Market Commentary

July 2014

- **Emerging market equities outperformed their developed market peers in July.**
- **Chinese equities outperformed their emerging market peers.**
- **Valuations across global equity markets remain attractive relative to long-term historic averages.**

Emerging Markets

Global equity markets were mixed in July, a month during which geopolitical events took center stage. Despite escalating tensions in the Ukraine and the Middle East, emerging market equities again outperformed their developed market peers. The MSCI Emerging Markets Index rose 1.43%, while the MSCI World Index and the S&P 500 Index fell 1.67% and 1.51%, respectively.

The MSCI China Index rallied strongly in July, closing up 7.35% in USD terms. Chinese equities gained on the back of cyclical and policy-related momentum. Recent macroeconomic data releases exceeded market expectations. HSBC manufacturing PMI registered 51.7 in July, an 18-month high. Industrial production rose 9.2% year-over-year in June, the highest growth rate since December. In addition, export data surprised on the upside, rising 14.5% year-over-year, exceeding the consensus estimate for 8% growth. On the reform front, the government continued to announce incremental measures, including a program aimed at increasing private investments and improving management at state-owned enterprises (SOE). We believe that these factors, combined with attractive valuations, are supportive for Chinese equities in the second half of the year.

Indian equities took a breather in July and the MSCI India Index closed flat in USD terms. While the new government's Union Budget may have fallen short of the market's very high expectations for reforms, we are encouraged by the change that we perceive happening on the ground as there are early signs of a revival in the economy. Reflecting some of this recovery is India's HSBC manufacturing PMI for July, which reached a 17-month high of 53, up from 51.5 in June. Also, industrial production rose 4.7% year-over-year in May, the highest level in 19 months and well above the consensus estimate of 2.5%. However, near-term challenges remain, including sticky inflation and high interest rates.

The MSCI Brazil Index rallied again last month and closed up 1.68% in USD terms. Gains continued to be driven by the possibility of political change in the October presidential elections, which equity investors believe could be a potential trigger for more market-friendly policies. Valuations currently remain reasonable, but earnings revisions have yet to turn positive. Overall, we remain cautious on the macro backdrop given low economic growth and persistent inflation, but we are more constructive than we were in the first half of the year due to the potential for a significant shift in economic policy and a reduction in the market risk premium should the current opposition party be elected in October.

We believe 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 13.4x, whereas the MSCI World Index trades at 18.2x and the S&P 500 Index trades at 17.6x. Historically,[1] these indices have traded at 14.4x, 21.3x, and 19.3x, respectively.[2]

China

Market Update

The Chinese market rallied in July, with the MSCI China Index gaining 7.35% in USD terms, for a year-to-date return of 4.61%. Gains were driven by policy reform and stronger liquidity input. Among the sectors that outperformed for the month were Internet, banks and insurance.

On the reform front, the government announced a SOE pilot program, aimed at increasing private investments and improving management at six SOEs. Meanwhile, using a new monetary tool called Pledged Supplementary Lending, the People's Bank of China extended credit totaling 1 trillion yuan ($161 billion) to the China Development Bank to support social infrastructure projects. Additionally, as mini-stimulus measures continue feeding through the economy, recent macro data has exceeded expectations. HSBC manufacturing PMI came in above market expectations, reaching an 18-month high of 51.7 in July. Industrial production also rose 9.2% year-over-year in June, the highest growth rate since December, and exports surprised on the upside, rising 14.5% year-over-year, dramatically exceeding the consensus estimate for 8% growth.

Investment Outlook

Following a weak first half, the Chinese market has been gaining cyclical and policy-related momentum. However, valuations remain attractive and fund flows to emerging markets are on the upswing, suggesting that China offers more upside potential than downside risk.

Sentiment towards the property sector may also be on the rise. The change in the loan-to-deposit ratio was a sign that policy makers remain vigilant on the growth outlook and will likely keep the policy stance relatively accommodative in the near term, which could remove tail-risk concerns over a Chinese hard landing/property crash. Meanwhile, if the government continues to move in the direction of greater openness to private capital in traditional sectors, which the new SOE pilot program suggests, this could be a long-run game-changer for efficiency improvement in productivity and capital allocation.

