



Global Emerging Markets

Monthly commentary

May, 2010

Market review

The MSCI Global Emerging Markets index fell 8.75% in May in response to the global de-risking process that has followed renewed sovereign debt and global growth concerns. No market or sector has been able to escape these trends, as would be expected in a sharp sell-off it was defensive sectors such as healthcare and staples that outperformed the more cyclical sectors such as commodities.

From a country basis, Mexico (-6.4%), China (-5.3%) and South Africa (-7.3%) outperformed. Russia (-11.4%), Turkey (-11.3%) and Korea (-13.3%) underperformed.

Outperforming sectors in May were healthcare (-4.60%) and consumers staple (-5.40%) while materials (-11.20%) and energy (-10.3%) underperformed.

Market outlook

The setback to equity markets over the past few weeks underlines the frailty of investor confidence; valuations are recognised as being low by historic standards and the recovery seems slowly to be gaining way, but the risks are high and volatility is expected to continue to remain high in the months ahead.

Investors are facing complicated questions 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 They have been replaced by more nuanced analysis, for example, the state of the earnings, monetary and regulatory cycles.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.

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 and 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 believe it is rational to reduce some of the strategy's exposure to cyclical stocks whose earnings are leveraged to global growth and maintain our exposure to those stocks whose earnings are driven by the strength of emerging markets domestic demand whose drivers (favourable demographics, middle income class growth and underleveraged consumer) are well known 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 the consumer staples and 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.