Market Commentary

August 2014

- **Emerging market equities outperformed the broader developed markets but lagged the S&P 500.**
- **Brazilian equities outperformed its emerging market peers.**
- **Valuations across global equity markets remain attractive relative to long-term historic averages.**

Emerging Markets

Global equity markets closed up in August after hitting a record high during the month. This occurred in the face of continued flare-ups in the geopolitical arena and uncertainty regarding key central bank policies. After outperforming their developed market peers for three consecutive months, emerging market equities again outperformed the broader developed markets, but lagged the S&P 500. The MSCI Emerging Markets Index rose 2.29%, while the MSCI World Index and the S&P 500 Index gained 2.26% and 4.0%, respectively.

The MSCI China Index underperformed the broader emerging market universe in August, but managed a small gain of 0.23% in USD terms. Some of China's more widely followed macroeconomic indicators turned softer last month. August HSBC manufacturing PMI came in below expectations and fell to 50.2 from 51.7 in July. The latest data shows housing sales continue to slow, as did Macau gaming revenue. However, inflation remains benign at about 2%, giving the central bank room to implement supportive monetary policy.

After taking a short breather in July, Indian equities resumed their upward march in August. The MSCI India Index advanced 3.25% in USD terms, outperforming the broader emerging market universe. Gains were driven by further signs of an economic upturn and continued strong sentiment. Lower crude prices also helped support the market. India's second quarter GDP surprised on the upside and grew 5.7% year-over-year, the best in over two years. Also, the country's current account deficit declined to 1.7% of GDP from 4.8% of GDP, largely due to a more favorable trade environment. On the other hand, after declining for two consecutive quarters, inflation accelerated in July with CPI rising 7.96% year-over-year on the back of higher food prices.

The MSCI Brazil Index continued its rally in August, gaining 11.06% in USD terms. The strength in the market has been led by polls that indicate an increased possibility of a change in government in October's presidential election. The strong performance of Brazilian equities contrasts with the economy's weak output, as the country is now in an official recession following two consecutive quarters of negative growth. Sentiment remains focused on the potential for future reform and more market-friendly policy.

Valuations across global equity markets remain attractive relative to long-term historic averages. The MSCI Emerging Markets Index currently trades at a price to earnings (P/E) multiple of 13.9x, whereas the MSCI World Index trades at 18.2x and the S&P 500 Index trades at 18.0x. Historically[1], these indices have traded at 14.4x, 21.3x, and 19.3 x, respectively[2].

[1]Historical averages since 1996
[2]Bloomberg, as of 8/31/14

China

Market Update

Despite the volatility throughout the month, the Chinese market ended August flat, with the MSCI China Index gaining just 0.23% in USD terms. Though economic conditions, corporate earnings, and fund flows continue to reflect a generally positive trend, they were not strong enough to extend the market rally. On a sector basis, large-cap stocks in the energy and telecom sectors performed well, while mid- and small-caps in the consumer and IT sectors underperformed.

On the macro front, PMI was weaker than consensus, with August HSBC manufacturing PMI falling to 50.2, from 51.7 in July, suggesting sooner-than-expected softness. On the other hand, services PMI rose to 52.8 from 51.6, but it could follow the same trend as manufacturing PMI in the coming months. Exports grew 9.4% year-over-year in August, while imports surprised to the downside, declining 2.4% and producing a record monthly surplus of $49.8 billion. Meanwhile, inflation remains benign, rising just 2% year-over-year in August, giving the central bank room to implement supportive monetary policy.

First-half earnings announcements so far have generally been in line with expectations; however, property sales and VIP gaming revenues continue to slow. Housing sales have dropped 10.5% in value year-over-year through July, while Macau gaming revenue fell for a third consecutive month in August.

On the reform front, the government continues to gradually implement state-owned enterprise (SOE) reforms, recently pushing for salary cuts for government-appointed senior personnel of SOEs.

Investment Outlook

While the Chinese market's positive momentum seems to have paused in August, we maintain a favorable outlook for the remainder of the year as we expect additional government easing policies, renewed capital inflows into emerging markets, and gradual SOE reforms to support the market. Though China continues to face a number of near-term challenges, the market is cheap and remains underowned. We believe that if the government continues to build upon governance reforms in SOEs, and the economy holds up with a moderate dose of credit, investment opportunities should abound for patient investors. Looking forward, we are positive on mid-caps in the consumer, healthcare, IT and industrial sectors. We favor investment themes in these sectors and believe they offer superior growth potential. However, we are less constructive on some large-cap names in banking, energy and properties, believing that they are now fairly priced given recent gains.

