

# Schroder ISF\* BRIC (Brazil, Russia, India, China) Fund Update

Covering November 2011

## Overview

The BRIC equity markets declined in November as concerns over the sovereign debt crisis continued to weigh on global risk appetite. The BRIC economies remain free of the debt and de-leveraging problems that are proving so painful in the developed world, and we expect them to deliver superior rates of GDP growth than their developed world peers over the long term.

## The market and the drivers of fund performance

Global equity markets continued to sell off as sentiment remained affected by the ongoing sovereign debt crisis in the eurozone and the lack of a decisive policy response. Meanwhile, in the US, the Joint Select Committee on Deficit Reduction was unable to reach an agreement, raising the risk that stimulus measures such as the payroll tax cut and extended unemployment benefits could expire. However, forward-looking US economic data releases provided some encouragement, with the Conference Board's index of leading economic indicators rising 0.9% month on month in October, well ahead of consensus expectations. Global equities then rallied strongly at the end of the month as developed world central banks announced a co-ordinated programme of action to reduce the risk of a credit crunch in the banking sector. The MSCI BRIC index underperformed the MSCI World index in November, and also underperformed the MSCI Emerging Markets index due to relatively poor performance from Indian and Chinese equities.

Russia strongly outperformed its BRIC peers in November, with the market supported by strength in energy-related names as Brent crude oil prices proved resilient during the month. Sentiment was also supported by encouraging GDP growth data; GDP expanded 4.8% year on year in Q3, up from 3.4% in Q2. Although this outcome was slightly below market expectations of 5.0%, quarter-on-quarter seasonally-adjusted growth was solid at 1.7%. Inflation data was mixed, with CPI surprising on the upside at 0.5% month on month in October. However, the annual headline rate held steady at 7.2% and food inflation slowed to 6.2% year on year. Industrial production growth was slightly ahead of expectations at 3.6% year on year in October and consumer-related releases were also broadly encouraging: retail sales rose 8.8% year on year in October and real wages rose 5% year on year. On the policy front, the central bank held the refinancing rate at 8.25%, as widely expected. In other developments, the WTO panel supported Russia's application to join the organisation, marking an end to 18 years of negotiations.

Brazil outperformed the wider BRIC bloc, supported by resilience in energy-related names and lower-beta areas such as beverages. However, weakness in the Real provided a drag on returns as international investors maintained a 'risk off' stance. Economic data releases during the month were mixed; industrial production fell 2.0% month-on-month on a seasonally-adjusted basis in September, resulting in fears that financial problems in developed markets could be starting to affect growth conditions in Brazil. However, domestic demand remained robust, with retail sales up 0.6% month on month (seasonally adjusted) in September. On the inflation front, October's monthly IPCA inflation reading was in line with expectations (+0.43%) and annual inflation for October eased to 6.97% from the 7.31% seen the previous month. Turning to policy, the central bank began to unwind some of its tightening measures; specifically, it removed some of the increases in capital requirements for new consumer loans and also announced that a planned increase in the minimum amount of credit card payments would be cancelled.

China underperformed its BRIC peers in November, as concerns of a hard economic landing and signs of further weakness in property markets weighed on sentiment. However, inflation continued to moderate, with CPI easing to 5.5% year on year in October from 6.1% the previous month, aided by slower food inflation and favourable base effects. Inflation pressures also eased, with PPI inflation slowing to 5.0% from 6.5%, reflecting the global commodity price correction. Industrial production, fixed asset investment and retail sales data for October came in broadly in line with market expectations, albeit indicating a moderation in growth. Imports also decelerated to 15.9% year on year in October from 17.1% in September, although imports rebounded strongly, rising 28.7% year on year in October. In other developments, broad money supply growth was weaker than expected, declining to a 10-year low of 12.9% year on year in October. Property price data provided further evidence of a slowdown, with the NBS 70-city property price data showing that existing home prices fell or were unchanged month on month in 57 cities in October, 11 more than in September. Towards the end of the month, the HSBC flash PMI for November slipped below the expansionary 50 threshold, adding to fears of a further slowing of growth in the short term. Turning to policy, the

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People's Bank of China continued to selectively ease, announcing a 50bps reserve requirement cut for all banks on the last day of the month, effective 5 December.

India sharply underperformed the BRIC index in November, with sentiment adversely affected by weakness in the currency, which has added to inflation concerns. WPI inflation came in at 9.7% year on year in October and rose 0.8% month on month. Annual core inflation eased in October, but the month-on-month rate rose 0.6%. Fiscal concerns also provided a headwind, reflecting fears that a larger-than-expected fiscal deficit for FY 2012 could force the government to increase taxes, with potentially negative effects for corporate earnings. Growth-related data releases were largely downbeat, with industrial production growth for September beneath already subdued expectations at 1.9% year on year. At the stock level, banking names performed poorly, but the market sell-off was broad-based. On the policy front, the central bank announced INR100 billion of open market purchases of government in order to ease a recent tightening of liquidity. In other developments, the government's proposal to allow 51% foreign direct investment in the retail sector caused controversy, and has since been put on hold.

On an underlying basis, the fund outperformed the benchmark in November; both country positioning and stock selection added to returns. In terms of country positioning, the fund benefited from being underweight India, which sharply underperformed its BRIC peers in November. The overweight to Russia, which outperformed, also added to returns. Stock selection was positive in China (overweight China Mobile, overweight China Resources Power Holdings) and Brazil (overweight Cemig, overweight Lojas Renner). Selection in Russia detracted (overweight X5 Retail, zero weight Surgutneftegaz). Selection in India had a neutral impact on returns.

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## The market outlook and portfolio strategy

We are overweight China. The Chinese market offers reasonable valuations and earnings growth. Chinese markets remain subject to fears of a hard landing, with the property sector a key focus of the current concerns, but we view these fears as being somewhat exaggerated. The Chinese authorities have resources available and scope to unwind tightening measures, as shown by the recent easing of reserve requirements for the banking sector. Inflation looks to have peaked and the recent decline in commodity prices should also help to ease inflationary pressure.

We remain overweight Russia. The Russian equity market is attractively valued and should respond positively if macroeconomic and debt concerns in the eurozone and US begin to ease. However, the market is very sensitive to the outlook for crude oil prices, which may be pressured by fears of a slowdown in developed world growth. Recent domestic political discontent could also provide a drag on sentiment, although this is anticipated to be temporary and the economic growth outlook in Russia remains strong.

We are underweight Brazil. Equity valuations are reasonable but earnings growth is deteriorating and the economic outlook is mixed in our view. Recent GDP growth has slowed faster than expected driven by weak manufacturing, although domestic consumption growth remains robust. Recent policy action from the central bank shows that it is likely to prioritise growth over inflation targeting in the short term and further interest rate cuts are anticipated subject to domestic and external environment pressures.

India remains our largest underweight. Growth is slowing from high levels and the equity market is expensive. The RBI has responded to inflation concerns by tightening monetary policy but inflation remains high, and while there is speculation in the market that the interest rate cycle has peaked, recent currency weakness is likely to add to inflation concerns. India's fiscal position is also deteriorating, resulting in fears that February's budget could see some fiscal tightening. India has typically been more insulated from a developed world slowdown than its BRIC peers but we continue to find more attractive opportunities elsewhere.

\*Schroder International Selection Fund.

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