Market Commentary

November 2014

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

Emerging Markets

Global equity markets delivered mixed performance in November. Developed market equities gained on the back of continued optimism about recent monetary easing in Japan and prospects for further quantitative easing by the European Central Bank (ECB). In addition, a sharp and continual drop in crude oil prices throughout the month added to expectations that major developed market economies would benefit. Emerging markets underperformed their developed market peers and closed down with much of the focus on Russia, which sold off on lower oil prices and a weakening currency. The MSCI Emerging Markets Index lost 1.05% while the MSCI World Index and the S&P 500 Index rose 2.08% and 2.69%, respectively.

Chinese equities had a good month and outperformed their emerging market peers, with the MSCI China Index closing up 1.55% in USD terms. November was a newsworthy month for the Chinese markets as the People's Bank of China (PBOC) unexpectedly cut interest rates for the first time in two years, in response to ongoing weakness in the Chinese economy. HSBC manufacturing PMI continued its downward trend, and industrial production and retail sales figures trailed expectations. Launch of the Shanghai-Hong Kong Stock Connect program, which opened up direct trading of certain shares between Hong Kong and mainland China, boosted investor sentiment, especially for the Shanghai A-share market.

The MSCI India Index gained 1.27% in USD terms and outperformed the broader emerging markets index in November. As a net importer of oil, India is a large beneficiary of lower crude oil prices. Recent data releases point to a meaningful decline in inflation. Falling commodity prices also increased investor optimism that the country's current account deficit will continue to improve, and that India's central bank will have increased flexibility to boost growth. Other macroeconomic data were encouraging as well. Third-quarter GDP growth registered 5.3% and exceeded expectations. HSBC manufacturing PMI expanded in November to 53.3, a 21-month high. On the political front, the cabinet expansion was viewed positively by the market as reformists gained control of key ministries.

Brazil was a disappointing and volatile market last month as the MSCI Brazil Index closed down 4.62% in USD terms, markedly underperforming the emerging market universe. Data releases continued to be weak amidst a low growth and high inflation economic backdrop. Politics continued to be a focus for the local market. The appointment of a market- and reform-friendly finance minister helped

buoy investor sentiment. However, this was offset by concerns about falling commodity prices, along with growing corruption allegations at a major oil producer.

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 12.9x, whereas the MSCI World Index trades at 17.9x and the S&P 500 Index trades at 18.3x. Historically[1], these indices have traded at 14.5x, 21.2x, and 19.3x, respectively[2].

China

Market Update

Chinese stocks finished a volatile month with a gain, with the MSCI China Index up 1.55% in USD terms, outperforming emerging markets overall. The financials sector, in particular, reflected strong outperformance driven by the People's Bank of China's surprise interest rate cut, its first in more than two years. Launch of the Shanghai-Hong Kong Stock Connect program, which allows direct trading of certain shares between Hong Kong and mainland China, also helped boost investor sentiment.

While the central bank's interest rate cut was viewed positively by the market, it was a response to China's ongoing weak economic data. HSBC manufacturing PMI continued its downward trend, declining to 50.0 in November to straddle the line between expansion and contraction. Industrial production and retail sales figures trailed expectations in October, rising 7.7% and 11.5% year-over-year, respectively. Additionally, despite the government's efforts in September to help spur the property market, including reduced mortgage rates, sales continued on a downward trend, though the pace slowed significantly from a decline of 10.3% in September to 1.6% in October.

Although the long-anticipated debut of the Shanghai-Hong Kong Stock Connect was met with enthusiasm, trading volume was less than expected. Northbound trading (trading of Shanghai A-shares from Hong Kong) was strong but southbound trading (trading of Hong Kong-listed stocks from Shanghai) was much weaker. In another step towards financial liberalization, the central bank announced a proposal to insure deposits of $500,000 yuan or less, a measure intended to increase competition in the banking sector and help curb shadow banking.