Additionally, we like telecoms in light of 4G-led improvements to average revenue per user, as well as Chinese food staples, as we believe the desire for quality food is a lifestyle change that will gain significant momentum in coming years. We are cautious on gaming, where data is likely to remain soft for the next couple of quarters before new capacity kicks in. Within the financials sector, following a meaningful rebound over the previous few months, we have a less favorable outlook for banks given the oversupply problem in the property sector. Instead, we prefer the insurance subsector as interest in more sophisticated financial products among middle-class households is expected to grow.

India

Market Update

Indian equities continued to advance, with the MSCI India Index up 3.25% in USD during August, on the back of the strong "feel-good" factor and cyclical economic recovery. Improving growth prospects in the US and lower crude prices, despite the instability in the Middle East and Russia, also helped buoy the market.

While Indian equities reached a historical high, gains were more discerning than we have seen since the election of Narendra Modi in May, as investors sought quality businesses that could benefit from the economic uplift rather than stretched balance sheets. On the economic front, second-quarter GDP surprised to the upside, growing by 5.7% year-over-year, up from 4.6% in the first quarter and well above the consensus estimate of 5.3%. Also, the country's current account deficit declined to $7.8 billion, or 1.7% of GDP, in the second quarter, from $21.8 billion, or 4.8% of GDP, a year earlier, largely due to the more favorable trade environment. Though the pace was slower than the previous two months, exports continued on an upward trajectory, rising 7.3% year-over-year in July, while non-oil and non-gold imports grew 2.9%, further validating the economic upswing. However, after declining for two consecutive quarters, inflation accelerated in July with the CPI rising 7.96% year-over-year on the back of higher food prices, leading to the Reserve Bank of India to hold interest rates steady.

While the pace of infrastructure clearances has picked up, the Supreme Court's ruling that government coal block allocations since 1993 are illegal presents a setback. This could be a litmus test of the government's ability to move to an auction-based system for natural resources in the coming quarters.

Investment Outlook

While second-quarter GDP reflects a revival of economic activity, the challenge remains building on this recovery through higher foreign direct investment (FDI), reforms like the Goods and Services Tax (GST), and reductions in food and fertilizer subsidies. The Prime Minister's statement on financial inclusion, advocating for at least one bank account for 75 million unbanked households by August 2015, is a significant positive as it would lay the foundation for direct benefit transfer, a much more effective way of helping the needy, and allow the government to reduce subsidies. One headwind still facing the economy, though, is persistently high inflation—CPI growth remains well above the central bank's target range of 2% to 6%—thus India's inflation trajectory will need to be carefully watched.

We have benefited from our focus on quality businesses at reasonable valuations, and we remain positive on mid-caps across the consumer discretionary, agriculture, auto ancillaries and financials sectors as we believe these industries reflect significant growth potential over the next five to seven years. We are also growing more constructive on Internet firms as smartphone penetration is likely to rise from just 4% today to 22% over the next four years, leading to exponential growth in Internet subscribers by 2018 and making India the second largest Internet market in the world behind China.

Korea

Market Update

The KOSPI Index was relatively flat in August, declining 0.38%. On a sector basis, transportation, food and beverage, telecommunications, and logistics outperformed on the back of improved earnings visibility and better sentiment following news of the government's domestic demand stimulus policy. On the other hand, cyclicals, including electronics, construction and equipment, underperformed.

Despite recent efforts by the government to revitalize domestic demand, economic data, thus far, has been soft. Exports declined slightly in August, falling 0.1% year-over-year as leading exporters in electronics, cars and industrials continue to face the headwinds of higher competition and weaker demand from Europe and China. Though imports rose 3.1%, this was well below the consensus forecast for 5.1% growth. On a more positive note, HSBC manufacturing PMI inched back into expansion territory, increasing to 50.3 in August, from 49.3 in July, as new orders rose for the first time in four months. Inflation continues on a downward trajectory, declining to 1.4% in August, from 1.6% in July, giving the central bank room to cut the policy interest rate for the first time in 15 months by 25 basis points to 2.25%, the lowest rate since November 2010.

On the earnings front, while second-quarter earnings fell short of consensus and earnings estimates continue to be revised downward, the environment reflects improvement over the earnings shocks seen over the previous few years.

