



Global Emerging Markets

Quarterly commentary

Quarter 2, 2009

The second quarter of 2009 saw a significant shift in investor sentiment; from the extreme risk aversion that followed the collapse of Lehman Bros in 3Q 2008, to the strong rally across global equity markets after the initial stages of stabilisation (green shots) began to emerge towards the end of March 2009. Stock and sector preferences shifted with risk aversion. During the second quarter of 2009, investors that had moved into defensive stocks in 2008 up until the end of March 2009 aggressively switched into cyclical stocks with earnings leveraged to a recovery in the economy. Commodity prices also moved in line with global growth expectations, declining sharply during 1Q09 to experience a strong recovery from March onwards on expectations that the restocking phase had commenced.

The MSCI Emerging Market index rose 34.8% in Q2, the second strongest quarter on record (Q1 1991 +36.8%), on (i) the return of risk appetite globally due to signs of economic recovery, (ii) rising commodity prices, with CRB up 8.1%, (iii) falling USD, and (iv) massive liquidity pumped into the financial system by central banks and governments. Emerging markets continue to behave as a higher beta play of developed markets, outperforming the MSCI World Free index by over 1200bps.

Of the main countries, Russia (+38.0%), Brazil (+41.0%) and India (+59.8%) outperformed on the back, respectively, of the recovery in commodity prices and a market favourable outcome in the Indian presidential election. As in other cases when commodity prices have been strong, Asia underperforms: China (+35.8%), Taiwan (+25%) and Korea (+25.1%) lagged in 2Q 2009.

Stock and sector preferences shifted with risk aversion. Financials (+46.8%), Consumer Discretionary (+46.2%) and Materials (+37.0%) outperformed while Healthcare (+15.3%), Telecoms (+21.3%) and Consumer Staples (28.2%) underperformed as investors moved into more cyclical stocks.

In terms of the outlook for the market, let's begin first with the negatives: emerging markets have risen 70% from their lows and 37.5% YTD, thus recouping all of their falls relative to developed markets. Valuations have risen sharply – both in absolute terms (around 13x 2010 P/E) and in relative terms (ratings are roughly comparable with the US). Cash inflows into the asset class have been massive – the \$26bn inflows of the last 11 weeks exceed inflows for the whole of 2006. Retail investors have again been heavy investors in emerging markets. Institutional investors have moved from a net underweight position in emerging markets to their highest ever overall overweight (source ML Fund Managers Survey, May 2009).

Tactically, all those factors suggest it's time to be contrarian and move more defensively.

However, such short term tactical views conflict with a much more positive longer term strategic view. As we have written many times in the past six months, we remain positive about the medium term prospects for both emerging economies and their markets and, despite the massive bounce, the MSCI Emerging Index is no higher now than it was this time three years ago. We read that the ECB is forecasting a decline in EU growth of 4-5% this year and another 1% decline next year. Japan is little better and the US and the UK have avoided similar fates only by massive quantitative easing. In contrast, the combination of lower interest rates and relatively modest stimuli has proved enough to boost growth forecasts for most of the larger emerging economies into the 3-6% range. Against this background our feeling is that any setback will be relatively modest and therefore, our short term fears of a correction are not leading us to change the risk profile of the strategy.



In summary, we believe markets will be higher than they are now in a year's time and that any setback in the interim will not be big enough to justify a defensive strategy.

On a country basis, we have closed our underweight in Mexico funded by existing cash and by reducing Malaysia, and are now overweight the country. We continue to be overweight Russia, India and Thailand funded by China, Korea and South Africa.

We continue to maintain an overweight to the Financials, Energy (in particular Exploration & Production) and Consumer Discretionary sectors. We are underweight the Consumer Staples and the Information Technology 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.