

January 2012

# Outlook on **Emerging Markets**

In the fourth quarter, emerging market equities continued to be dominated by macroeconomic and political concerns stemming from the debt crisis in Europe, despite the asset class's more resilient growth prospects. Despite returning slightly positive results for the fourth quarter, emerging market equities experienced sharp volatility and high correlations during this time. We expect that these conditions will most likely persist in the short term, given concerns about issues surrounding Europe, the United States, and China. Meanwhile, global headlines were dominated by the European sovereign debt crisis. Europe's leaders appear to have agreed in principle to leverage the European Financial Stability Facility (EFSF) in order to help stabilize debt markets, and Greek bureaucrats have also agreed to large austerity measures. Despite these positive signals, many investors were increasingly concerned about the high levels of indebtedness in Italy's \$2 trillion economy. The yield on Italy's 10-year government debt exceeded 7.0% over the quarter, with all eyes now focused on the large principal payments due in early 2012. We continue to hold the view that Europe and the United States are in a period of prolonged deleveraging, which we believe translates into muted growth for these countries. On the other hand, we believe that emerging market countries should continue to grow at relatively healthy rates, albeit at a slower pace than was recorded prior to the financial crisis in 2008.

In Asia, China's economy performed better than many had expected, which the market viewed as news that the country will be able to manage a soft landing. Furthermore, India's central bank announced further interest rate hikes to combat inflation, and its ruling party began to pass anti-corruption legislation. North Korea's long-serving leader Kim Jong-Il passed away in December, sparking concerns about economic and political uncertainty. Tensions between the United States and Pakistan continued to mount after a NATO strike resulted in Pakistani military deaths.

In Europe, the Middle East and Africa, rebels announced the death of Libya's leader, Muammar Qaddafi and the United States officially concluded its effort in Iraq and withdrew its last remaining combat troops. Russian Prime Minister Vladimir Putin was confronted with protests against his administration after his United Russia party's poorer-than-expected showing at Russia's parliamentary elections, despite allegations of ballot stuffing. Egypt continued to experience an escalation in protests against the army, despite ongoing parliamentary elections.

In Latin America, Brazil's former President Luiz Inacio Lula da Silva was diagnosed with throat cancer, raising concerns about his political future. Similarly, recently re-elected Argentinean President Cristina Kirchner announced her thyroid cancer condition.

## Equity

Relative to the rest of the world, emerging markets appear to be supported by better fundamentals, lower levels of indebtedness, and more robust levels of economic activity. We believe that China will continue to dominate the performance of emerging markets, even though its growth could potentially moderate to more sustainable levels with a greater proportion of economic activity stemming from the domestic economy.

We continue to be bullish about emerging market equities over the short, medium, and long term across various investment styles. Broadly speaking, we believe that much of the market uncertainty has been priced in at current valuations. While current concerns over global growth are causing contagion to the emerging markets, we believe that fundamentals and valuations in that region remain attractive. Within emerging markets, wide valuation gaps exist between sectors, rendering broad market valuation gauges less useful than in the past, in our view. Although we do not expect emerging markets to decouple from developed markets, we are confident that the growth differential between developed markets and their emerging counterparts will remain substantial, given the structural differences at both the public and private levels. We believe that the impact of fiscal consolidation in Europe, the United States, and China, coupled with policy responses across the globe represent both key risks and opportunities for emerging markets investors in 2012.

From a value perspective, we continue to identify attractive fundamentals for some Brazilian stocks that have underperformed in the last few years as a result of concerns about high inflation levels and slowing economic growth in Brazil. We have also taken advantage of recent weakness in the financials industry to add to positions in that sector. Although many investors have been concerned about the effect of European sovereign debt issues on the banking industry, we have concluded that exposure to troubled European sovereign debt is negligible among most emerging market banks. Even so, we believe that peripheral effects from a European crisis, such as reduced global liquidity, remain a relevant consideration. Other areas where we continue to identify value opportunities include companies in South Africa and Turkey, as well as in the consumer discretionary sector.

