Market Commentary

June 2014

- **Emerging market equities outperformed their developed market peers in June.**
- **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 in positive territory again in June. While Iraq tensions served as a concern, strong jobs data in the US and monetary easing by the European Central Bank (ECB) were positive catalysts for the markets. Emerging market equities outperformed their developed market peers. The MSCI Emerging Markets Index rose 2.3%, while the MSCI World Index and the S&P 500 Index gained 1.7% and 1.9%, respectively.

The MSCI China Index closed up 1.9% in USD terms in June. Chinese equities benefitted from improved macroeconomic data. HSBC manufacturing PMI came in at 50.7 in June, the highest in seven months, and up from 49.4 in May. Industrial production rose 8.8% year-over-year in May and retail sales grew more than expected, increasing 12.5% year-over-year versus a forecast of 12.1%. Export data for May also surprised on the upside, rising 7% versus expectations for 6.7%. Our outlook for China going into the second half is constructive as we foresee continued improvement in cyclical and structural factors.

Indian equities delivered another month of strong gains in June, and the MSCI India Index rose 4.2% in USD terms. The positive election verdict of Narendra Modi, viewed as pro-growth and reform, continued to drive positive sentiment. Notwithstanding the positive political climate, India's economy continues to face near-term challenges including a high fiscal deficit and stubborn inflation. In addition, the country faces a poor monsoon season, which could keep food inflation high. However, recent macro data showed slight improvements, with inflation easing modestly in May, and HSBC manufacturing PMI for June registering 51.5, up slightly from May's 51.4. Market sentiment is expected to be shaped by the new government's upcoming budget, and corporate results.

The MSCI Brazil Index posted an impressive gain in June of 5.1% in USD terms. After some profit-taking in May, Brazilian equities resumed the strong performance experienced in March and April. The prospect of political change in the fourth quarter elections, which likely would be accompanied by improved macroeconomic policy, has been a key driver of Brazil's broad-based market strength. Nonetheless, incumbent President Dilma Rousseff still leads in the polls, and the macro backdrop continues to remain a concern given the country's low growth and persistent inflation. Investor sentiment likely will be focused on upcoming polls, and give reason for the market to remain volatile.

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 13.3x , whereas the MSCI World Index trades at 18.6x and the S&P 500 Index trades at 17.9x. Historically,[1] these indices have traded at 14.4x, 21.3x, and 19.3 x, respectively.[2]

China

Market Update

The Chinese market moved within a very narrow range in June, with the MSCI China Index rising just 1.9% in USD terms for the month. All sectors delivered positive returns, led by telecom, industrials and healthcare. However, year-to-date through June, the index sits at a loss of 2.6%. Interestingly, "new economy" stocks, which have dominated the market over the last two years, have produced losses so far this year, while cheap, large-cap "old economy" stocks have outperformed.

Despite weak market momentum, we have seen some small improvements in macro indicators. Manufacturing PMI, industrial production, retail sales and exports were all in line with or exceeded expectations. HSBC manufacturing PMI registered 50.7 in June, up from 49.4 in May and nearly on target with the consensus estimate of 50.8. Services PMI also rose to 53.1, its highest level since March 2013, further reinforcing the recovery seen in the manufacturing sector. Meanwhile, industrial production rose 8.8% year-over-year in May, in line with forecasts, and retail sales grew 12.5%, beating analyst expectations for a 12.1% increase. Exports also rose more than expected, increasing 7% year-over-year in May, surpassing the forecast for 6.7% growth. On the other hand, imports fell 1.6%, dramatically trailing expectations for a 6% gain and producing the country's largest monthly trade surplus in five years.

Also supporting the macro environment, the Chinese government implemented a number of measures to improve liquidity and stimulate growth, including cutting the Reserve Requirement Ratio (RRR) by 50 basis points and easing the loan-to-deposit ratio by adjusting the way it is calculated.

Investment Outlook

While we expect China to continue trading in a narrow range in the near future, we foresee gradual improvements in cyclical and structural factors to reflect an improved trend in the second half compared to the first. However, though macro data released in June was positive, we are not overly optimistic on the recovery as declining coal consumption, fewer construction company orders, and a slowing property market continue to weigh on the economy. Since January, residential construction starts and sales are down 22% and 9%, respectively, compared to the same period last year. Looking forward, more mini-stimulus policies might be needed to achieve stable growth, but large-scale monetary loosening remains unlikely.