Investment Outlook

Though the Korean government has expressed strong determination to stimulate the domestic economy, which has created an atmosphere of policy anticipation, the market impact may not be the same as seen in Japan. In Japan, the implementation of "Abenomics" resulted in a weaker yen and improved earnings, allowing the Japanese market to rally from low valuations. In contrast, Korean valuations are already higher than those of other emerging markets, capping the market upside to the stimulus policies. Additionally, the Korean market could be affected by external uncertainties, including monetary policy in the US, growth stagnation and deflation risk in Europe, and the unknown growth trajectory in China.

The combination of the KOSPI's recent rally and continuing downward earnings revisions has increased the index's 12-month price-to-earnings ratio estimate to 11.1x, the upper limit of its range since 2012. This high valuation level has sparked some fears of a bubble, particularly in the consumer staples, IT, software and service sectors, which reflect some of the highest valuations. However, we believe it is too soon to classify the current situation as a bubble as earnings forecasts are turning around and government policy support to revitalize domestic demand justifies higher valuations in the private consumption and service sectors.

As foreign investors increase allocations to emerging markets, supply and demand dynamics are likely to remain intact. However, domestic redemptions continue as the KOSPI may have surpassed its resistance point, making an additional rally seem unlikely.

The Association of Southeast Asian Nations (ASEAN)

Market Update

Within the ASEAN region, the Philippines and Thailand outperformed, while Malaysia and Indonesia underperformed. The Philippines continues to be the sweet spot of the region, with second-quarter GDP up 6.4% driven by strong domestic investment and exports, while the Thai market gained as the military coup that took place in May helped resolved the political impasse.

In Indonesia, the constitutional court upheld Jokowi's victory and he will assume office in October; however, the economic backdrop continued to reflect slow growth with second-quarter GDP coming in at 5.1%, the slowest pace since third quarter 2009. Meanwhile, the trade deficit widened, making it imperative for Jokowi to institute tough measures to reduce fuel subsidies and boost exports.

Investment Outlook

The ASEAN region has performed well in recent months, thanks to ample liquidity and the hope for political improvement in Indonesia. Looking ahead, we remain positive on the Philippines due to a number of catalysts and growth engines, including relative political stability, expansion in Overseas Filipino Workers remittances, growth of business process outsourcing (BPO) businesses, and forthcoming infrastructure projects. In fact, the World Bank's forecasted growth rate for the Philippines of 7% for 2014 and 2015 is second only to China. That said, persistent inflation remains a concern as it could lead to an interest rate hiking cycle. In terms of sectors, we generally prefer consumer names, as rising employment could initiate an aspirational consumption trend. We are also constructive on gaming, with the new gaming site at Manila Bay set to become a true gaming cluster over the next few quarters as new properties open later this year.

We are cautious on Malaysia as we do not see significant growth opportunity or an attractive business model. Malaysia is highly dependent on energy prices, as one-third of its fiscal revenue comes from energy production, and a large portion of its export market is in the energy sector. With energy prices expected to remain subdued for an extended period of time, and as most large companies are government-related, Malaysia lacks a significant growth catalyst.

With political uncertainty behind it, Indonesia can now move forward, but after two quarters of strong gains, we are less bullish. Key to the country's future will be whether the new government can facilitate more efficient use of fiscal revenue, including a reduction in fuel subsidies, which currently account for one-fifth of revenue. What is needed in Indonesia is not fresh ideas, but sincere execution of old reform ideas. Therefore, significant gains going forward will be predicated on the government's ability to implement an economic reform agenda. We remain positive over the long-term as the country's structural growth story remains intact given its young population and fast progression towards urbanization.

In Thailand, though the market has gained over the last three months, we believe the optimism is a bit ahead of fundamentals and we remain concerned about the long-term outlook for the economy.

In terms of sectors, across the region, we prefer healthcare, tourism and infrastructure-related names. We are growing more cautious on the financial sector, particularly the real estate industry, as it is the most vulnerable to rising interest rates.

Brazil/Latin America

Market Update

The Brazilian market continued to gain, with the MSCI Brazil Index rising another 11.06% in USD terms during August, extending year-to-date gains to 25.31%. The market has been propelled by polls that indicate an increased probability of a change in government in the October presidential election. On a sector basis, energy, utilities and financials have led performance, driven by state-controlled companies that would likely benefit the most from a change in political leadership and economic policy. On the other hand, the materials sector, notably steel and mining companies, remains weak, weighed down by high domestic inventory levels coupled with weak economic output and demand.