On a sector basis, we believe that with the initial stage of the market rebound well underway, mid-caps will soon begin to outperform. We particularly like select quality healthcare names, consumer companies that are expanding their global market share, IT component makers, and automobile stocks. We also believe that clean energy and pollution-control sectors could maintain their strong momentum given increasingly favorable policy, especially the milestone China-Russia natural gas deal. On the other hand, following strong outperformance, defensive names, including some in the consumer staples and utilities sectors, now reflect relatively high valuations.

Longer term, we believe China will move forward at a 5% to 6% GDP growth rate over the next three to four years. If growth falters, the government will likely implement mini-stimulus measures, then tighten credit once conditions normalize. As a result, we are positive on secular growth sectors, such as Internet, healthcare, travel and tourism, but more cautious on old economy sectors like financials and telecom, where we will seek tactical opportunities when they become cheap or reforms gain momentum.

India

Market Update

Following a rally that began in February, the Indian market was flat in July, as investors paused to see how political hopes translate into improved economic momentum.

The much-anticipated Union Budget, which was unveiled on July 10, focused on controlling the fiscal deficit while continuing incentives for business investments; however, it may have fallen short of the market's very high expectations given the lack of detail on subsidy reductions. While the government continues to prioritize reducing the fiscal deficit to 4.1%, the budget also raised the foreign direct investment (FDI) caps for the insurance and defense sectors from 26% to 49%, and set aside $8.3 billion to invest in infrastructure projects, which the government believes will spur job growth. Also supporting infrastructure investment in the country, the central bank eliminated the Cash Reserve Ratio (CRR) and Statutory Liquidity Ratio (SLR) requirements on infrastructure loans, thereby lowering the cost of long-gestation projects by 100 to 200 basis points.

[1]Historical averages since 1996
[2]Bloomberg, as of 7/31/14

On the economic front, while CPI inflation remains above the central bank's target range, rising 7.3% year-over-year in June, it is on a downward trajectory, declining from 8.3% in May. Additionally, the expected monsoon season rain shortfall has been significantly reduced following a sharp increase in rainfall in recent weeks, which should help alleviate some of the pricing pressure on food prices.

Improvement in consumer sentiment is visible in rising car and cement sales, as well as improving industrial production. HSBC manufacturing PMI reached a 17-month high of 53 in July, up from 51.5 in June, and the industrial production index rose 4.7% year-over-year in May, the highest level in 19 months and well above the consensus estimate of 2.5%. However, corporate results have been mixed, with technology and financials in line with expectations while pharmaceuticals surprised to the upside and industrials reflected the tough business conditions of the past. Additionally, though improving global growth has led to increased exports over the past couple of months, gold imports surged in June as the central bank eased restrictions, resulting in a monthly trade deficit of nearly $12 billion.

Investment Outlook

Though the market was somewhat disappointed by the lack of detail in the Union Budget, our own observation has been that change is happening on the ground and that there are early signs of a revival in the economy. However, near-term challenges remain in the form of sticky inflation and high interest rates. Moving forward, policy implementation and execution will continue to be key to India's economic rebound and further market re-rating, but instead of the "big bang" reforms the market may have been expecting, the government seems to be approaching reform in a progressive manner so as not to attract undue opposition for the whole program.

On a sector basis, we remain positive toward quality cyclicals in the financials and consumer discretionary sectors, and believe that these positions should perform well over the medium term. Within financials, we prefer well-managed public sector banks, as we expect asset quality concerns to abate in the coming quarters on the back of improving economic momentum.

Korea

Market Update

The KOSPI Index climbed 3.69% in July as Korean equities rallied on the back of attempts by the government to improve domestic sentiment and consumption. In July, the government agreed to raise the loan-to-value ratio to a single rate of 70%, and the debt-to-income ratio to 60% in Seoul in an effort to boost the sagging property market. Meanwhile, the government announced a domestic demand revitalization plan, which will include income tax credits and a reduction in levies for companies that increase wages and dividends.

Despite increasing exports and the announcement of efforts to improve domestic consumption, the Bank of Korea lowered its growth outlook for 2014 from 4% to 3.8%, while at the same time maintaining the benchmark interest rate at 2.5% for the fourteenth consecutive month, even though inflation has been subdued, rising just 1.7% year-over-year in May and June. The central bank expects the pace of inflation to accelerate over the remaining months of the year, ending 2014 at 2.1%. Export growth continued on a upward trajectory, increasing 5.7% year-over-year in July, up from 2.5% in June. While exports to developed markets, particularly the US, increased significantly, exports to China, which accounts for about a quarter of Korea's total export market, contracted 7%. Imports also surprised to the upside, growing 5.8% year-over-year.

