



Global Emerging Markets

Monthly commentary

October, 2009

Market review

October proved to be a volatile month for equity markets as investors began to assess the relative merits of the "reflation trade" in light of the expectations of higher interest rates in 2010 and of a potentially prolonged period of time before any significant earnings recovery emerges. The MSCI Emerging Markets index resumed its positive momentum during the first two weeks of October and reached a new 12 month high by mid month (MSCI EM index level 975.9, +6.75%) before some profit taking saw the market finish flat. The market has now rallied over 95% from its low in March 2009, but remains 33.0% off its high in November 2007.

On the corporate front, over 75% of NYSE listed companies reported third quarter results that beat analysts' expectations. On the economic front, the International Monetary Fund upgraded expectations of world economic growth for the first time in two years, to an overall +3.1% rate of expansion. The improvement was heavily biased towards developing economies, which are expected to grow by +5.1% compared with +1.3% in the more mature nations. Chinese GDP estimates certainly supported the suggestion of strong growth in the emerging economies. Third quarter growth was estimated at +8.9%, so strong that it sparked concerns of over-heating and speculation as to when the government might ease back the stimulus programme still in place.

Against this broadly positive backcloth, investors continued to embrace sectors with earnings leverage to an improving economy, although this theme now appears to be well owned and at risk of fading. The energy (+2.4%), materials (+1.60%) and financial (+1.1%) sectors outperformed while the information technology (-4.8%), utilities (-2.4%) and telecom (-2.4%) sectors lagged.

China outperformed on the back of stronger than expected domestic economic growth that resulted in higher commodities prices (the Jeffrey Commodity Price Index rose 4.5% during the month). As the main beneficiary of higher commodity prices, Brazil and Russia also outperformed. India, Korea and Taiwan underperformed.

Market outlook

After the rises of the past quarter, it is very tempting to take some profits and move to a defensive strategy - markets are, after all, up over 60% so far this year. We are not doing so.

Leading global economic indicators continued to suggest emergence from recession. Central bankers acknowledged the budding improvement, but given weak employment conditions in the developed world and the tentative flow of credit, they reiterated that removal of monetary stimulus likely remains a distant prospect. With liquidity worldwide staying flush and short-term investments offering a dismal return potential, funds continue to flow steadily into equities.

Within the asset class, emerging markets equities are in the "sweet spot" – global interest rates are low, the US fiscal position is taking its toll on the dollar (which supports commodities) and while developed market economies are improving, growth in emerging markets has already recovered and will continue to stay strong and stronger than that of developed markets for many years to come.



Two consecutive quarters of scintillating returns have swiftly reversed the despair that prevailed back in March and have now left equity markets measurably extended to the upside. A bout of profit taking could happen at any time, but even so, we expect any corrective activity to be short lived. Already paltry returns on short-term investments continue to erode, many investors continue to be sceptical about the recovery, short sellers are still abundant and the robust rallies in government and corporate bonds have made fixed income valuations much less competitive. With an average of 20-25% earnings growth to come in 2010 (risks to this consensus estimate are on the upside in our opinion), emerging equity ratings are not extreme and further progress does not require a re-rating.

Risks to watch include military escalation with Iran and an unexpected tilt towards central bank hawkishness, but the major economic trends still point to recovery. The chances for a broad array of earnings disappointments seem limited in the months ahead, and appear unlikely to reach dangerous levels until both expectations and share prices have accounted for recovery more fully.

Strategy

The strategy is overweight Russia, Mexico and Thailand, funded by underweights in China, India and South Africa.

We continue to maintain an overweight to the financials, energy (in particular exploration & production) and consumer discretionary sectors. We are underweight consumer staples and the information technology 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.