Schroder ISF* Global Emerging Market Opportunities
Monthly Fund Update

Market Review

Global equity markets rallied in October, reflecting hopes that policymakers in the eurozone would announce further measures to address the fiscal and financial challenges facing the region. Enhancements to the European Financial Stability Facility were ratified by all EU member states in October and policymakers in France and Germany proposed a further increase to the size of the fund. However, at the end of month, market sentiment deteriorated due to increasing political uncertainty in Greece which has continued in November. Meanwhile, US economic data releases remained mixed; housing starts recovered strongly in September but consumer confidence suffered a further decline in October. In other developments, the Chinese premier said that China would 'fine tune policy at a suitable time and by an appropriate degree', which was viewed by the market as a sign of potential future monetary policy easing. The MSCI Emerging Markets index posted a strongly positive return and outperformed the MSCI World index, reflecting a rally from depressed levels and the announcement of easing measures in some emerging markets in order to support growth.

Our core markets for October were China, Korea, Russia, Thailand and Egypt. All of the core markets produced positive returns in October, reflecting the broad-based rally in emerging markets over the month.

The Russian market produced a strongly positive return in October, reflecting strength in the oil price and the rouble, and the Russian market's high-beta nature. The September indicators from Rosstat also helped to boost sentiment: retail sales growth accelerated to 9.2% year on year from 7.8% in August, real wages climbed 6.2% year on year and unemployment dropped to 6.0%. Encouragingly, inflation also eased to 7.2% year on year from 8.2% in August. On the policy front, the central bank left the refinancing rate unchanged but said it would keep a closer watch on the potential inflationary effects of a weaker rouble, rising prices for consumer goods and increased economic activity.

The Chinese market rallied strongly in October, supported by hopes of selective policy easing. On the economic front, China's Q3 real GDP growth was broadly in line with expectations at 9.1% year on year, while September's official activity indicators also helped to support sentiment; industrial production surprised to the upside, rising to 13.8% year on year from 13.5% in August. On the inflation front, September's CPI came in at 6.1% year on year, in line with market expectations. However, there were further signs of a slowdown in the property sector, reflecting the impact of earlier policy tightening.

The Korean market rose in October, aided by local currency strength. Market sentiment was supported by resilience in exports, which rose 19.6% year on year in September. Inflation concerns also eased as CPI moderated to 4.3% year on year in September from a three-year peak of 5.3% in August. In other developments, the trade surplus widened to $3.1 billion in September, aided by an increase in car shipments. On the policy front, the Bank of Korea left interest rates unchanged at 3.25%. At the post-meeting press conference, the governor took pains to highlight that Korea was still on a rate normalisation path and that there had not been any discussion of a rate cut. At the end of the month, the advance estimate of Q3 GDP came in at 3.4% year on year, largely in line with expectations.

Thailand's equity market rallied in October although sentiment was adversely affected by heavy flooding in parts of the country. Flood-related losses are now estimated at more than THB 100 billion, resulting in GDP growth downgrades for 2011, although the longer-term impact on the economy should be limited by an increase in government infrastructure spending. Inflation concerns eased somewhat as headline inflation came in at 4.0% year on year in September, down from 4.3% in August. Turning to monetary policy, the central bank kept rates on hold at 3.5%; however, speculation of a temporary rate cut rose after the Bank of Thailand indicated that it stood ready to hold a special MPC meeting, if needed.

Egyptian equities rallied in October, benefiting from the broader rally in emerging markets and improvement in risk appetite over the month. A moderation in inflation concerns also helped to support sentiment as annual urban inflation eased to 8.2% in September from 8.5% in August. However, political and sectarian risks provided a headwind for the market, while S&P downgraded Egypt's foreign currency credit rating to BB- from BB. On the monetary policy front, the central bank left its key benchmark interest rate unchanged at 8.25% to help support growth.

Performance comment

The fund produced a positive total return in October, reflecting the rebound in emerging markets over the month.

All of our core markets produced positive contributions to returns in October. China and Korea produced the largest positive contributions in the core markets. In China, our holdings in cyclical areas such as real estate, autos and banking produced strongly positive contributions to returns, while in Korea our favoured names in areas such as electronics and chemicals benefited from a broad-based recovery. Elsewhere, the vast majority of our Russian holdings enjoyed double-digit percentage gains in October, aided by rouble strength and the market's high beta.

In the non-core component of the fund, all markets except India produced a positive contribution to returns in October. Brazil provided the largest positive contribution to returns in the non-core markets, reflecting a strong recovery in our construction and real estate-related holdings.

The market outlook and portfolio strategy

The outlook for emerging markets remains largely unchanged. The immediate outlook is driven by global events and equity markets are likely to remain volatile until there is increased political consensus and action to tackle the challenges in the developed world. However, improved stabilisation in the developed world or more positive news flow from the US or policy action in China could see stockmarkets rebound and emerging markets look well placed to outperform their developed peers. In stark contrast to the debt-ladened developed world, emerging economies do not face the same structural headwinds from fiscal tightening and de-leveraging that are proving so painful in the US and Europe. Consensus expectations of GDP growth in emerging markets over 2012 remain robust at 6.1% and continue to underline the existence of a two-speed world. Although investor concerns year to date have been dominated by whether emerging markets are growing too quickly and creating inflationary pressure, more recently these pressures appear to be abating somewhat and we are beginning to see a shift in the policy stance of emerging markets' authorities away from prioritising inflation in favour of growth. More restrictive tightening policies look to be peaking in many cases and several markets have already started to implement expansionary measures. Investor concerns over the ability of China to orchestrate a 'soft landing' remain following recent weaker data releases, although we continue to believe the concerns to be somewhat overstated. The Chinese authorities have resources available to unwind tightening measures and peaking inflation, in combination with softer commodity prices, should remove constraints to policy easing in future. Valuations are attractive, with the MSCI Emerging Markets trading on 9.0X PER, below its long-term average of around 13X, and such valuation levels have historically been followed by strong market returns. Furthermore, these valuations are supported by robust earnings growth expectations of around 10-15% and strong underlying fundamentals, with typically low debt at the government, corporate and household level. Although the absolute performance of emerging markets over the shorter term remains unclear, the medium- and longer-term outlook is positive, supported by investors seeking yield in a low growth environment.

Our core markets are China, Korea, Russia, Thailand and Egypt.

Chinese equities offer attractive valuations and earnings growth relative to the global emerging markets average. We also view the recent fears of a hard economic landing as being unwarranted.

South Korean equities are attractively valued and the country benefits from strong economic fundamentals. Russia offers attractive valuations and the market should rally strongly if macro risks in the developed world ease. However, the market is very sensitive to crude oil prices, which may be impacted by concerns over global economic growth. In Thailand, valuations are reasonable and the economy is benefiting from strong rates of growth. The political environment has also stabilised following the recent elections. Egypt is cheaply valued versus broader emerging markets, although it remains subject to domestic policy and political uncertainty. We retain a 15% cash allocation although we will look to take advantage of opportunities to invest the cash as and when they occur.

*ISF = International Selection Fund

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