Investment Outlook

In Korea, we anticipate an interest rate cut within the next six months, as well as greater details on the domestic demand revitalization plan and the 2015 budget. In particular, we expect that an interest rate reduction will have meaningful implications for the Korean market, as it will shift investments from risk-free vehicles to risky or "yield" assets, and offer profit protection to exporters by helping to weaken the currency.

Solid foreign investor flows into the Korean market may continue as investment spreads across emerging markets. That said, the Korean market may reach a resistance point at around the 2,060-2,080 level for the KOSPI, spurring equity fund redemptions.

On a sector basis, the domestic demand revitalization announcement coincided with the Chinese market rebound, leading to net purchases in sectors that had been neglected for a long time. However, we believe that stock valuations have already reached the top of their fluctuation range, and we don't expect further upside from the current price level.

The Association of Southeast Asian Nations (ASEAN)

Market Update

The ASEAN region gained in July, led by Indonesia, which rallied on the victory of market-favorite candidate Joko "Jokowi" Widodo in the presidential election. Though the market responded very positively to Indonesia's presidential election result, the economy continues to reflect slowing growth, with GDP growth falling to 5.12% year-over-year in the second quarter from 5.22% in the first. However, inflation declined dramatically in June, falling to 4.5% year-over-year, from 6.7% in May, and exports rebounded strongly, increasing 4.5% year-over-year in June, from a decline of 8.1% in May.

The recent political turmoil in Thailand continues to be reflected in its results. Chinese tourist arrivals were down 23% in the first half and in an effort to reignite the tourism industry, the government has announced visa fee waivers for Chinese and Taiwanese tourists over the next three months. Meanwhile, political issues continue to dominate the news. In July, the military-led National Council for Peace and Order (NCPO) which took over the government in May, announced that local administration officials with terms expiring by the end of the year will be replaced with selected officials, and that local elections would be suspended for the foreseeable future. However, following price control measures implemented by the government in June, inflation has been on the decline, falling to 2.16% year-over-year in July.

While Malaysia's inflation held relatively steady at 3.3% year-over-year in June, FDI has disappointed due to the government's inward looking growth focus, suggesting tighter domestic liquidity. In the Philippines, inflation continues on an upward trajectory, rising 4.9% year-over-year in July, from 4.4% in June, leading the central bank to increase the benchmark interest rate for the first time in over three years by 25 basis points to 3.75%.

Investment Outlook

The market will keenly watch quarterly results in August for further cues on growth and margin recovery. Monthly macro growth will also be closely evaluated to determine whether the recovery is gaining strength or losing momentum. We believe that investors have been underweight the region over the last two years and will increase allocations on the back of a growth recovery and greater political certainty in Indonesia.

In Indonesia, Jokowi is likely to progressively reduce fuel subsidies and focus on infrastructure and manufacturing-led growth. However, the market anxiously awaits Jokowi's master plan, and with a fractured mandate, a growth revival will be more difficult to implement.

The market will also pay attention to the infrastructure plan in Thailand, including whether the NCPO passes it relatively soon and the level of spending it contains. Expectations are high that expenditures will focus on railway, mass transit, roads and expansion of the Bangkok airport. However, if not passed in August, concerns that the delay will negatively impact the economy could hit the equity market.

In the Philippines, a further 100 basis point interest rate increase is expected over the next 12 months. Meanwhile, the domestic growth story remains on track, as evidenced by greater than 20% growth in auto sales year-to-date.

Brazil/Latin America

Market Update

In July, the MSCI Brazil Index rose 1.68% in USD terms, extending its year-to-date gains to 9.58%. The Brazilian market continues to rise on the possibility of political change in the October presidential elections, which equity investors believe could be a potential trigger for more market-friendly policies, particularly within the energy, banking and utilities sectors. For the month, on a sector basis, materials continued to lag due to weak iron ore prices and subdued domestic steel demand, while financials outperformed, particularly in the private banking and insurance subsectors.

Despite the market's upward momentum, earnings revisions have yet to turn positive, and inflation remains stubbornly high, rising 6.52% year-over-year in June, slightly above the central bank's target ceiling of 6.5%.

