Schroder ISF* Global Emerging Market Opportunities
Monthly Fund Update

Market Review

Global equity markets continued to sell off in November 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. The MSCI Emerging Markets index underperformed the MSCI World index, reflecting the continued 'risk off' environment. However, equities 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.

Our core markets for November were China, Korea, Russia, Thailand and Egypt. Thailand produced a positive contribution to returns and the contribution from Russia was flat. The remaining core markets produced negative contributions to returns, reflecting the broader decline in emerging markets over the month.

The Russian market produced a broadly flat return in dollar terms in November, reflecting weakness in the rouble. However, the market was 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.

The Thai equity market declined in November but proved more resilient than broader emerging markets, benefiting from its perceived relative lack of sensitivity to the continuing problems in the eurozone. At the stock level, defensive names in areas such as telecoms and food ranked among the strongest performers. However, Q3 GDP was weaker than expected at 3.5% year on year and industrial production fell 35.8% year on year in October, reflecting the impact of recent heavy flooding. On the policy front, the central bank reduced the repo rate by a quarter of a percentage point at the end of the month, in order to help support business and consumer confidence.

The South Korean market declined during November; however returns were broadly in line with those of wider emerging markets. At the stock level, industrial names suffered due to the deteriorating growth outlook in the developed world, while defensive areas such as telecoms proved more resilient. Data releases were mixed; export growth came in at 9.3% year on year in October, below consensus. However, the current account surplus widened to US$4.2 billion in October, while industrial production growth was stronger than expected at 6.2% year on year. Turning to policy, the Bank of Korea left interest rates unchanged at 3.25%, as expected.

The Egyptian market sold off in November. Political risks provided a drag on sentiment, following further unrest in Cairo ahead of the first stage of the lower house elections, which took place at the end of November. However, the election itself was peaceful with a high turnout (62%) although the strength of support for the somewhat more extremist Salafi Nour Party was largely unexpected. Turning to policy, the central bank raised rates in November: the overnight lending rate rose by 50bps 10.25%, the overnight deposit rate by 100bps to 9.25%, the discount rate by 100bps to 9.5% and the 7-day repo by 50bps to 9.75%. The central bank's move was viewed as an attempt to address concerns on the currency, as well as seeking to attract foreign investors back to Egypt. On the inflation front, CPI eased to 7.1% year on year from 8.2%, a four-year low, aided by lower food inflation.

Performance comment

The fund produced a negative total return in November, reflecting the decline in emerging markets over the month.

Looking at the core markets, Thailand produced a positive contribution to returns, reflecting resilience in our favoured oil-related names, which were supported by robust oil prices. Russia produced a broadly flat contribution to returns, with our holdings in defensive areas such as telecommunications delivering very strong gains. The remaining core markets produced negative contributions to returns in November. China provided the largest negative contribution, reflecting price weakness in some of our auto-related and banking names. However, a number of our energy-related holdings in China performed strongly. Korea also provided a negative contribution, with market sentiment affected by global growth concerns.

In the non-core component of the fund, all markets except South Africa produced a positive contribution to returns in November. Our South African gold mining exposure added value as gold prices rose in November. Brazil provided the largest negative contribution of the non-core markets, largely reflecting share price weakness in our holdings in real estate and construction.

The market outlook and portfolio strategy

Global equity markets remain extremely volatile and sensitive to global macro news flow. The situation in developed Europe has deteriorated, leading to increased policy action from the ECB and the announcement of an enhanced fiscal pact among EU members. In the near term, the outlook for emerging markets continues to be extremely uncertain and primarily dependent on exogenous developed world macro drivers. However, the medium- to longer-term outlook is strongly positive and current valuations are very attractive.

In response to the worsening eurozone crisis, the ECB has cut its main policy rate, extended the maturity of funding, reduced the quality of the collateral required to access liquidity and reduced the reserve requirements for banks. Enhanced fiscal coordination between members of the EU in the form of a new pact incorporating tighter budgetary controls has also been announced. However, policy will take time to implement and there have been few signs of growth stimulus, leading to concerns that the situation needs to deteriorate further before the necessary policy response is provoked. The Schroder Economics team forecasts the eurozone to fall into recession in 2012 with GDP falling -1.8%. The weakness in the eurozone has prompted 2012 global growth to be downgraded to 1.8%. The economic situation in the US offers some respite to investors following improved data releases and the US is forecast to grow 1.6% in 2012.

The case for emerging markets over the medium term is strongly positive. Valuations are attractive, with the MSCI Emerging Markets index trading on 9.5X PER, below its long-term average of around 13X, and such valuation levels have historically been followed by strong market returns. 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 economic growth momentum is slowing globally, emerging economies do not face the same structural headwinds from fiscal austerity that are proving so painful in the US and Europe. Consensus expectations of GDP growth in emerging markets over 2012 remain robust at 6.0% and continue to underline the existence of a two-speed world.

Moreover, key investor concerns year to date are typically showing signs of dissipating. Inflationary pressure continues to recede in most countries removing a headwind to growth and also removing constraints to policy easing, if required. Recent data from China continues to point to a moderation in growth, rather than a ‘hard landing’, and the authorities have responded with selective policy easing including reducing the reserve requirement for the banking sector. Significantly, resources remain available to counter any more severe moderation in growth. Despite the benign longer-term outlook for emerging markets, the immediate outlook is far less clear. There is currently an exceptionally high degree of uncertainty surrounding developed Europe and while that remains the case, sentiment is anticipated to continue to drive global markets, including emerging markets. Subsequently markets will likely continue to be characterised by elevated levels of volatility and cross-asset correlation. However, emerging markets have sold off more than expected year to date and if there is progress in Europe, emerging markets are well placed to rebound strongly and outperform their developed peers.

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 somewhat exaggerated and inflation looks to have peaked. South Korean equities are attractively valued although the economy and earnings growth are slowing. 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. Recent political tension could also provide a drag on sentiment, although this is anticipated to be temporary and the economic growth outlook in Russia remains strong. In Thailand, valuations are reasonable and the impact from the recent flooding should be limited over the medium term. Egypt is cheaply valued versus broader emerging markets, although it remains subject to domestic policy and political uncertainty. The fund's cash allocation was moderated to 7% from 20% in early December although we remain defensively positioned owing to ongoing developed world concerns.

*ISF = International Selection Fund

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