From a growth standpoint, we continue to find opportunities in China and Russia where our analysis suggests that concerns about slowing global growth have led to substantial mispricings of future earnings growth among select companies. In our view, price-to-earnings-growth ratios are relatively low, based on our estimates of earnings growth for certain businesses over the next few years. As a result, we have been able to initiate or add to positions in these two countries at valuations that we find compelling. Conversely, we continue to find that future earnings growth among most South Korean companies appears to be fully priced into the local market. From a sector perspective, concerns about the global growth rate weighed on economically sensitive sectors such as financials, energy, industrials, and consumer discretionary. Subsequently, we added exposure to companies in the latter two sectors based on discounts relative to our view of future earnings growth. We will most likely continue to reduce positions where we believe future earnings growth has been fully factored into share prices. During the quarter, we made small reductions in our exposure to Taiwanese and Turkish stocks, and to the information technology sector. On the other hand, consumer staples remains a sector that appears to be priced at a premium to its future growth rate, and we find reasonably-priced opportunities there to be scarce.

In terms of opportunities in emerging markets discounted assets, our analysis suggests that average discounts remain more than 500 basis points wider than their historical average. We remain heavily invested in Asia, with significant underweight exposures to both Africa and Latin America. These weights are driven by a two-pronged approach consisting of macroeconomic and fundamental analysis, combined with an analysis of discounts in a particular country or region. We believe that Asia will prove to be the driver of global economic growth and we find the underlying fundamentals of several countries and companies in that region very attractive. We continue to find China, Indonesia, and the Philippines to be key areas of opportunity as discounts in these countries are often in excess of 50%, thus creating attractive investment opportunities, in our view.

In addition, from an emerging markets discounted assets perspective, Russia is our key weight in Europe, and we are underweight most of the other countries in the region. While the current political maneuvering in Russia may create some near-term volatility, we believe it may also provide an attractive entry point into the Russian equity market, which is currently among the cheapest equity markets globally, in our view. In addition to changes in Russian macroeconomics, we believe we are able to access opportunities in Russia at a further discount, thanks to attractive underlying equity valuations. Meanwhile, from a growth perspective, we are more constructive on Latin America now than we were six months ago, as a result of improving economic conditions there. While we find that asset valuations tend to be high on average in that area of the world, we believe that there may be existing discounted opportunities that will allow us to narrow our underweight, which we have maintained for some time.

In Latin America, our team maintains a cautious stance on equity markets in the region for the first quarter, as global concerns continue to weigh on risk assets broadly. We believe the underlying economic fundamentals of the region remain relatively healthy and growth for the region is estimated to be in the 4%–4.5% range for 2012, thus, we continue to be constructive on the region over the longer term. As much of the bad news of 2011 appears to have been priced into the region's equity and currency markets, we find valuations attractive. However, we believe global growth will need to accelerate in order to fuel significant equity outperformance. We anticipate that continuing concerns about China's growth path will weigh on the materials and energy sectors in Latin America and that companies with export businesses will be constrained by Europe's austerity measures. Mexico is likely to benefit from a strengthening U.S. economy, while Brazil's domestic growth engine appears to be intact. Peru and Chile, with their more export-oriented economies, may experience muted economic growth. Nonetheless we have identified potential opportunities among companies there. Colombia, though a small market, also offers value in the domestic sector, in our view.

Overall, we believe that the consumer and the financials sectors in the emerging markets are well positioned to benefit from an improved domestic growth environment aided by governments' willingness to loosen monetary policy in order to foster growth. We also look to high-dividend-paying stocks in the utilities and telecom services sectors to act as a potentially attractive means to bolster returns.

## Fixed Income

We believe that market sentiment has been strongly influenced by growth concerns as well as fears of a double dip in the United States, worries of a hard landing in China, and worsening Eurozone solvency stress with contagion across banking channels. While U.S. data has shown marginal improvement over the last few months of 2011 and China's policy-engineered slowdown does not yet suggest a hard landing, the stalemate in Europe has been a dark cloud over most global markets. Until a solution to the debt crisis in Europe is crafted, emerging markets (which still boast relatively solid fundamentals) are likely to be strongly influenced by investor sentiment. However, these strong fundamentals may limit the downside and may provide a backdrop for improved performance in the period ahead. We anticipate that European banks' deleveraging will impact growth, trade, and financial flow dynamics across emerging markets borders. Therefore, we believe that it is vital to remain nimble with regard to country selection, position sizing, and willingness to either book profits or limit losses into sharp, short-term market moves that are not driven by country-specific fundamentals. A lack of progress in addressing Italian, Greek, and other peripheral European debt underscored the market's reticence to deploy capital despite substantially cheaper valuations and lighter foreign investor positioning in emerging markets local currencies (despite the fact that emerging markets local debt remains sought after by investors).

