



Global Emerging Markets

Quarterly commentary

June, 2011

Market review

After a bright start in April, sentiment deteriorated through May and into June as investors grappled with credit downgrades for Portugal and Greece and weaker economic data from the West. Yet again events from outside the emerging world took centre stage. The fact that the MSCI EM Index fell a mere -1.04% over the second quarter, hides the picture of yet another volatile quarter. Greece dominated the headlines and market attention with a “will-they-won’t they” confidence vote for the prime minister followed by a crucial vote to ratify a \$40bn austerity package. The passage of the latter helped global equity markets rally into the last week of the quarter. Also helping markets at the end of June was the surprise release of oil inventory (supposedly to make up for lost production from Libya) by the International Energy Agency. The resulting dip in the oil price is seen as some relief to the weak growth in developed economies.

Chile (+8.8%), Indonesia (+8%) and Colombia (+5.9%) were the best performing markets. Amongst the worst performers were Peru (-15%) as former army commander Ollanta Humala unexpectedly won the presidency sending asset prices tumbling. Turkey was also weak (-4%) as rising inflation concerns and a deteriorating currency outlook hit the market.

Market outlook

Farewell and adieu to Quantitative Easing 2! The US Federal Reserve bond purchase plan ended on June 30th. Will we see the third instalment to make a trilogy? Our current feeling is that the US recovery is still firm enough that version three is not yet contemplated – a big spike up in unemployment (accompanied by a big leg down in asset prices) would probably be a necessary condition.

On Greece, we see some sort of “restructuring” as almost a foregone conclusion. But the moment of reckoning will be pushed into the future with yet another bail out (the use of the analogy of “kicking cans down the road” is as battered as the can!). In the short term this should allow the market to worry about something else for a while.

We have not changed our medium-term view - namely that we continue to expect stable global growth, driven by China and the rest of the emerging economies. As before, we believe that the Chinese authorities will succeed in a “soft landing” of the economy (we define this as a higher than 6% GDP growth rate). Its worth noting that China is finding it tricky to slow an economy with a lot of growth momentum – any worry about a hard landing would likely see the authorities willing and able lift their foot off the brakes a little. Compare and contrast with the West, where growth is going through a soft patch despite extreme monetary stimulation such as the aforementioned Quantitative Easing programmes.

Inflation and the policy response to it continues to be the main issue we are focussed on within the emerging world. Some countries continue to look behind the curve i.e. Turkey. Signs are that we are close to a peak in many of the other economies we follow, but that does not mean that rates can then fall. They will stay elevated. Contained inflation at a higher level can be positive for EM equities if currencies stay stable (i.e. appreciate in real terms).

Finally valuations; EM equities are trading at 10.6x forward earnings, compared to a five year average of 11.8x (including the 6x low of the 2008 global financial crisis).



Strategy

The strategy is overweight Russia and Argentina, funded by under weights in South Africa, Chile and Taiwan. There are more significant divergences at the sector level. The strategy is overweight the consumer discretionary sector and underweight consumer staples and energy.

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.