



Global Emerging Markets

Quarterly commentary

Q3, 2009

Market review

The MSCI Emerging Markets index rose 21% in the third quarter of 2009 and has surged 60% in Q2/Q3'09, making them the best two quarters of return on record. Year-to-date the MSCI Emerging Market index has risen up 61.2% driven by the strong performance of Brazil (+97.0%), India (+86.4%) and Russia (+81.4%).

Emerging Markets currency returns, as per the JP Morgan ELMI Index (a basket of 24 EM currencies), rose 4.4% in Q3; EMBI spreads fell 98bp to 327bp; commodity prices, as per the CRB index, edged up 3.8% in Q3 and oil prices rose 1% during the same period. Global credit markets rather than China and commodities were the main drivers of the strong equity performance during the third quarter. EMEA equities (+20.0% in Q3) benefited from a recovery in Europe and the rally in global bank stocks; LatAm equities (+24.0% in Q3) continued to be buoyed by lower rates, risk appetite and global growth upgrades; Asia (+18.7%) was held back by worries over China policy tightening.

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 markets 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 is on the upside in our opinion), emerging equities 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, Israel 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. We are further increasing Russia, Mexico and Technology, funded by reductions in Israel, Czech Republic and Malaysia.

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.