setting global energy prices and hence the production costs for most manufactured goods, which tend to be heavily reliant on energy inputs throughout their supply chains, both directly and indirectly. The Brent crude price shows the 2016 rebound following the 2014/15 price collapse but also the greater recent stability, which has been helped by the Organization of the Petroleum Exporting Countries’ (OPEC) renewed discipline.
\end{itemize}
The chart of U.S. oil production is a reminder of the surge in output, led by shale technology, which at least partly precipitated the price decline. Note the supply then fell in reaction to low prices during 2016 but has since recovered as prices once again became economic for the industry. This provides a strong argument for range-bound oil prices in the US$40-$65 per barrel range.

Thus, inflationary pressures should temper as the year-over-year oil-price change moderates from +78% in January to around +10% by May, assuming a flat rate of US$55 per barrel for Brent crude. We can expect inflationary commentary to ease progressively, together with forecasts of more aggressive interest-rate rises. Real (inflation-adjusted) U.S. wages have collapsed owing to this short-term inflationary spike despite nominal wages having picked up.

Sources: Bloomberg, EIA, May 2017.
It is worth bearing in mind the strong year-over-year effects that the oil price is having. Oil is vital, not just as a direct fuel for vehicles, but also given its heavy influence on the price of all other energy, such as natural gas and coal, and hence electricity. It takes time for price changes to filter through supply chains and economies. Many emerging markets have taken the opportunity of lower prices to remove historic fuel subsidies—Indonesia, India and Mexico, for example. This is good for fiscal positions and for economic flexibility, but it does remove buffering for the consumer.

A number of emerging markets are net exporters of oil, and have had to adjust to a new lower-price reality, despite the recent rally. Most now let their currencies help the adjustment, as seen in Russia and Colombia, for example. Currency weakness forces the consumer to adjust, which can be recessionary, as we have seen. Governments in such positions are not banking on a sustained price rally, despite OPEC actions, and hence they are staying fiscally prudent.

While the OPEC agreement reached in December is encouraging, and while production behavior so far has been quite close to quota, there is a strong incentive to cheat as the shift to electric vehicles and renewables calls into question how much oil will actually be left in the ground. It is no coincidence that Russia ramped up production just prior to the production-cut agreement, which just brought it back to prior levels, while Iran is still increasing production from previously restricted levels owing to trade sanctions.

U.S. shale oil seems to be highly economic in the US$50-$60 per barrel range, so this may provide a through-cycle price cap and this seems broadly priced into market expectations; thus we struggle to find attractive ideas in the oil sector. Anticipation of price moves beyond this would be mere speculation on our part, and we prefer investment to speculation. This mirrors our stance on most mining stocks.

Inflationary effects should ease over the next few months, if the oil price stays at around the US$55 per barrel level. With the year-over-year price change falling mathematically from +78% at the beginning of 2017 to around +10% by May 2017 and other energy and goods prices likely to track this, there is a disinflationary impetus. We will then understand better in the second half of the year whether there are more stubborn inflationary forces from Trump et al.

So one conclusion is that the near-term trade outlook for emerging-market exporters is brighter, subject to whether protectionism spirals into a global trade war, which is not our central scenario but remains a possibility.

A FEW IMPORTANT COUNTRY VIEWS

India

“Demonetization,” the process by which high-denomination Indian bank notes were withdrawn from circulation in November 2016 in order to clamp down on the black market, seems to have had far less impact than many commentators would have had you believe, not least for the formal part of the economy, which is where nearly all listed companies are most exposed.

Prime Minister Modi’s economic reforms continue to impress us, but he is playing the long game, which may prove tiresome for the short-term speculator. We like what we see, which is promising in capitalizing upon strong underlying growth potential (such as demographic growth), allowing well-positioned companies to grow future returns for a sustained period.
China dominated the financial headlines a year or more ago on fears of a large currency devaluation, which we had considered unlikely as it would have been self-defeating in efforts to rebalance the economy towards more consumption and services, and away from heavy industry. In any event, the Central Committee of the Communist Party pulled another of its “levers” and re-exerted a stimulus on the economy that has reinvigorated the housing market and related industries. This has been further boosted by forced reductions of output in certain heavy industries, such as iron and steel production. The aim has been to focus on efficient large-scale production, forcing out uneconomic capacity and allowing balance sheets, particularly of state-owned enterprises, to be rebuilt.