The MSCI Latin America Index also rose in July, bringing year-to-date gains to 6.21%. In addition to Brazil, Colombia and Peru have performed well year-to-date, supported by robust economic growth in the 5% to 6% range. Only Chile has registered negative performance as tax reform continues to weigh on the corporate earnings outlook. Meanwhile, after a strong re-rating, Mexico has traded sideways, as investors digest the combination of a long-term positive growth outlook with a more conservative near-term view as consumer activity remains sluggish. In terms of sectors, financials, specifically Brazilian and Peruvian banks, outperformed, while the consumer discretionary and materials sectors underperformed.

Investment Outlook

Our stance towards Brazil is marginally more constructive than in the first half of the year due to the potential for a significant shift in economic policy and a reduction in the market risk premium should the current opposition party be elected in October. This is largely a binary call, and while we acknowledge substantial upside to state-controlled companies, these names are likely to experience selling pressure if the incumbent is re-elected.

We believe valuations continue to be reasonable, though we remain cautious on the macro backdrop given low growth and persistent inflation. GDP growth is expected to remain weak over the near term, rising around 1% in both 2014 and 2015. However, until the elections next quarter, the market is likely to stay focused on politics. As other emerging markets, including India, Mexico and Indonesia, have recently shown, markets offering the potential for significant economic or political reform may re-rate in advance of both earnings and growth revisions.

In Brazil, we have a continued preference for structural growth stories, including insurance, financial services and retail, and we have also identified several value opportunities offering dividend and buy-back support at current levels, notably within the financials, real estate and consumer sectors. Meanwhile, we remain less constructive on the telecom sector, where the potential for M&A activity is already priced in. We are also highly sensitive to the utilities sectors, given currently political and rationing risks.

Across the Latin American region, we remain optimistic on Brazil and Mexico but less so on Chile and Colombia, where we do not find significant value. In Mexico, we are structurally positive on the investment case, though we are being selective given current valuations. Initial signs of a recovery in output and consumer activity indicate an improving backdrop in the second half, making us more positive on financials, REITs, and select consumer names. Broadly within Latin America, though we continue to prefer companies offering above-average growth at attractive valuations given the weak prevailing macro-economic backdrop, we do see some output recovery into 2015 and therefore have a more favorable outlook for pro-cyclical growth companies, including cement, real estate and banks.

Eastern Europe, Middle East and Africa (EEMEA)

Market Update

The Russian market fell in July, with the MSCI Russia Index declining 10.88% in USD terms for the month. Tensions around the conflict in Ukraine flared as the tragedy surrounding the Malaysia Airlines flight that was shot down over eastern Ukraine on July 17 proved to be a pivotal point that led to increased pressure on Russia from the international community. The increased sanctions, coupled with uncertainty over even greater sanctions and the inevitable effect on Russia's economy and political ties, mean the risk premium in the market could remain elevated for some time.

The Eastern European region as a whole also declined; however, underperformance by Russia and Hungary was partially offset by outperformance from Turkey. Turkey, which was the only regional market to post a gain during the month, rose on better-than-expected macro data, allowing the central bank to further reduce interest rates by 50 basis points to 8.25%. The Czech Republic and Poland also proved more defensive than their regional peers, demonstrating slight outperformance for the month.

In contrast to Eastern Europe, the Middle East/Africa region was up for the month. Though South Africa lagged, Qatar and the United Arab Emirates regained momentum following significant underperformance in June.

Investment Outlook

Volatility is likely to remain a feature of the Russian market in the near-term given the uncertain political outlook for the Ukraine and the risk of further sanctions. Given developments during the month and the fact that increased sanctions will negatively impact the economy, we have moderated our positioning in Russia until we gain more clarity. We continue to be invested in high-quality companies in industries that are generally left alone by the government, such as retail and the Internet, where the focus is on profitable growth for shareholders. We also continue to favor certain cheap cyclical stocks and exporters that benefit from a weaker currency 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, we maintain an improved outlook for Turkey as greater political stability, accelerating growth and a sharp improvement in the current account deficit all contribute to a more attractive investment case in the second half of the year. On the other hand, we are less constructive on Poland, as the strong growth outlook is already priced in and valuations are no longer compelling.

In the Middle East/Africa region, we see select opportunities in the Middle East after profit-taking resulted in more attractive valuations. With the end of quantitative easing, dollar-linked economies in the Middle East, such as Qatar and the United Arab Emirates, which have low dependency on global liquidity to fund them, could be more interesting in coming quarters compared to South Africa, which remains vulnerable due to ongoing labor unrest and structural issues surrounding its fiscal and current account deficits.