

Global Emerging Markets

Quarterly commentary

December, 2011

Market review

Despite a reasonable bounce of 4.5% in the final quarter, 2011 was a poor year for emerging markets. The 18.2% decline was not only one of the weakest years for the asset class but also only the second time since 2000 that emerging equities underperformed developed markets.

The fact that both emerging corporate and sovereign debt continued their trend outperformance suggests markets were signalling concerns about growth and/or earnings rather than any significant deterioration in underlying economic or political fundamentals. At a regional level EMEA was the worst performer both during the month and for the year as a whole but the differences were not large; Asia, the best region declined by 19.1%, not much different from the 22.6% decline for EMEA.

At the country level the smaller markets bounced most in the last quarter, Malaysia, Thailand and Peru all showing double figure returns. Turkey and India (both suffering from the consequences of overheated domestic economies) were the worst performers, down 15.7% and 14.2% respectively.

Market outlook

First, some numbers. Consensus (IBES) forecasts for 2012 suggest EPS growth of 10.2% for 2012 – a bit less than nominal GDP growth. These numbers are some 4% less than the estimates from 3 months ago. At current levels this means emerging markets are, in aggregate, valued at 9.7x 2012 earnings. This is the low end of the historic range for valuations; interestingly on each occasion in the last decade that prospective multiples have moved into single figures then market returns over the following year have been very strong:

Year	Forward P/E at beginning of year	12 month US\$ return
2009	8.0x	78.5%
2005	9.4x	34.0%
2012	9.7x	?
2003	10.0x	55.8%

Source: Factset

We believe the balance of probabilities suggests this pattern can be extended for a fourth time but of course there are risks to offset the rewards.

Risk 1: Europe. A major breakdown in the European banking system would have knock on effects on emerging markets.

Risk 2: Middle East. Renewed tensions around Iran added to instability in Iraq, Syria and Egypt.



Risk 3: Hard landing in China. We do not expect China to have a hard landing. The government has already started easing modestly (e.g. RRR cuts in November) and we expect more measures in 2012. That said growth has been slowing in response to previous tightening and sharp slowdowns in global trade and we expect Q1 numbers to signal a slowdown, especially from exports. This slowdown should not be a big surprise – it has been well signalled by PMI numbers and other leading indicators. Nevertheless when the figures are announced (maybe including a y-o-y growth rate starting with “only” a 6) it could add fuel to the fire for already nervous investors. We believe that the Chinese authorities have enough ammunition to prevent this slowdown accelerating into a hard landing. The worse the numbers, the more vigorous the policy response will be and so, overall, we maintain our view that China will maintain its growth at a rate sufficient to keep job creation plentiful. China is and will still be the locomotive for emerging markets.

Risk 4: The fabled “Black Swan” – an unforeseen problem.

The first three risks are well known and well researched and we have commented on them all over recent months. Our position is that, in the end, none of these problems will escalate into a worst case scenario and markets will then re-rate to more normal valuation levels as perceived risks abate.

Strategy

As explained above, we do not share markets’ current pessimism about the prospects for growth in emerging markets. Our forecast returns for emerging assets on a one year view remain high. As a consequence, the portfolio is overweight to risky assets. We acknowledge that we may be early, but if/when confidence begins to return the response will be instant – it will very quickly be “too late” instead of “too early”. More fundamentally, we have to acknowledge that we will be wrong if the current bout of jitters on any or all of the risk factors listed above deteriorate into a genuine crisis.

The portfolio is overweight Russia and Argentina, funded by underweights in South Africa, Chile and Taiwan. There are more significant divergences at the sector level. The portfolio is overweight the consumer discretionary sector and underweight consumer staples and energy. It should also be noted that within the materials area there is no exposure to gold stocks, which are negatively correlated with most other material stocks.