The result has been a boom in house sales and prices, at least in tier-1 and tier-2 cities, clearance of some excess housing inventory, and a commodity price rebound. The exit of some Chinese mining production has boosted exporters of materials globally, not least in Australia and Brazil, where volumes have quickly responded.

As a result, we have seen rapid inventory building in China (to record levels), helped by the usual speculative restocking on top of the rebuilding of inventories from very low levels. Prices have risen rapidly from low levels but the fundamental outlook does not appear attractive to us, as China has already started withdrawing credit stimulus, and commodities such as iron ore appear over-supplied. We would expect a price correction within the next year, which should remove one support from currencies, such as the

India Monthly Car Sales

Broadly, we are seeing a cyclical recovery, led by the consumer, following a period of retrenchment. India is far earlier in its cycle than most economies and is not burdened by the past excesses of the West.

We see structural growth potential as being supported by demographics, low household credit penetration, economic reforms and catch-up productivity. In our view, the previous government was inept and caught up in bureaucracy, whereas the Modi government has a clear vision and is driven by people with a long-term game plan, which we think bodes very well for future growth.

India Monthly Car Sales

Source: Bloomberg, April 2017.

China

China
South African rand and Brazilian real, that rallied significantly earlier this year, arguably from too-cheap levels given high real bond yields. In fact, we have now seen the first signs of correction in this area.

The steel price move has been driven by supply controls while demand has recovered somewhat, but it has been accentuated by recent speculation, as have iron ore prices and the fundamentals, to us, appear ominous.

In our view, China has too much debt and continues to build this considerably, albeit at a slower pace than previously. If one combines all government and pseudo-government debt, including borrowing by local governments, asset management companies and local government finance vehicles (LGFVs), the GDP-relative level remains low compared with the developed world, although not against most emerging markets. Interestingly, in developed markets we tend not to include liabilities such as out-of-pocket pensions and public-private partnership financing, which are off-balance-sheet but which constitute a future call on government spending, yet these are often included in relation to China.

That said, we still find Chinese banks unattractive and believe their profits tend to be overstated and balance sheets risky. They tend to gyrate violently, but have made little progress as investments over time.

OPPORTUNITIES IN CHINA

Many commentators are wary about the high level of corporate debt in China. Much of this is related to state-owned enterprises and is therefore pseudo-government in nature. While this makes us vigilant regarding the need for debt forgiveness and very wary about owning Chinese banks (which probably need significant recapitalization over time), it also means a debt spiral and banking collapse is far less likely, even if some are allowed to go bust over time. The government’s recent industrial capacity interventions are a case in point.
We are fearful of some capital misallocation (although much is good) and we are relatively bearish about the outlook for Chinese GDP growth. However, we remain happy to invest in specific industries and companies where we see sustained strong growth prospects, notably in consumer services. We believe China has a large, diverse economy with some excellent growth opportunities in very under-penetrated service industries. Chinese stocks have been some of our consistently strongest performers in recent years and we continue to find what we believe to be strong ideas at attractive valuations, not least against a backdrop of generalized fears about China.

OUR APPROACH

We aim to find the best stock opportunities in which we see the highest return potential on a five-year horizon, with the lowest level of fundamental risk—we believe the balance is critical. This means trying to invest in companies with strong brands and barriers to entry that allow them to sustain returns on capital well above their cost of capital. We like companies with the opportunity to reinvest in a long runway of future growth and hence the potential to compound returns over many years. We also like companies that are demonstrably run for all shareholders, not as an instrument of state or for a single oligarch with interests that are unlikely to be aligned with the majority of shareholders. We favor companies that have the potential to provide substantially higher returns than we expect from the market as a whole, together with strong balance sheets and cash generation.

