



Global Emerging Markets

Monthly commentary

January, 2010

Market review

Following a reasonably positive start to the year, equity markets saw some profit taking to finish January lower. The MSCI Emerging Market index fell 5.6% vs. a 4.4% fall for AC World. Equities were hurt by concerns about Chinese monetary tightening, US banks over-regulation and by the increased risk of Greek debt default. Macro drivers turned negative: commodity prices were down 6% (as per the CRB Jefferies Commodity Index), oil prices fell 7%, EMBI spreads rose 30bp and the USD was up 2% (as per the DXY Dollar Index).

Albeit a difficult month for emerging markets, January followed six successive months of positive returns. The asset class is up 126% (as at January 31st) from the November 2008 low.

From a country basis, Brazil, a key exporter of commodities to China, was the worst performing market falling by 11% in dollar terms abetted by the 8% decline in the Brazilian real. Key drivers were Chinese monetary tightening and lower commodity prices. By the same token, Peru fell also by 10%. In Asia, Chinese policy announcements related to a stricter monetary policy dragged the Chinese equity market 8.6% lower.

EMEA was the best performing region for the second consecutive month, falling just 0.7%. Despite the decline in oil prices, Russia ended the month higher, buoyed by gains in the materials and financials sectors. The defensive market of Israel also posted slight gains. Turkey also performed well, up 2.4% on renewed hopes of a deal with the IMF and on cheap valuations.

With an increase in risk aversion, out-performing sectors in January were healthcare (-0.3%) and utilities (-1.3%). Consumer discretionary (-8.6%) and materials (-6.9%) underperformed.

Market outlook

Now that all the world's major economies are out of recession, the focus has shifted to the upturn and how strong it might be. Recent evidence of indifferent growth in the developed world and signs that China might be about to slow the pace of future expansion, caused concerns that the upturn - and as a possible consequence company profits - might be less strong than hoped in the upcoming years. These doubts are reasonable, but we should bear in mind that in months following changes of economic trend there is often changeable and sometimes conflicting data and that it will be some time before the real shape of the uptrend is clear. This background will keep equity markets volatile at times.

We continue to believe that the recovery of the global economy is ongoing, but we think that the acceleration phase, which was based on easy financial conditions, is over. In addition, the recovery will continue to proceed at different speeds in the various regions. We expect developed economies to grow at a subdued and below trend pace during the next couple of years. On the other hand emerging economies will grow at a much stronger pace driven by the BRIC countries. To talk numbers, the IMF in its latest projections (26th of January 2010) expects emerging economies to growth at 6.1% in 2010 and accelerate to 6.3% in 2011. While developed economies are expected to grow at 2.0% in 2010 and 2.4% in 2011.



We believe that the biggest risk to developed markets relates to managing their current account deficits and large balance sheets. Given the ample output gap, inflation will not be a problem in 2010 for developed countries. On the other hand, managing growth and inflation will be the biggest task for emerging economies. If emerging economies succeed in maintaining growth with limited inflation, we expect to see a further re-rating of the asset class given the higher growth rates relative to developed markets.

As far as financial markets, we expect them to be more balanced as financial conditions have improved since 2008/09. As it does, the broad market-directional themes that have been driving the markets in 2009 will likely need to be replaced by, above all, an emphasis on relative value and asset selection – in other words, to rely a little less on beta and focus on alpha.

Strategy

The strategy is overweight Russia, Mexico, Turkey and Thailand funded by under weights in Brazil, China 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.