April 2011

Outlook on **Emerging Markets**

Emerging markets underperformed developed markets during the quarter. The asset class has come under pressure as economic growth has begun to recover in the developed world, and subsequent growth in the developed world is forecast to be at a higher pace than had been expected. This recovery has resulted in fund flows rotating from emerging to developed markets, with the emerging markets equity asset class showing fund outflows in 2011, after a record pace of inflows in 2009 and 2010. Investors' focus on mature economies was also influenced by negative events in the developing world, where investors were concerned about the political instability in the Middle East and inflationary pressures, which caused market weakness. However, we believe that emerging markets' central banks will be vigilant in addressing recent inflation trends. We remain confident in the emerging markets' robust fundamentals, and we believe that the longer-term outlook for the asset class is bright.

Equity

The Middle East instability created a marked increase in oil prices to over $100 per barrel. While the future political shape of the Middle East and North Africa is unknown, it is reasonable to believe that oil prices may continue to be strong and their effect on economic activity has become much more relevant. A robust oil price is not universally negative for the asset class, with Russia and other commodity countries being the prime beneficiaries. However, many of the Asian economies import oil and might be negatively impacted. Beyond the question of "how high for how long", we need to examine if the increase in oil prices can be passed on to consumers. Some countries subsidize the price of energy, so that the impact on the population is mitigated, but this can result in a weakening of the fiscal position of the country. The most likely countries to implement this strategy are Indonesia, India, and China.

From an earnings growth perspective, we believe we may see increased earnings from the oil companies. However, cost pressures may surface for most other sectors that are reliant on oil, oil derivatives, or other commodities. Many of the companies are unable to pass on these costs in full, and margins will be squeezed. The same can be said following any potential supply bottlenecks as a result of the Japanese disaster. Some companies will see volume growth negatively impacted, as they are unable to purchase the necessary materials or experience margin pressure as these components become scarce due to the lack of supply. However, some of the Asian refiners could benefit in the short-term due to the substantial Japanese capacity that has been temporarily shut down, resulting in higher demand for liquefied natural gas and refined oil products.

From a perspective of profitability and valuation, the effect of the recent spike in oil prices has led to an improvement to the revenues of upstream oil and gas exploration companies, resulting in an outperformance of the energy sector in recent months. However, in our opinion, the effect on bottom-line earnings is expected to be curtailed by large capital expenditure programs as many of these companies hike spending in an effort to maintain reserves by drilling in more remote areas where it is difficult to access hydrocarbon sources. In some cases, such as Petrobras in Brazil, a significant portion of this spending is on building downstream refining assets, where margins are relatively low.

In addition to rising oil prices, inflationary pressures in emerging economies are building fast. The increase in food prices across the world continued to contribute to an overall rise in consumer prices, with emerging markets being the most affected. Given stronger economic activity in these countries, a more robust policy response is likely. We believe that some of the causes of higher food prices are short-term, but the trends driving structural change in world food markets, along with the rise in living standards within emerging markets will not be easily reversed.

The impact of the Japanese disasters is still being determined, as is the extent to which this will negatively impact economic growth. With increasing Asian trade, we may see a slowdown in exports and imports to and from Japan. However, we view any disruption as near-term

and not a long-term headwind. So we see growth slowing or deferred, but not eliminated, as a result of the situation. Commodity companies might see lower demand for metals, given that Japan's industries are heavy users of these materials. Other potential beneficiaries of the unfortunate events could include Korean industrial companies, such as auto manufacturers, as well as Korean and Taiwanese semiconductor manufacturers that typically compete with Japan in these areas. Japan has temporarily shut down capacity in these industries as they inspect facilities for damage from the earthquake. On the other hand, many of the information technology companies in Asia that rely on components from Japan may be negatively affected as deliveries are delayed. In the longer-term, we can expect the monumental reconstruction effort to result in higher demand. On the whole, though, we do not expect the situation in Japan to have a meaningful effect on the profitability of emerging market companies.

With the underperformance of emerging market equities, compared to developed market equities, we believe the asset class remains attractively valued. Forward valuations, which had experienced a narrowing of the discount to developed markets in 2010, have now expanded to greater levels. The record investor inflows in 2010 and the possibility of major corporate issuance have tempered our short-term enthusiasm. However, recent investor outflows are a sign that speculative capital is leaving the asset class. Therefore, we believe that investors with long-term investment horizons should maintain an exposure to this asset class.

Fixed Income

From a local currency fixed-income perspective, we believe that performance dispersion by country will likely continue, with differentiation largely explained by the fiscal and monetary policy response to balance of payments, inflation, and growth trends. As we have mentioned before, the macroeconomic data has prompted notable hawkishness from emerging market central banks, resulting in numerous interest rate hikes, as monetary policy normalization takes hold. This policy shift should be generally supportive of local currency fixed-income investments via higher yields and selective tolerance for currency appreciation, barring a significant shock to global risk appetite or a very dramatic spike in oil prices, which may evoke growth concerns globally. The foundation for attractive local currency fixed-income risk-adjusted returns derives from our high conviction views governing the emerging market growth drivers and their sustainability, as well as the increasingly divergent monetary stance relative to the developed world. We also believe that the frontier markets should continue to play a valuable role in local currency debt absolute returns.

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