We are discriminating and hold only around 50 stocks in our portfolio and we are not bound by index-driven constraints. We do not anticipate our returns to investors will manifest in a straight line, even if the underlying company profit generation is rather smoother. Furthermore, returns may not coincide with those of the markets as a whole; hence we may lag indices periodically. However, over the long term, we are confident in our approach and we seek attractive returns with a lower level of absolute risk to our investors' capital than is exhibited by emerging-market equities in aggregate.
Investors should consider the investment objectives, risks, charges, and expenses of a mutual fund carefully before investing. Contact your financial advisor or visit Dreyfus.com to obtain a prospectus, or summary prospectus, if available, that contains this and other information about the fund, and read it carefully before investing.

1Source: The Coming Pensions Crisis, Citigroup, March 2016. 2Source: Transparency International – Corruption Perception Index 2016 survey (released January 2017). 3Sources: Newton, UN Population Information Network – World Population Prospects: The 2015 Revision, April 30, 2016. 4Moore's Law posits that the number of transistors in a dense integrated circuit doubles approximately every two years. 5Note that this is normally considered in U.S.-dollar terms, which has led to a tricky benchmark for comparison as the dollar has strengthened against most global currencies in recent years, including late 2016.

Risks

Investing in foreign denominated and/or domiciled securities involves special risks, including changes in currency exchange rates, political, economic, and social instability, limited company information, differing auditing and legal standards, and less market liquidity. These risks generally are greater with emerging market countries. Equities are subject to market, market sector, market liquidity, issuer, and investment style risks, to varying degrees. Diversification cannot assure a profit or protect against loss.

The price-to-earnings ratio is the current market price of a company share divided by the earnings per share of the company and is a means for measuring the value of a company relative to history or another company. The price-to-book ratio (P/B ratio) is a ratio used to compare a stock's market value to its book value. It is calculated by dividing the current closing price of the stock by the latest quarter’s book value per share. The Organization for Economic Cooperation and Development (OECD) is a unique forum where the governments of 34 democracies with market economies work with each other, as well as with more than 70 non-member economies to promote economic growth, prosperity, and sustainable development.

The Organization of the Petroleum Exporting Countries (OPEC) is a group consisting of 14 of the world’s major oil-exporting nations: Iran, Iraq, Kuwait, Saudi Arabia, Venezuela, Qatar, Indonesia, Libya, the United Arab Emirates, Algeria, Nigeria, Ecuador, Gabon and Angola.

The MSCI Emerging Markets Index is a free float-adjusted market capitalization-weighted index that is designed to measure equity market performance of emerging markets. The MSCI World Index is a free float-adjusted market capitalization-weighted index that is designed to measure the equity market performance of developed markets. The Morgan Stanley Global Trade Leading Indicator (MSGTLI) allows the forecasting of global trade dynamics with a one-month lead. It is an equally weighted composite of the following standardized variables: Crude Oil (Brent) EUCRBRDT Index HP, Reuters/Jefferies CRB Index (CRY Index HP), Baltic Dry Index (BDIY Index) HP, U.S. dollar broad trade weighted exchange rate (USTWBROA Index HP), U.S. ISM Manufacturing NAPMPMI Index HP and German Ifo Business Expectations GRIFFPEX Index HP. The Hang Seng Financials Index is a free float-adjusted market capitalization-weighted stock market index in Hong Kong. It is used to record and monitor daily changes of the largest companies of the Hong Kong stock market and is the main indicator of the overall market performance in Hong Kong. These 50 constituent companies represent about 58% of the capitalization of the Hong Kong Stock Exchange. The Westpac real effective trade-weighted index for the Chinese Yuan tracks the Chinese remnimbi, adjusting for inflation and weighting according to the trade balance, as calculated by Westpac. Reflects reinvestment of dividends and, where applicable, capital gain distributions. Investors cannot invest directly in any index.

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