Emerging Markets Equity

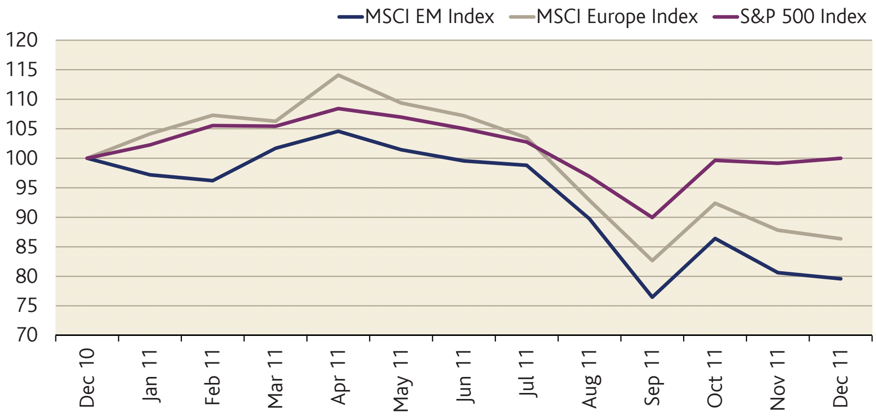
Review & Outlook 2012

January 2012

Market Overview

After two years of double-digit gains, 2011 saw emerging equities fall sharply amid unusual turbulence. The MSCI Emerging Market Index's decline of around 18% in US dollar terms lagged the total return of both the US and European markets, which rose by 2% and fell 10% respectively. Concerns over global growth, fuelled by Europe's debt crisis dominated market sentiment. By region, Emerging Markets Europe Middle East Africa (EMEA) was the worst performer, followed by Latin America and emerging Asia. EMEA suffered because of its proximity to the Eurozone and the deteriorating economic outlook in that region; resource exporters in Latin America failed to recover fully from the decline in commodity prices; while emerging Asia was dragged down by concerns of a potential "hard landing" in China.

Global emerging markets vs developed peers



Source: Bloomberg, Jan 12
Rebased to 100

Emerging stockmarket performance during the year was marked by two key periods. The first occurred early on when gathering concerns of inflation and overheating prompted emerging central banks to tighten monetary policy. Social unrest across the Middle East North Africa, which disrupted oil supplies and accelerated price hikes, further undermined confidence. These concerns led to a reallocation of funds from the asset class into developed markets. A relative improvement in advanced economies' growth prospects fuelled market rotation.

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After a brief rebound, emerging market equities fell a second time on tighter money and widening contagion in the Eurozone Greek-led. Repeated efforts by European leaders to address the crisis fell short of promises and several of them lost elections. In addition, fresh economic wobbles in the US were compounded by political wrangling that brought the country to the brink of default and led to the subsequent downgrade of its triple-A credit rating. Concerns that monetary tightening in Brazil, China and India would curb already slowing growth prospects weighed on markets.

Outlook

A challenging year lies ahead as the fundamental problems that have beset the global economy and equity markets still prevail. The biggest risk clouding the investment horizon is the continuing crisis in Europe. Therefore, what the EU does to resolve the crisis will be of global significance. Concerns about sovereign debt sustainability have spread from the periphery to the core. The fate of the euro is in question while the risk of recession has intensified as tighter credit conditions and austerity measures take a toll on the region's economy. Without growth, it is uncertain how debt burdens can be alleviated.

Across the Atlantic, there is considerable uncertainty over the US fiscal trajectory. Political gridlock in Congress has stalled progress in bringing the deficit under control. Failure to break the impasse may undermine the anaemic economy. However, some encouraging signs are emerging. Recent employment, manufacturing and housing indicators pointed to modest growth which could put the economy on a firmer footing.

Developing countries will not be immune from global economic turmoil. Notably, the more open export-driven economies will be concerned about waning demand from developed markets and tighter credit conditions. In addition fears that China may still face a hard landing after years of breakneck expansion loom large, while inflation in countries such as India and Turkey remains elevated. Political events could also test markets. Key elections are due in India's major states, Taiwan, Mexico, Russia and the US; as well there will be a leadership handover in China.

Despite the grim outlook, we still believe that emerging markets continue to offer a compelling investment opportunity. First, the problems are mainly external. Emerging economies may be moderating but growth is still expected to outpace their developed counterparts. Developing economies are forecast to grow by about 6% in 2012, which is healthy compared with the 2% growth projected for the advanced nations. In China and India, for example, slowing growth has been largely a result of domestic tightening measures. The economic slowdown, coupled with easing commodity and energy price adjustments, should provide some relief for one of the most challenging aspects of the asset class: inflationary pressure. Falling inflation should enable central banks to follow a more expansionary monetary policy, which would support domestic demand. In fact, policymakers in Brazil, Indonesia and several other emerging countries have already cut interest rates to support growth. China also lowered lenders' reserve requirements in November, the first cut since December 2008.

Second, many emerging economies are also in a much healthier fiscal position than the advanced nations. Most governments are fiscally sound which will enable them to implement stimulus if the external environment deteriorates further. Corporate and household balance sheets are healthy and the potential for increasing demand from a growing middle class is also positive.

Caution is merited in view of the uncertainty ahead. Global markets have become more correlated amid sharp swings. In this climate little attention is being paid by investors to fundamentals. Our defensiveness underpinned our outperformance last year, and we expect it should help in what could be a more challenging period. Valuations have become attractive following the market turbulence, making it an opportune time to buy or add to stocks that are trading at reasonable levels; we have topped up our preferred holdings in turn.

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