

## Global Emerging Markets

### Quarterly commentary

March, 2010

#### Market review

Global equities produced a decent return in the first quarter, but it was hard work. Good micro news (on profits) eventually managed to overcome bad macro news (on sovereign debt).

Global equity markets were hurt early in Q1 by Chinese policy tightening, the risk of Greek debt default and fears over US bank regulation. Emerging market performance was more negatively impacted by worries over rising emerging market inflation, a 4% rally in the US dollar and 4% decline in commodity prices and the fact that most investors entered 2010 overweight emerging market equities. Emerging market equity recovered in March thanks to the quiet recovery in US consumption and strong emerging market debt (spreads fell to 251bp versus US Treasuries, the tightest since June '08).

The MSCI Emerging Markets index ended the quarter up 2.45% in dollar terms, slightly underperforming the MSCI World Free index (up 3.0%). However, it was a roller-coaster ride. At one point, the benchmark index was down 8%.

From a country basis, Russia (+6.7%) and Mexico (+7.8%) outperformed driven respectively by accommodative monetary policy in Russia and better than expected US economic data. China (-1.6%) and China-sensitive Brazil (flat) underperformed, hurt by concerns over Chinese fiscal and monetary policy tightening.

Out-performing sectors in the first quarter were healthcare (+12.1%) and materials (+5.30%), while information technology (-0.10%) and utilities (1.30%) underperformed.

#### Market outlook

Most emerging economies have rebounded from the Great Recession more vigorously than analysts' forecast six months ago. Emerging market economies are now expected to grow 6.3% in 2010, more than twice as fast as developed markets (+2.5%), driven by growth in domestic consumption and a pick-up in world trade.

Looking further ahead, as the US and other developed markets economies continue to recover, the cyclical outlook for emerging markets gets even better.

Although growth in developed economies is and will continue to gradually pick up, developed markets will also have to contend with:

- 👑 Unprecedented large fiscal deficits and potentially rising risk premia for their sovereign debt. The cases of Portugal, Ireland, Greece and Spain are well-known, but increasingly investors may be focused on large markets like the UK and the US.
- 👑 Still fragile banking systems, further write-downs by financial intermediaries of real estate and other loans (commercial properties loans in particular) are still possible.
- 👑 A sub-par recovery, stubborn unemployment and a painful de-leveraging process that may take several years.
- 👑 Multi-year politically contentious fiscal adjustments.



On the face of it, these factors alone enhance the medium term attractiveness of emerging markets. High savings rates, relatively low rates of consumer, government and corporate indebtedness and the potential for a commodity super cycle in emerging markets, all enhance the story.

Supported by the aforementioned favourable economic backdrop and interest rates that will remain low in developed markets, we also expect emerging markets equities to do well in 2010 while being more bottom up driven than in 2008/09 as financial conditions along with earnings visibility have improved since then. 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 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.