EMERGING MARKETS EQUITY

Remaining Optimistic Despite the Downturn

It may be too soon to claim with conviction that the darkest days in the global equity markets lie behind us, but a slightly positive first quarter for emerging markets equities has given investors some limited, but long overdue, cheer.

Two distinct and welcome observations, both with important ramifications for emerging markets, can be made about the current investment environment. First, governments in the developed world are, by and large, pulling out all the stops to reflate their declining economies. If successful, these efforts will likely help exporters in emerging markets. Secondly, U.S. and European governments are spending vast sums of taxpayers' money on subsidies, asset insurance schemes, and recapitalization programs in a bid to avoid the 100% nationalization of their domestic banking systems. As a result, some of the uncertainty surrounding the survival prospects of Western financial institutions is slowly dissipating; investors now have a clearer sense of those financial companies that will make it through the subprime crisis, although this chapter is probably yet to be fully written and there may be one or two more shocks ahead. This easing of the uncertainty surrounding the financials sector is of critical importance. The restoration of stability to the global financial system, which we believe will happen in 2009, will be a vital component in any tangible recovery in the stock markets. It will be especially helpful in casting off the shackles currently holding back emerging markets, where underlying fundamentals are, broadly speaking, significantly better than in the developed world.

The economic outlook for emerging markets inevitably varies by country, but, overall, we remain optimistic about the growth prospects for the developing world. Despite the pronounced economic downturn in the developed world, it remains reasonable to project economic growth of 2%-8% per annum across the broad emerging markets over the next three years. There will doubtless be pockets of weakness—the economies of Mexico (on U.S. economic woes), Russia (depressed energy prices), Eastern Europe (a burst property bubble and excessive indebtedness), and South Korea (export weakness) could contract significantly over the near term. Other export-oriented Asian economies are also facing the challenge of a global downturn that has surprised with both its speed and intensity. Yet, encouragingly, our research suggests that the economies of Indonesia, Philippines, and Thailand are performing reasonably robustly despite the collapse in demand in the developed world. Elsewhere, despite the dive in commodity prices in the latter half of 2008, many Latin American and South African companies are showing relative resilience.

The overall prospects for emerging markets equities appear compelling based upon their valuations and profitability, particularly when compared to their developed world counterparts. Generally, the asset class is not facing the same type of leverage or solvency issues plaguing the Western financial system. We view the current weakness in emerging markets as a global crisis of confidence, and we believe that performance will become focused on fundamentals once fears over the solvency of the Western financial services industry are addressed. To that end, we remain optimistic on the asset class over the short, medium, and long term. We can probably expect emerging markets to see-saw over the next several months, as major bear market rallies are punctuated by sell-offs caused by negative surprises and adverse situations. But looking beyond what is likely to be a volatile period of trading, we anticipate significant share price strength as markets stabilize.

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NOTES:

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