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

## Covering February 2012

### Overview

The BRIC equity markets continued to rally in February 2012 as global risk appetite was supported by the ECB's Long Term Refinancing Operation, some encouraging economic data releases from the US, and further selective policy easing in China. The BRIC economies remain free of the debt and de-leveraging problems that are proving so problematic in the developed world, and we expect them to deliver superior rates of GDP growth versus their developed world peers over the long term.

### The market and the drivers of fund performance

Global equities continued to rally in February 2012. Market sentiment was supported by improving liquidity conditions in European interbank lending markets due to the ECB's Long Term Refinancing Operation, some strong economic data releases from the US, and further selective policy easing in China. Towards the end of the month, the risk of an immediate Greek sovereign debt default eased after a second bailout was approved by the EU and IMF, on the condition that Greece implements further austerity measures. However, there was little evidence of the European authorities tackling the underlying structural problems in the region. The MSCI World index rose over the period, aided by the continuation of the 'risk on' environment seen in January. The MSCI BRIC index outperformed the MSCI World index and performed broadly in line with the MSCI Emerging Markets index, supported by a strong rally in the Russian equity market.

Russia outperformed its BRIC peers and broader emerging markets in February, benefiting from the high-beta nature of the market, an increase in Brent crude oil prices due to a further deterioration in relations between the US and Iran, and strength in the rouble. At the stock level, energy-related names ranked among the best performers amid a broad-based market rally. The official macro data releases also helped to support sentiment: CPI eased to 4.2% year on year in January from 6.1% in December, while industrial production accelerated to 3.8% year on year in January from 2.5% the previous month. Retail sales rose 6.8% year on year in January, reflecting the continuing improvement of consumer demand, while wage growth accelerated to 9.0% year on year from 4.9% at the end of 2012. Turning to policy, the central bank kept its key policy rates unchanged in February. In its press release, the bank's policymakers acknowledged the sharp decline in inflation in recent months while noting that the shift of the regulated tariff increase from 1 January to 1 July implies a pickup in inflation in H2 2012. In other developments, protests against Vladimir Putin continued ahead of the early March presidential election. (In the event, Putin won the election in the first round, taking 63.8% of the vote with 99% of the ballots processed.)

China performed broadly in line with its BRIC peers in February; market sentiment was supported by further selective policy easing and continued evidence of a soft landing for the macro economy. At the start of the month, the NBS manufacturing PMI rose to 50.5 in January from 50.3 in December, defying the usual seasonal decline associated with the Chinese New Year, while exports declined 0.5% year on year in January, a better-than-expected outcome. However, imports were much weaker than expected, falling 15.3% year on year versus a gain of 11.8% year on year in December. Inflation data also proved disappointing as CPI accelerated to 4.5% year on year in January from 4.1% in December, reflecting a higher-than-expected rise in food inflation. Turning to policy, the People's Bank of China announced a 50bps reduction in the reserve requirement ratio (RRR), effective 24 February. The move is expected to release close to CNY400 billion of liquidity to the banking system; market participants continue to anticipate further RRR reductions in 2012.

Brazil modestly underperformed its BRIC peers in February although returns were boosted by strength in the Real. At the stock level, a number of the consumer cyclical and real estate names performed strongly, reflecting some robust domestic data releases, while a number of the commodity and financial-related names also outperformed. On the data front, December's retail sales surprised to the upside at 0.3% month on month seasonally adjusted, while December's IBC-Br (the monthly GDP proxy) rose 0.53% month on month. Labour market data remained very robust: stripping out seasonality, unemployment remained at a record low of 5.6% in January and real wages rose 0.2% month on month. Inflation data also provided some support for market sentiment as IPCA-15 inflation eased to 0.53% month-on-month in February from 0.65% in January, driven by lower food and transportation costs. In other developments, the government announced its budget expenditure reduction programme, with the public spending forecast cut by R$55bn for 2012. Nonetheless, the new government spending forecast still anticipates a 12% year-on-year pickup in total expenditure.

India underperformed its BRIC peers in February, reflecting profit taking, some policy uncertainty ahead of March's federal budget and the unfavourable sentiment impact of higher crude oil prices. At the stock level, telco names ranked among the main laggards as the regulator proposed levying additional fees on the sector while the market digested the impact of the Supreme Court's decision to cancel 122 of the telecom licenses awarded in 2008, following allegations of fraud. Data releases were mixed, with December's industrial production growth coming in at 1.8% year on year, below expectations, although inflation concerns eased somewhat as January's WPI inflation was softer than expected at 6.6% year on year while core inflation dropped below 7%. At the end of the month, India's Q3 FY2011-12 (October-December) GDP came in at 6.1% year on year, broadly in line with expectations, but nonetheless the weakest quarterly growth number since Q4 FY2008-09.

On an underlying basis, the fund underperformed the benchmark. Country selection had a broadly neutral impact on returns while stock selection was negative. At the country level, the fund benefited from being overweight Russia, which outperformed, and underweight India, which underperformed. Cash provided a negative contribution, reflecting the strong rise in markets over the month. Stock selection was positive in Brazil (underweight Petrobras, overweight BR Malls, overweight CCR) and Russia (overweight Sberbank, overweight Gazprom). Selection was negative in China (overweight China Petroleum & Chemical Corp., overweight China Resources Power) and in India (overweight Dr Reddy's Laboratories, overweight ICICI Bank).

## The market outlook and portfolio strategy

In the short term, the outlook for the BRIC markets remains uncertain and will be influenced by exogenous macroeconomic risks in the developed world, most notably in developed Europe. The risk of an immediate disorderly Greek default appears to have eased, but little has been done to address the significant structural problems within the eurozone. Despite the rally over 2012 to date, BRIC valuations remain attractive in absolute terms and relative to history, and we believe that there is scope for the BRICs to achieve an upward re-rating in valuations this year. We also expect earnings growth to remain strong relative to the developed markets.

We are overweight China. The Chinese market offers attractive valuations and recent data releases suggest that concerns of a hard landing are unwarranted. The Chinese authorities have signalled their intent to respond to a moderation in growth with looser policy and have already implemented selective policy easing.

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. The market remains sensitive to the outlook for crude oil prices, which have benefited recently from escalating political tension between Israel and Iran and supply constraints in Libya. On the political front, Vladimir Putin is likely to continue to face allegations of electoral fraud following his victory in the presidential election, but we do not expect any significant changes in the political regime in the foreseeable future. Overall, the economic growth outlook in Russia remains strong and recent data releases have been encouraging.

We are underweight Brazil. Valuations are reasonable, as is earnings growth. Further interest rate cuts are anticipated in the short term, subject to domestic and external environment pressures. However, macro data releases appear to be improving overall. Risks remain of increased government intervention following the recent increase in the IOF tax in order to dampen pressure on the Real, and in the longer term infrastructure bottlenecks are likely to constrain GDP growth.

India remains our largest underweight. Economic growth is slowing from high levels and the equity market remains expensive. Headline inflation has eased but core inflation remains elevated. India's fiscal position is deteriorating, resulting in concerns that March's budget could see some fiscal tightening. The recent increase in crude oil prices provides a further short-term headwind for the market. 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.