We believe that the fundamental case for investing in emerging markets fixed income continues to be well supported due to: 1) high GDP growth differentials relative to the developed markets; 2) more sustainable debt burdens, both in terms of stock (solvency) as well as flow (liquidity), even among countries closest to the problems in peripheral Europe; and 3) healthier banking systems in general, in terms of both ability and willingness to lend. Furthermore, most emerging market governments have sufficient foreign exchange (FX) reserves to cover more than 200% of their short-term debt, while term structures of emerging markets debt are less vulnerable to short-term liquidity and funding strains compared to developed market issuers. However, from an emerging markets income standpoint, we remain defensively positioned despite very attractive levels of many emerging markets currencies, given current levels of market sentiment and general risk aversion.

Emerging market bond spreads are at multi-year highs, while emerging market FX has barely recovered from the sell-off in fall 2011. Due to high levels of economic stress that have persisted over multiple quarters, investors are naturally reticent to put money to work and we believe this has manifested in low valuations and thinly traded markets. It is largely impossible to accurately forecast asset returns past a three-month timeframe as significant concerns and opportunities, as well as global macro events, are lurking in almost every segment of the world. Given this low transparency, from an emerging markets debt viewpoint, we have chosen to focus on value-oriented strategies. In our view, valuations in emerging markets fixed income (both external and local debt) remain quite compelling, on both a fundamental and historical level. As such, we are starting the year with a bullish bias, but heavily weighted toward liquid instruments, should economic conditions sharply deteriorate. We have resisted the compelling valuations in high-yield corporate bonds and higher beta FX, largely to minimize downside mark-to-market risk. Instead, we have deployed capital in sovereign and quasi-sovereign U.S. dollar-denominated debt across the credit rating spectrum as these instruments tend to be less sensitive to global shocks. Needless to say, in this type of rapidly moving market, we intend to remain nimble, remain in liquid positions, and avoid undue risk. We believe that over time, emerging market investments will revert to higher valuations, in line with our estimates of fair value, but we expect considerable volatility in the interim. As market conditions change and the path of economic growth becomes clearer, we intend to adjust our positioning from an emerging markets debt perspective, as we seek to capture the best risk-adjusted returns in the space.

## Important Information

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Past performance is not a reliable indicator of future results.

Equity securities will fluctuate in price; the value of your investment will thus fluctuate, and this may result in a loss. Securities in certain non-domestic countries may be less liquid, more volatile, and less subject to governmental supervision than in one's home market. The values of these securities may be affected by changes in currency rates, application of a country's specific tax laws, changes in government administration, and economic and monetary policy. Emerging market securities carry special risks, such as less developed or less efficient trading markets, a lack of company information, and differing auditing and legal standards. The securities markets of emerging market countries can be extremely volatile; performance can also be influenced by political, social, and economic factors affecting companies in emerging market countries.

An investment in Emerging Markets Debt positions are subject to the general risks associated with fixed income investing, such as interest rate risk and credit risk, as well as the risks associated with emerging market investments, including currency fluctuation, devaluation and confiscatory taxation.

Investments in global currencies are subject to the general risks associated with fixed income investing, such as interest rate risk, as well as the risks associated with non-domestic investments, which include, but are not limited to, currency fluctuation, devaluation and confiscatory taxation. Furthermore, certain investment techniques required to access certain emerging markets currencies, such as swaps, forwards, structured notes, and loans of portfolio securities, involve risk that the counterparty to such instruments or transactions will become insolvent or otherwise default on its obligation to perform as agreed. In the event of such default, an investor may have limited recourse against the counterparty and may experience delays in recovery or loss.

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