The strong performance of Brazilian equities is at odds with its weak economic output, as the country is now in an official recession following two consecutive quarters of negative growth. Investors, however, remained focused on the potential for future reform and more market-friendly policy, rather than near-term GDP data.

The Latin American region as a whole also continued to advance, with the MSCI Latin America Index gaining 7.96% in USD terms for the month. In addition to Brazil, Peru also outperformed while Chile lagged as tax reform weighs on both consumer and corporate confidence.

Investment Outlook

Our stance towards Brazil remains marginally more constructive than it was in the first half of the year as a potential shift in economic policy and a reduction in the market risk premium are likely should the opposition candidate be elected in October. While the situation could move either way; we see the substantial upside to state-controlled companies in the event of an opposition win and believe these names would face considerable selling pressure if the incumbent is re-elected.

Despite recent gains, valuations remain reasonable, though we continue to be cautious given the macro backdrop of low growth and persistent inflation. In broad terms, we favor companies offering above-average growth at attractive valuations, with a preference for high earnings visibility and proven cash flow generation potential. In terms of sectors, we see opportunity in the financial, real estate and consumer sectors, where there is dividend and buyback support at current levels. However, we are less constructive on the telecom sector, where the potential for M&A is already priced in, and we remain wary of the utilities sector given the current political and rationing risk.

Across Latin America, we are most positive on Mexico and Brazil, and less so on Chile and Colombia, where we do not see significant value. While the Mexican market has been largely flat, we remain

structurally optimistic on the investment case, though we continue to be selective given valuations. Additionally, encouraging signs of a growth revival in the second half are beginning to emerge, including initial indications of a recovery in output and consumer activity.

Regionally, on a sector basis, we continue to prefer financials and secular consumer growth stories, including casual dining, insurance and education. Additionally, as we expect some output recovery into 2015, we are positive on pro-cyclical growth companies, including cement, real estate and banks.

Eastern Europe, Middle East and Africa (EEMEA)

Market Update

The Russian market fell again in August, with the MSCI Russia Index declining 1.52% in USD terms for the month. The possibility of further sanctions and pressure from the international community to resolve the conflict with Ukraine continued to drive equities lower as increased violence and more hostile rhetoric between Russia and the West weighed on the market. Across Eastern Europe, however, Russia, along with Poland, outperformed, while Hungary and Turkey underperformed for the month. In Turkey, local elections highlighted the increased political risk and clear pressure on the central bank, which overshadowed positive earnings revisions. In general, the regional market was characterized by low volumes, which led to equity volatility.

The Middle East/Africa region was flat in August. Within the region, Qatar, United Arab Emirates and Egypt outperformed, while South Africa underperformed. In particular, a major property developer in United Arab Emirates added significantly to performance in that market.

Investment Outlook

In Russia, we expect the risk premium to remain elevated until a plan to resolve the conflict with Ukraine is put forth, and volatility is likely to remain a key feature of the market for the foreseeable future given the uncertain political outlook and risk of further sanctions. However, as one of the worst performing emerging markets year-to-date, Russia's price-to-earnings multiple is now equal to its expected dividend yield for 2015, offering attractive opportunities for investors. Against this backdrop, we maintain a preference for high-quality companies in industries generally left alone by the government, such as retail and Internet companies, where the focus is on profitable growth for shareholders. We are also constructive on certain cheap cyclicals and exporters that benefit from a weak ruble and better cost controls. Meanwhile, we remain wary of government-controlled entities that can be affected by adverse government policy and generate poor returns on invested capital. Elsewhere in Eastern Europe, Turkey remains vulnerable to political risk, as well as global liquidity events, including rising US interest rates. Additionally, the domestic interest rate easing cycle is already priced into the market, making valuations less attractive, particularly in the financials sector.

In the Middle East/Africa region, South Africa will continue to be impacted by its high fiscal and current account deficits as its dependence on global liquidity causes its currency and cost of debt to come under pressure given expected increases in US interest rates. On the other hand, Middle Eastern countries that do not rely on global liquidity, including Qatar and United Arab Emirates, are becoming more interesting as these relatively isolated markets whose currencies are pegged to the US dollar could help with capital preservation for investors looking for growth.