



## Global Emerging Markets

### Quarterly commentary

September, 2011

#### Market review

Investors definitely needed hard hats and strong stomachs during the third quarter. MSCI EM Index fell 22.46% over three months and underperformed the World index by some 6%. Investor sentiment was battered by a trilogy of worries – Euro sovereign debt, slowing Chinese economic growth and fears of a second US recession. After a weak August, falls in emerging markets were exacerbated in September by a flight to the perceived safety of the US Dollar - the resulting outflows of capital led to emerging market currencies falling by -7.8% against the USD, including some dramatic moves in the Brazilian Real (-15.5%) and South African Rand (-13.7%) over the month.

Over the quarter there was little to provide shelter from the storm, with no market, sector or country able to provide a positive return in US Dollars. Asia was the best performing region (-13%) followed by EMEA (-17.3%) and Latin America (-17.5%), as the latter two regions bore the brunt of currency weakness in the last weeks of the quarter.

Peru (-5.2%), Philippines (-7.7%) and Morocco (-9.6%) were the best performing markets, with Hungary (-44.1%), Poland (-34.7%) and Russia (-31%) the worst. Hungary and Poland are the two countries within emerging markets with the most direct exposure to the Euro zone and Euro.

Telecoms (-11%) and Consumer Staples (-13.3%) provided the best relative sector returns as investors sought the safety of these defensive areas. Conversely, economically sensitive sectors such as Industrials (-29.6%) and Materials (-28.2%) fared worst.

#### Market outlook

When looking at the problems of developed economies the only thing that we can be sure of now is that there is no magic wand that can be waved to make the problems disappear – we are in for a prolonged period of uncertainty. For the time being the direction of emerging markets will be determined by developments in peripheral Europe and on Wall Street. For most of the last two years our central scenario has been that the West will “muddle through”, thus providing a background of low interest rates and low growth from developed economies. The risks of a worst case outcome – namely a second credit crunch, a double dip in the United States and the possible disintegration of the Euro have clearly risen.

The pressure on European politicians (especially in Germany and France) to “do something” about Greece has been building steadily as the economic environment deteriorates. They probably actually welcome that pressure, since it makes it easier for them to sell the eventual rescue package to their own electorates. Our bet is that they will, belatedly, succeed in insulating Spain and Italy from Greek contagion.

We have not changed our medium-term view - we continue to expect solid growth in emerging economies, driven by China, and slower growth in the West. As before, we believe that the Chinese authorities will succeed in a “soft landing” of the economy (we define this as a higher than 7% 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 to 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.



## Strategy

We do not share markets' current pessimism about the prospects for growth in emerging economies and we were already anticipating a low-growth environment in developed economies. Our forecast returns for emerging assets on a one year view are now as high as they were in the 2008 crisis. As a consequence, we have increased the sensitivity of the portfolio to risky assets by reducing outperforming "defensive" stocks and increasing exposure to growth sensitive stocks. 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 turns into a full blown credit crisis along the lines of 2008. At that time, emerging markets underperformed developed for about six months, and took another six to claw back the losses.

During the weak markets of August and September we have, at the margin, reduced exposure to defensive sectors such as consumer durables, with the funds being employed to add to hard-hit high conviction stocks in areas of the portfolio more sensitive to economic growth. 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.

Given the highly correlated "risk-on, risk-off" nature of markets at the moment, it may be useful to outline the "top down" perspective reflected in the portfolio.

Global environment: Continued low growth and low interest rates for the foreseeable future. Possible "double dip", but a gentle recession – not a depression.

Europe and the Euro: No uncontrolled break-up of the Euro. Politicians eventually succeed in putting together a rescue plan for Greece, probably in line with the recently leaked proposals of 40-50% write-downs on Greek sovereign debt. Italy and Spain do not follow Greece into restructuring.

China. No hard landing – growth is slowing, but this is good, not bad, and we still forecast 8%+ this year and next.

Rest of emerging world: Economic activity and corporate earnings growth are slowing, but only modestly. Provided we are right on the global environment, we expect both to surprise current consensus on the upside.

Of those factors it is the problems of the Euro that are the most difficult to predict. If we are wrong and this situation deteriorates far enough to break up the Euro, it would trigger unsolvable liquidity problems in the global banking system. This would obviously be catastrophic for both developed and emerging economies. In such an eventuality, emerging markets would be impacted more severely than we now anticipate and our strategy will suffer accordingly.