



Global Emerging Markets

Quarterly commentary

June, 2010

Market review

With the well publicised problems in Europe, more concerns of a “double dip” and further evidence of a slow-down in Europe, it is no surprise that emerging markets fell in the second quarter. Since commodities also fell and the dollar rose perhaps the surprise was actually that the markets didn’t fall more – the 8.4% decline being slightly more modest than the fall of developed markets. As one would expect, the commodity and high risk markets led the way down – Russia and Brazil both fell an above average 15%, but it was Eastern European markets that bore the brunt of the worries – Hungary fell 32%, Poland 22% and the Czech Republic 14%.

Market outlook

Markets have plenty to worry about (whenever that statement is not true investors should sell!). Globally, the travails of Greece and the consequent health of European banks continue to provide a negative backdrop. Recent disappointing data out of the United States meanwhile raises again the possibility of a “double-dip”. Clearly if the Euro broke up or if the Western economies moved back into recession markets would indeed fall – and emerging markets would suffer more than most as befits their status as “high risk” assets. We just do not believe either of those events is likely – we are working on the assumption that central banks and governments will “do what it takes” to head off such cataclysms. More parochially, the slowdown in China has impacted confidence, especially in commodity dominated markets such as Russia and Brazil. Again, we are in the bullish camp. China is indeed slowing – but from 11-12% to 8-9%. The slowdown marks a return to trend and a renewal of the re-balancing of the Chinese economy away from infrastructure spending towards consumption led growth. This change does have negative consequences for commodities, but it is nevertheless good news, not bad – the last thing China or the rest of the world needs now is an unsustainable binge in one of the worlds largest growth locomotives – to be followed by a painful crash.

So, we are relatively relaxed about all the big worries facing markets. On the more positive side, we are assuming developed economy interest rates will stay very low for the foreseeable future and, importantly, we are assuming corporate profits in emerging stocks will continue to benefit from the growth in their domestic economies despite a slow-growth environment in developed economies. It is worth quoting some numbers here: consensus earnings growth for emerging markets show a rise of 43% for this year (after a fall of 11% last year) and 20% for next year (source: Morgan Stanley, IBES, all numbers in USD). Our own numbers are marginally higher still. The actual numbers will of course differ from this consensus, but the trend and the general magnitude will not alter if we are right on the macro-economic environment. Using consensus numbers emerging markets trade on under 10x next years earnings – a discount to both their own history and to developed markets. Given continued low bond yields these valuations look too low.



Strategy

The strategy is overweight Russia, Mexico, Turkey and Thailand funded by under weights in Brazil, China and South Africa. We are looking for opportunities to increase India to an overweight position – probably funded from Taiwan.

The strategy is overweight the consumer discretionary sector. We are underweight the 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.