On a sector basis, we have grown more constructive on high-growth sectors, such as the consumer discretionary, insurance and IT sectors. Within consumer discretionary, we like Macau casinos as corrections over the last several months have provided a good entry point. Meanwhile, the insurance sector looks more attractive than big banks, which have outperformed over the last few months, and IT companies are experiencing structurally improved competitiveness through more sophisticated technology and a more flexible approach to client needs. On the other hand, our outlook for defensive positions in sectors such as utilities, banks and energy is less positive. Over the long term, the healthcare and consumer sectors remain among our top picks as the Chinese economy continues to transition from an investment-led economy to a consumer-oriented one.

India

Market Update

The Indian market continued to build on its positive election verdict, with the MSCI India Index gaining 4.2% in USD terms during June. The new government, led by Prime Minister Narendra Modi, didn't have much time to settle in before beginning to prepare for a poor monsoon season and addressing the country's high fiscal deficit. However, so far, the government has lived up to expectations by continuing fuel price increases and hiking railway freight and passenger fares.

Despite the positive political climate, challenges continue, including persistent inflation. Though inflation eased slightly in May, with the CPI increasing 8.28% year-over-year down from 8.59% in April, the poor monsoon season will likely keep food inflation relatively high. An escalation in Middle Eastern tensions could also lead to a spike in crude oil prices, which would negatively impact the Indian economy given its

[1]Historical averages since 1996
[2]Bloomberg, as of 6/30/14

heavy reliance on imported oil. Additionally, the country's fiscal deficit could widen if the economy recovers without a commensurate rise in domestic manufacturing capacity. The HSBC manufacturing PMI for June came in at 51.5, only a slight improvement over May's reading of 51.4.

Investment Outlook

In the near term, the market's attention will be focused on the Union Budget, which is likely to include rationalization of the tax regime, incentives for exports of goods and services, and tax concessions for the infrastructure sector. With the Union Budget and corporate results upcoming in July, we are keenly tracking measurements of the country's growth recovery. We believe that the market's reaction in re-rating all companies has been too simplistic, as GDP growth is unlikely to return to the 7% to 8% range in the short-term future. That said, we believe that quality, well-capitalized companies will continue to perform well and we maintain a positive outlook for a number of sectors, such as financials, consumer discretionary, including autos, pharmaceuticals and industrials. However, we continue to hold a less constructive view of consumer staples and telecom. Globally, the improving outlook for the US and stabilization in Europe also bode well for Indian IT companies, which continue to gain market share from their developed market peers on the back of competitive and customized service offerings.

June was highlighted by significant capital raising across sectors ahead of a growth recovery and is likely to be followed by large-scale public sector divestments as the government strives to meet its fiscal deficit target. The new Indian leadership has also shown resolve to fix the issues of underinvestment and inefficient bureaucracy to kickstart investment in the infrastructure sector. We believe the upcoming budget will include incentives to boost infrastructure spending, like tax breaks for Special Economic Zones or fundraising by infrastructure companies.

In our view, India is on the cusp of a multi-year bull market as the combination of strong political leadership and a pragmatic central bank helps to ensure that the country's much-touted demographic dividend is finally realized. Looking forward, India's GDP growth is likely to accelerate to nearly 6% in 2016, with infrastructure positioned to be a primary beneficiary of the government's drive to boost productivity.

Korea

Market Update

The KOSPI Index rose just 0.4% in June, posting the lowest performance among major global markets for the month. Earnings concerns of a major technology provider and the strong won negatively influenced the market. Additionally, foreign demand, which has led the KOSPI as of late, started showing signs of slowing, contributing to the Korean market's underperformance. Large-caps outperformed small caps, and despite weak performance of a major provider, the IT sector outperformed, while continued stagnation in distribution, real estate and construction caused these sectors to decline.

On the domestic front, consumption over the last couple of months has been impacted by the ferry disaster earlier this year. Imports grew 4.5%, trailing estimates for a 10.8% increase; however, after contracting 0.9% year-over-year in May — largely the result of subdued Chinese imports — exports rebounded in June, rising 2.5% year-over year to produce a monthly trade surplus of $5.3 billion, on par with last month. Trade surpluses consistently above the $5 billion mark have led to continuing appreciation of the won against the US dollar.

HSBC manufacturing PMI continues on a downward trajectory. After falling below the expansionary mark of 50 in May, PMI registered 48.4 in June as new orders contracted for a second consecutive month. Inflation was on par with last month, rising 1.7% year-over-year in June, and though this is higher than the country has seen over the last several months, it remains well below the central bank's target range of 2.5% to 3.5%.

