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Outlook on **Emerging Markets**

Economic activity in emerging markets continues to be robust, while growth in the developed markets has been subdued due to consumer deleveraging and sovereign debt issues in Europe and in the United States. Recently however, the emerging markets asset class has been facing headwinds to growth, specifically, rising inflation and speculative inflows of capital. Over the first half of the year, we believe that contractionary monetary policy has been an impediment to growth in many countries.

The European debt crisis is having a negative influence on global growth, due to contagion fears. This is having an impact outside of Europe given that the global economy is so finely interconnected. Some of the indirect effects of the crisis, including increased volatility in global financial markets, the higher risk of interbank funding, cross-border deposit flight, and deleveraging of the peripheral European countries' subsidiary banks within the emerging markets are also factors. While we remain confident in the emerging markets' robust fundamentals, we are keenly aware that a potential default of the debt in any of the peripheral European countries would be expected to cause chaos in global markets and, in our view, emerging markets should not be considered as a safe haven.

Equity

Inflation and the ensuing policy responses across emerging markets countries continue to be the main concern for investors, and the emerging markets banks are caught in the middle of macroeconomic and government policy. While underlying demand for loans is high, governments have resorted to measures beyond raising rates to slow growth. Hiking reserve requirements and setting loan growth quotas highlight the extent to which countries would like to see banking growth slow. As such, we expect banking growth to moderate in the future.

We also see wage pressure in many countries, notably in China, India, and Brazil citing this as a cost that remains stubbornly high. With inflation running high, and borrowing costs increasing, we feel this is a tough environment for investors. In addition, we are cautious observers of the growing optimism with respect to fixed asset investment in China and the 2016 Olympics in Rio de Janiero.

None of the banks in our flagship Emerging Markets Equity strategy have meaningful exposure to the sovereign debt of troubled European peripheral countries such as Portugal, Ireland, Italy, Greece, and Spain. Indeed, for the most part, we believe that the direct effect of the crisis on emerging markets economies is minimal with the bulk of these peripheral European countries' bonds being held by developed market European countries, such as France, Germany and Belgium. The shift in risk perception of emerging markets versus developed markets is underlined by the recent outperformance of even low-rated emerging market sovereign debt in nations such as Ukraine, Bulgaria, Lithuania and Romania over those of these troubled European peripheral economies.

Chinese equities have also underperformed recently. We believe that this underperformance is primarily a result of investors' fears of a slowdown in the local economy as interest rates and banking reserve requirements were lifted by the central bank in response to higher inflation levels, and due to concerns over high real estate valuations. Valuations in China are beginning to look more attractive, in our view, and we have been adding modestly to our exposure in our Emerging Markets Equity and Discounted Assets strategies as we explore additional investment ideas.

From an earnings growth perspective, we view the potential of Chinese companies to remain strong as the country continues its infrastructure build-out. We also remain positive toward those companies who have exposure to this capital spending. We therefore have been adding to our Chinese exposure in our Developing Markets Equity strategies, particularly companies within the industrials, materials, and technology sectors as they became increasingly attractive to us during the second quarter.

In our Discounted Assets strategies, we have added to positions during the recent underperformance in China and Hong Kong based on what we believe to be attractive valuations and fundamentals. Importantly, our exposure to China is through holding companies and investment funds that trade, on average, on a further discount of 16% which further supports our thesis as to the attractiveness of China today.

Beyond China, the continued instability in the Middle East and energy prices continue to make headlines as well. From a profitability and valuation perspective, while the revenues of upstream oil and gas companies benefited from the spike in oil prices earlier this year, the effect on profitability was moderated by large capital expenditures in many of the energy firms as they pursued additional reserves and production. Despite its recent underperformance, we believe that the sector is looking more compelling and we have been reviewing our investment options in our Emerging Markets Equity strategies. This is particularly evident in Russia where equities have been volatile year-to-date, driven by political and corporate governance concerns, as well as the volatile commodity trade.

Overall, given attractive fundamentals and reasonable valuations, we remain relatively optimistic in our long-term outlook for emerging markets. However, we acknowledge that inflationary pressures, record recent investor inflows, and the possibility of substantial equity capital raising could act to moderate returns in the near-term.

Fixed Income

The situation in Europe's periphery is far from resolved a year into the crisis. A Greek default is a left-tail risk that we are watching closely, as such a default is likely to have a negative impact on markets, not only in Europe, but throughout the developed world and emerging markets as well. We are also closely monitoring data releases that appear to indicate stagnant U.S. growth and cooling growth in China. We expect inflation to pause in the near term, but this is likely to be transitory, due to year-over-year base effects. While we are watching the data carefully, we do not anticipate a hard landing in China or a double dip in the United States just yet. Policy response to these data points will likely vary from country to country and have differing levels of success.

From a local currency fixed income perspective, we believe that strong emerging markets economic growth and credible tightening responses should support returns via rising short-term interest rate differentials, relative to those in developed markets, complemented by selective EMFX gains as well.

We believe that markets will remain volatile and will likely continue to trend downward until one of three macroeconomic conditions is met: (1) Economic data begins to reverse and surprise to the upside; (2) Expectations and asset prices correct to a point that negative data is fully priced in; or (3) A new round of fiscal or monetary stimulus is announced in the United States and/or fiscal or monetary tightening eases in China.

If none of the above scenarios materialize in the near term, we believe markets may easily experience draw-downs similar to those seen in the summer of 2010, in which emerging market debt spreads widened to 340 basis points, and emerging market currencies sold off 5% to 10%. We have already witnessed some of this negative market movement in May and June, however, most market participants continue to believe that market data will imminently improve.

From an emerging markets debt and currency perspective, we still believe that sovereign debt spreads have further to tighten and the general re-rating of EMFX versus developed market currencies will likely continue. While we expect near-term volatility in global markets, we believe that a short-term correction may create an opportunity for emerging markets to have a robust second half of 2011, the magnitude of which will be determined by growth, stimulus, and asset price conditions.

Over the next 12 to 18 months, we believe that the outlook in emerging markets remains relatively strong and that growth rates will slow to a healthy level. Furthermore, we continue to expect headline inflationary pressures to subside as growth declines marginally and liquidity tightening measures work their way through emerging markets economies. Perhaps most importantly, we believe that valuations are reasonable in emerging markets, given this backdrop.

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