Schroder ISF* Emerging Europe
Fund Update

Covering November 2011

Overview

The financial crisis in the eurozone continued to pressure global equity markets in November. The MSCI Emerging Europe index performed broadly in line with the MSCI World index in euro terms and strongly outperformed the MSCI Emerging Markets index, aided by resilience in the Russian equity market. In terms of country positioning, we remain overweight Russia and neutrally positioned in Turkey and Hungary. We are underweight Poland and the Czech Republic.

The market and the drivers of fund performance

Global equity markets remained under pressure in November as sentiment continued to be 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. At the end of the month, global equities benefited from a strong rally 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 Emerging Europe index performed broadly in line with the MSCI World index and strongly outperformed the MSCI Emerging Markets index, aided by resilience in the Russian equity market.

Russia strongly outperformed its regional Emerging European and broader emerging market peers in November, aided by strength in Brent crude oil prices. 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 (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. On the policy front, the central bank held the refinancing rate on hold at 8.25%, as widely expected.

Hungary outperformed broader Emerging European markets during the month, benefiting from strength in oil-related names. The market was also supported by news that the government has reopened dialogue with the IMF. However, economic data releases remained weak in November, highlighting the highly-open nature of the Hungarian economy: the PMI declined to 48.2 in October from 50.7 in September, and has remained under pressure in November. Industrial production expanded 3.0% year on year in September, while Q3 GDP growth was better than expected at 1.4% year on year, driven by agriculture. In other developments, Moody's downgraded Hungary's sovereign paper to non-investment grade status, citing uncertainty surrounding the Hungarian government's ability to meet its targets on fiscal consolidation and public sector debt reduction in a low-growth environment. Turning to policy, the central bank raised interest rates by 50bps to 6.5%, in line with expectations, as it moved to defend the forint.

Turkey underperformed its Emerging European peers in November. Concerns over recent currency weakness and the large current account deficit continued to provide a headwind in November. Economic data releases remained indicative of a strong domestic economy, with industrial production rising 12% year on year in September, well ahead of expectations. At the start of the month, the PMI reading for October came in at 53.3, up from 51.5 in September, providing a contrast with the softening PMI readings seen in a number of other markets. On the downside, inflation readings continued to show the impact of recent lira weakness; in early November, official data showed that CPI rose 7.7% year on year in October. On the policy front, the central bank left the benchmark repo rate on hold at 5.75%, in line with expectations, and said it would adjust lira funding up or down through repo auctions as it monitors inflation.

The Czech market underperformed the regional Emerging Europe index in November, with sentiment hit by the ongoing uncertainties in the eurozone. However, defensive names in areas such as telecoms benefited from the continued 'risk off' environment. Data releases continued to reflect the impact of the deterioration in conditions in the EU, with the HSBC manufacturing PMI easing to 51.7 in October from 52.3, the weakest reading since 2009, with a number of firms reporting weakness in the important German market. Industrial output growth also eased to 2.5% in September from 5.9% in August. The first estimate of Q3 GDP was weaker than expected, at 1.5% year on year, and has since been revised down to 1.2%. Inflation data also disappointed, with CPI accelerating to 2.3% year on year in October from 1.8% in September, the highest rate in ten months.

Poland underperformed its Emerging European peers in November. The market was hit by a heavy sell-off in commodity-related names after the government announced an increase in taxes on natural resources such as copper and silver. However, in a Central and Eastern European context, economic data releases remained encouraging: industrial output rose 6.5% year on year in October, and Q3 GDP growth of 4.2% year on year was slightly ahead of expectations. The central bank held interest rates at 4.5%, in line with expectations, having raised rates by 100bp year to date.

On an underlying basis, fund performance was ahead of the benchmark in November, with country allocation and stock selection adding to returns. At the country level, the main positive contributions came from the underweight positions in Poland and the Czech Republic, which underperformed in November. Stock selection was strongly positive in Russia and was also favourable in Turkey and Poland. Selection in the Czech Republic and Hungary had a neutral impact.

The market outlook and portfolio strategy

We remain overweight Russia. Equity valuations are attractive but market sentiment remains highly sensitive to the oil price. The Russian market is a high-beta market and would be a clear beneficiary of a global rally if macroeconomic concerns in the developed world begin to ease. Moreover, fiscal drag should ease in 2012, providing some support to growth. Valuations have recently improved as the market has been negatively affected by popular reaction to alleged electoral fraud. Protests have thus far been peaceful and we believe concerns of deterioration in the situation or a sudden transition of power away from the current ruling elite to be somewhat overstated, not least because there is no credible opposition candidate.

The fund retains a neutral stance in Turkey. Macro risks remain elevated: a high current account deficit, combined with low quality (short-term) funding, means that there are risks to the currency, interest rates and growth. Moreover, depreciation in the currency is driving inflation higher. However macro risk has already been largely priced in: the currency is cheap, trading at a c.12% discount to the real effective exchange rate line. Furthermore, we have started to see some moderation in the monthly trade deficit and could see the peak in this series soon. Foreign equity holdings have declined markedly over the year and valuation levels are becoming selectively attractive.

The fund remains neutrally positioned in Hungary. The main argument for Hungary is its valuation, which we regard as attractive versus broader emerging markets. However, the market is likely to struggle should the eurozone debt crisis deteriorate further, as exports are the only strong support for the economy, and we are watching events closely. Within Emerging Europe, Hungary is clearly most affected by the broader European situation but fortunately is a small proportion of the benchmark.

We remain underweight the Czech Republic. The Czech index has a high weighting in more defensive names and benefits from a high yield, meaning that it should outperform if global markets sell off, and valuations are reasonable. However, the earnings growth outlook is poor in comparison to other markets.

The fund retains an underweight in Poland. Valuations in Poland are attractive versus history and the emerging markets average. However, privatisations (currently on hold) and the associated new equity issuance continue to provide a potential overhang risk. Moreover, political interference at the corporate level is increasing and the tax take is set to rise. We continue to find more appealing opportunities elsewhere.

We retain our off-benchmark exposure to Kazakhstan for stock-specific reasons.

*Schroder International Selection Fund.

Risk warnings: Investments in emerging markets are subject to market risk and, potentially, liquidity and currency exchange rate risk. Investments in equities are subject to market risk and, potentially, to currency exchange rate risk. This fund may use financial derivative instruments as a part of the investment process. This may increase the fund's price volatility by amplifying market events.

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