Investment Outlook

External markets continued to outperform toward the end of the first half, including the US, which rebounded in the second quarter, the Eurozone, and China, where HSBC manufacturing PMI exceeded the expansion level of 50 in June for the first time since December. Given the recovery in these markets, Korea is likely to see continued export growth.

Meanwhile, on the domestic front, policy expectations, such as debt-to-income (DTI) and loan-to-value (LTV) ratio mitigation and interest rate cuts, may be premature. Additionally, any DTI and LTV regulation reform is unlikely as these measures have already been alleviated in response to the real estate market change.

Though capital inflows into emerging markets continue, the intensity has weakened and volatility has increased. Limited inflows into emerging markets in general combined with sensitive foreign investor sentiment regarding the strong currency's impact on export-focused firms' profitability are likely to prevent significant inflows into the Korean market.

At a forward price-to-earnings ratio of 10.3x and a forward price-to-book ratio of 1.08x, we do not consider the KOSPI's valuation to be attractive. Additionally, the KOSPI's year-to-date operating profit has declined by 6% over the past three months, and sensitivity analysis shows that won appreciation of 50 against the US dollar would cause major export corporations' operating profits to drop by 10% within the IT and auto sectors. However, it is expected that political intervention will limit further currency appreciation.

The Association of Southeast Asian Nations (ASEAN)

Market Update

The ASEAN region delivered a modest gain in June. The Philippines and Thailand outperformed the region, with Thailand gaining an impressive 6.9% in USD terms, while Malaysia was largely flat and Indonesia posted a slight loss of 1.3%. In Thailand, improved domestic sentiment following last month's military coup and economic measures endorsed by the military administration were key drivers of the market's outperformance. Meanwhile, the Philippines continues to perform well, though early signs of overheating, such as a rising money supply and inflation, are starting to emerge.

Though the Indonesian market has largely been driven by uncertainty over its impending presidential election, a number of macro measures reflected improvement in June. Inflation fell to a rate of 6.7% year-over-year, down from a steady level of 7.3% over the previous two months. Additionally, the country returned to a slight trade surplus of $70 million in May, as exports rose 3.73% year-over-year while imports declined 9.23%.

In Malaysia, inflation declined to 3.2% year-over-year in May, down from 3.4% in April and trailing analyst expectations for a 3.3% increase. After reaching a 14-month high of 2.62% year-over-year in May, Thailand's inflation also eased to 2.35% in June as the new military government implemented measures to control energy and other prices. Inflation in the Philippines continues to persist with the CPI rising 4.4% year-over-year in June on elevated food prices.

Investment Outlook

July is a critical month for Indonesia as a verdict in the presidential election will finally be announced. The lead that market-favorite candidate Joko "Jokowi" Widodo had enjoyed has significantly narrowed from 30% in early 2014 to nearly 3% in June. Following a strong first quarter, the Indonesian economy has slowed considerably as reflected by subdued auto and cement demand in recent months. Faced with a challenge of diversifying away from commodity-led growth, Indonesia needs strong leadership to pursue tough measures, like the removal of fuel subsidies, and to kickstart the investment cycle to put the economy back on a growth path. Our recent trip to Indonesia confirmed our view that infrastructure growth is about the country's potential from a low base and remains at a very early stage; however, the pace of growth is conditional on increased participation from the private sector and foreign direct investment (FDI).

Political issues continue to dominate the news in Thailand. Local investors reacted positively to the military coup and remain optimistic that coup leaders have the country's best interests at heart and will enact long overdue reforms. As evidence of this, payments owed to farmers from the rice pledging program were promptly paid and gave a boost to market sentiment in the hope that it will kickstart consumption. Expectations are also high that long-delayed infrastructure projects will move forward as well. However, Thailand's strong performance was a surprise and our view remains that the problems in the country are unlikely to ease over the short term given a highly indebted consumer and a military leadership focused on populist policies as it consolidates its power base. While the new government is enjoying a "honeymoon" period, the market is likely to be unforgiving of missteps.

Brazil/Latin America

Market Update

The MSCI Brazil Index rose 5.1% in USD terms, taking year-to-date performance to 7.76%. All sectors have posted positive year-to-date returns with the exception of the materials sector, which has been negatively impacted by falling iron ore prices and weakening steel demand, as well as the strengthening Brazilian real. The broad-based market strength has largely been the result of increasing likelihood of political change in the fourth quarter elections, which would likely be accompanied by improved macroeconomic policy. That said, incumbent President Dilma Rousseff still leads in the polls and may benefit from greater TV air time as campaigning continues in the third quarter; therefore, we expect ongoing market oscillation in the near term.

