2009Q4 **Outlook**

EMERGING MARKETS EQUITY / OCTOBER 2009

Optimistic in the Medium and Long Term

Emerging markets equities continued their impressive recovery in the third quarter of 2009, as credit and global equity markets, as well as investor sentiment, showed significant signs of improvement. Remarkably, every sector and every country but Morocco rose over the quarter, while stable prices continued in many commodities, and crude oil remained around $70 per barrel.

Relative to the MSCI Emerging Markets Index, we presently have higher exposure to countries such as Brazil, Mexico, Indonesia, Egypt, Turkey, and South Africa, and lower exposure to China, as we believe valuations in companies in those emerging markets, compared to their level of profitability, are more attractive than those of Chinese firms. On a headline P/E basis, China's market does not appear to be exorbitantly expensive relative to the rest of the emerging markets. However, China's large exposure to the financials sector skews the headline valuation, which we believe makes it appear cheaper than it actually is. When comparing across sectors within emerging markets, as we do, it becomes clear that Chinese companies trade at premiums and often have either similar or lower profitability versus their sector peers elsewhere among the emerging markets.

Also, while it is true that China has consistently grown faster than most of its global peers over the past 10 years, the best-performing markets during that period have been countries with much slower growth rates, like Brazil, Egypt, Russia, India, and Mexico.[1]

Nevertheless, it is important to stress that we have a positive view on China's macroeconomic outlook. Indeed, we see the Chinese economy as crucial at this moment, given that it is still growing while much of the rest of the world economy is contracting. However, it is not only China that benefits from strong Chinese growth. The positive impact is global, affecting certain countries and sectors more than others. Cognizant of that, we are analyzing the impact of China's strong domestic growth on domestic companies as well as on foreign companies in other emerging markets. For example, we see companies like Kumba Iron Ore, a South African iron producer, First Quantum Minerals, a Canadian copper mining company active in Congo and Zambia, and Grupo Mexico, a Mexican mining company, benefiting from the increased demand for metals deriving from Chinese economic strength. Similarly, we see companies like Hon Hai Precision Industry, a Taiwanese electronic components manufacturer, HTC, a Taiwanese producer of smartphones and mobile computers, and Oriflame Cosmetics, a Swedish direct-sales cosmetics company active in emerging markets, benefiting from China's low-cost manufacturing base.

At the sector level, given the large rises in the more economically sensitive sectors like materials and energy, we find higher value in more defensive areas, such as consumer-related sectors and telecom services.

We remain reasonably optimistic about emerging markets in the medium and long term, but are concerned, and therefore neutral, in the short term. Valuations have increased considerably due to a dramatic change in investor attitudes—from deeply bearish six to nine months ago, when we were bullish about the outlook, to widely enthusiastic now. We would therefore advise investors not to be aggressive at this time.

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NOTES:

1. Source: MSCI Emerging Markets Index.

Published on 15 October 2009.

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