



## Global Emerging Markets

### Monthly commentary

April, 2010

#### Market review

After a positive start to the month which saw the MSCI Emerging Market index up as much as 4.50%, risk aversion returned on renewed concerns of China's strategy to slow its economic growth and the re-emergence of sovereign debt risks after Greece's bonds were downgraded to junk status. Emerging markets equities ended the month up 1.21%, outperforming developed markets equities (MSCI AC World), which fell 0.2%.

Asian equities was the best performing emerging market region in April after underperforming last month. The region rose 1.2% on stronger economic data. Indonesia, Korea and Malaysia all outperformed and benefited from strong currency gains. China was one of the worst performing Asian markets due to property tightening.

Latin America was the worst performing region, falling 0.8% in April. Defensive Chile outperformed, but the regional index was dragged down by underperformance of Brazilian resources and Mexican financials.

EMEA equities fell 0.4% in April. Turkey outperformed again in April on fading domestic political risk. However, the regional index suffered from falls in Eastern European equities, which were hit by risks of contagion from the Greek debt crisis.

From a sector standpoint, information technology and consumer discretionary outperformed driven by strong 1st quarter earnings. Emerging market financials were the worst performer as financials were hit globally by worries over exposure to sovereign debt.

#### Market outlook

After the sharp recovery in stock markets in the spring and summer of 2009, the pace of improvement has clearly moderated into the spring of 2010. This reflects more complicated questions facing investors about the structural as well as the cyclical issues facing the world economy in the aftermath of the financial crisis. Valuation signals are no longer giving as strong a steer. They have been replaced by more nuanced analysis, i.e. the state of the earnings, monetary and regulatory cycles.

On a structural basis, investors are still trying to understand the extent of the adjustment that many countries will have to face, making for a complex interaction between economics and politics, which periodically will add to market volatility. One example is the sovereign debt risk pressures facing many OECD economies, exemplified by the crisis in Greece. Beyond the immediate concern about debt refinancing lies two deeper issues. The first is the lack of competitiveness in many European countries. On some measures countries such as Greece, Ireland, Italy, Portugal and Spain now have unit labour costs 20-30% higher than those seen in Germany. Improving their competitiveness will require years of real wage restraint and productivity improvements, negatively affecting end demand. Secondly, to deal with the sizeable public sector debt burdens built up in most OECD economies during the recession, governments will have to implement a tighter fiscal policy in order to limit the impact of onerous debt servicing levels. This suggests to us two likely outcomes: 1) the need to de-leverage by consumers and governments points to a muted upswing in domestic demand and economic growth outside the emerging markets space; 2) markets' volatility could re-appear at any sign of reform fatigue.



On a cyclical basis, even in a low inflation/low growth environment, there is a positive underpinning from corporate profits. Increased operational leverage reveals itself in the early stages of the cycle and allows profits and cash-flows to grow faster than nominal GDP. The early signs for this cycle are promising and hint at corporate earnings continuing to surprise, in the absence of policy error, and the foundations starting to be put in place for a sustained upswing in the business investment cycle. Global corporate EPS have largely beaten expectations this year. At the start of the year consensus expectations were for 2010 EPS growth of 29% versus 36% now. The 12m forward PE has fallen from 14x to 12.5x.

Our view continues to emphasise a low growth, low inflation and a low rates world for the OECD economies contrasting with strong growth and early signs of inflation pressures in selected global emerging market (GEM) economies. China, India, Brazil all face inflation pressures which are forcing their central banks to consider further monetary policy tightening.

In an environment of low global growth because of the low level of activity in the developed world, OECD sovereign debt risk and uncertainties related to the extent of the policy tightening in China, there are clear advantages in keeping our strategy well diversified. In particular, we think it is rational to reduce some of the portfolio's exposure to cyclical stocks whose earnings are leveraged to global growth and maintain our exposure to those stocks whose earnings offer better visibility that are driven by the strength of emerging markets and domestic demand (whose drivers - favourable demographics, middle income class growth, underleveraged consumer etc. - are well know and very powerful).

### Strategy

The strategy is overweight Russia, Mexico and Turkey funded by under weights in Brazil, Malaysia and South Africa.

The strategy is overweight the materials and consumer discretionary sectors. We are underweight consumer staples and the energy sectors.

In keeping with our core philosophy, we are seeking to maintain a fully invested, fully diversified exposure to the asset class. This does not mean we are looking to take risk out of the strategy, rather that we are trying to diversify that risk by country and sector.