The Latin American market overall also rose, with the MSCI Latin America Index gaining 3.9% for the month in USD terms, driven by Brazil and Colombia, but partially offset by Chile. Year-to-date, the index has gained 5.3%, led by Peru, Colombia, and Brazil, while Mexico and Chile have underperformed. On a sector basis, IT, financials, healthcare and utilities led for the month, while materials, energy and industrials underperformed.

Investment Outlook

Our outlook for Brazil is marginally more constructive than it was earlier in the year given the significant potential upside should the opposition party gain popularity before the October elections. As a result, we are in the process of reassessing key large-cap sectors that could benefit from a change in government, including the energy sector.

Valuations in the Brazilian market are reasonable, though we remain cautious on the macro backdrop given low growth and persistent inflation. However, over the next quarter, markets are likely to focus more on politics than growth. In general, we like companies offering above-average growth at attractive valuations, high earning visibility and proven cash flow generation potential, and we have a continued preference for structural growth stories including insurance, financial services and consumer staples. We have also identified several value opportunities offering dividend and buyback support at current levels, notably within the financials, real estate and consumer sectors. However, we are less constructive on the telecom sector, where the potential for M&A is already priced in, and we are highly sensitive to the utilities sector given current political and rationing risks.

Across Latin America, we are modestly constructive on Mexico, Brazil and Peru, but less positive on Chile and Colombia, where we do not see significant value. While we remain structurally positive on the investment case in Mexico, we are selective given relatively high valuations. Initial signs of recovery in output and consumer activity indicate an improved backdrop within Mexico during the second half. In particular, we like financials, industrials, REITs and select consumer names. Elsewhere in the region, on a sector basis, we like Chilean and Peruvian banks, along with Colombian building materials. Though the prevailing macroeconomic environment in Latin America remains relatively weak, we see the potential for output recovery in 2015 and therefore have an improved outlook for procyclical growth companies, including those in the cement, real estate and banking industries.

Eastern Europe, Middle East and Africa (EEMEA)

Market Update

The Russian market gained again in June, with the MSCI Russia Index rising 4.6% in USD terms for the month, as tensions with Ukraine continued to ease and oil prices rose. On a sector basis, the materials, consumer discretionary and energy sectors delivered strong performance, while financials underperformed. The Eastern European region overall also delivered a modest gain, as Russia's outperformance was partially offset by Turkey, which underperformed as tensions in Iraq flared up.

The Middle East Africa market was largely flat during the month, with the MSCI EMEA Index rising just 0.4% in USD terms in June. South Africa continued to perform better than its peers, while the newly added markets of United Arab Emirates and Qatar significantly underperformed during the month, with both losing around 20%. On a sector basis, the South African materials sector continued to detract from performance, as labor unrest in the mining industry continued to weigh on the market.

Investment Outlook

In Russia, even though the government has committed to de-escalation and stopping its support for destabilizing military forces in Eastern Ukraine, the risks of more sanctions are still present. Though we expect Russia to continue to close the performance gap relative to the rest of the region and global emerging markets in general, we also anticipate continuing volatility. That said, Russia remains one of the worst performing markets year-to-date, presenting an attractive opportunity given the decreasing political risks. Within Russia, we continue to prefer high-quality companies in industries that are generally left alone by the government, including the retail and Internet segments, where the focus is on profitable growth for shareholders. We also remain constructive on certain cheap cyclical stocks and exporters that benefit from a weaker ruble and better cost controls.

Across the Eastern European region, we remain most positive on Russia, where we continue to prefer high-quality private companies that enjoy limited state interference and whose owners' interests are aligned with shareholders. We also have a more positive 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 2014. Additionally, as expectations for an interest rate cut have become a reality (the

Turkish central bank reduced the benchmark interest rate by a total of 125 basis points in May and June to 8.75%), the financial sector should be supported in the near term. On the other hand, we are less constructive on Poland, as the country's strong growth outlook is now priced in and valuations no longer offer such an attractive opportunity.

Within the Middle East Africa region, South Africa remains vulnerable given the greater-than-expected impact from labor unrest and the structural issues surrounding its fiscal and current account deficits. We see select opportunities in the Middle East after profit-taking resulted in more attractive valuations; however, with Ramadan beginning at the end of June, we remain cautious over the near term.