

EMERGING MARKETS EQUITY / JANUARY 2010

Strong Fundamentals

The calendar year 2009 was very volatile for emerging markets, following a period—the last two quarters of 2008—where they had underperformed their developed counterparts for a couple of reasons. First, many investors had significant profits in emerging markets and were eager to realize them. Second, many investors recalled what happened in the 1980s and 1990s, when emerging markets underperformed the developed world in down movements.

Since bottoming in February and March of 2009, emerging markets have done extremely well, substantially outperforming the developed world. There are multiple drivers for this: the fundamentals in the developing world today are very good; their financial systems are not overleveraged; and consumers in many parts of the emerging world have a greater ability to spend in comparison to what is happening in the industrialized world.

The most critical economy in the world today, China, is demanding large amounts of commodities and basic manufactured goods, many of which are being sourced from other emerging countries. With people streaming from its rural areas to its cities, we believe that China, because of its need to employ those individuals, must continue growing. To avoid social unrest, enough jobs will have to be provided; we foresee this trend continuing for the next 10 years.

Compared to 10 years ago, when marginal demand came from the developed world, today there is a larger component of domestic consumer demand in emerging markets. Indeed, we believe that even export-oriented countries, like China, will have to depend to a greater degree on domestic consumption.

Currently, our strategy is positioned to benefit both from consumer and corporate/government spending in emerging markets, as we believe all these players are in reasonably good shape and will likely do well over the next five years. Consumers have more money than they have had for a long period of time; employment rates are relatively high; governments have been helped by larger tax revenues; and corporations have generally had good profits over the course of the last six or seven years.

From a sector perspective, we have found less relative value recently in economy-sensitive areas, such as energy and materials, and more value in certain defensive areas. Therefore, we have allocated more capital to the telecom services and consumer sectors, and sold stocks in energy and materials.

From a country perspective, we continue to hold large exposures to Brazil, Mexico, Indonesia, Egypt, Turkey, Russia—for the first time we have larger-than-index exposure to Russia—and South Africa. Recently, we have trimmed some of our exposure in Indonesia and in Russia, because of upward price movements, but our emphasis is still there. For the last three years, we have found relatively little value in Chinese public equities. We do not have a large exposure in Taiwan; stocks are not terribly expensive there, but profitability is not high. We do not have a high exposure in Eastern Europe, either, particularly in Poland, Hungary, and the Czech Republic, where we still see expensive valuations. Chile is also a very expensive market, and we have no exposure there.

We remain optimistic over the long term. We believe that today, the fundamentals for the emerging markets equity asset class are as good as they have been at any time since the 1970s—and in our opinion we are in a period very similar to the 1970s. There is an industrial revolution taking place, and we believe we are going to see sustained demand for commodities and basic manufactured goods that will have to be sourced particularly from emerging markets.

Therefore, our outlook is optimistic over a three- to five-year term. However, we believe that this optimism must be tempered by the enormous rise we have seen in emerging markets equities since February 2009. As these markets do not tend to move in a linear fashion, we believe that investors should not be aggressive on a one-year view, and we are neutral over this shorter time period.

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NOTES:

Published on 4 January 2010.

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