Investment Outlook

While the weak economic trend remains a concern, the government's recent actions, including a 40 basis point cut in the lending rate to 5.6% and a 25 basis point reduction in the savings rate to 2.75%, are encouraging. We expect monetary policy to remain loose and money to continue flowing into the Chinese equity market, significantly benefiting deep-value sectors such as financials.

Although the initial volume of the Shanghai-Hong Kong Stock Connect program was weaker than expected, we still view it as a meaningful event and a long-term positive driver of the Chinese market as a whole. More global money can now access the Chinese A-share market, improving liquidity flow and creating increased structural demand for Chinese companies with strong fundamentals and long-term competitiveness.

On a sector basis, we hold a less constructive outlook for the energy sector as the weak crude oil price trend could continue much longer given that overall demand is soft and a supply adjustment by OPEC looks unlikely. We are less favorable on Internet stocks as they have outperformed for an extended period of time, leading to a wide valuation gap relative to the rest of the market. On the other hand, in addition to financials, we have grown more constructive on the consumer and healthcare sectors, as both continue to reflect a strong structural growth trend.

India

Market Update

The MSCI India Index gained 1.27% in USD in November, outperforming most other emerging markets. The decline in commodity prices led to a sharp decrease in inflation, with the CPI increasing just 5.52% year-over-year in October, down nearly 1% from 6.46% in September. Unlike the currencies of many of its emerging market peers, the rupee was relatively stable in November as lower commodity prices and inflation help to relieve pressure on the country's current account deficit.

India's economic growth remains subdued but recent figures may indicate the beginning of a revival. While third-quarter GDP growth of 5.3% was down from 5.7% in the second quarter, it exceeded expectations of 5.1% growth. HSBC manufacturing PMI expanded from 51.6 in October to 53.3 in November, a 21-month high, and industrial production surprised to the upside, growing 2.5% year-over-year in September, significantly surpassing expectations for a 0.6% increase.

[1]Historical averages since 1996
[2]Bloomberg, as of 11/30/14

However, sluggish demand from Europe and Japan took a toll on exports, which contracted 5.04% year-over-year in October as shipments of engineering goods and electronic products declined sharply. Imports grew 3.62% as the dramatic decline in oil imports (year-over-year decrease of 19.2%) was offset by a substantial increase in gold imports, resulting in a monthly trade deficit of $13.35 billion.

On the political front, the much-anticipated cabinet expansion was viewed positively by the market with reformists gaining control of key ministries like defense and railways, further improving the outlook for infrastructure development.

Investment Outlook

We believe the sharp decline in crude oil prices will result in improved consumption in the coming months. This, coupled with falling inflation would provide the central bank with increased flexibility to boost growth. The Reserve Bank of India's governor has indicated that if inflation continues on a downward trajectory, the central bank may begin reducing interest rates early next year. In addition to monetary easing, the market is also focused on the government's ability to pass bills in the current session of parliament. Among the most closely watched bills are a proposal to increase the foreign direct investment (FDI) cap in the insurance sector from 26% to 49% and a proposal to introduce a goods and services tax (GST), which would simplify the country's current indirect tax regime. The GST, which would be applied at each point in the value chain from manufacturing to consumption, would make India more competitive both internationally and domestically.

The fall in commodity prices makes India's structural growth story even more compelling in the short term; however, the market may take a breather as valuations at 16x forward earnings are fair. We believe current valuations do not fully capture the expansion in operating leverage and ROE that a growth revival will bring about. From a sector perspective, we are growing increasingly constructive on financials and consumer discretionary names, which are poised to be the primary beneficiaries of an easing monetary cycle and a resurgence in economic growth.

Korea

Market Update

The KOSPI Index recovered from its sharp decline in October to post a gain of 0.83% in November, the Korean market's recovery was limited due to the rapidly depreciating Japanese yen following further quantitative easing by the Bank of Japan. On a sector basis, electronics, insurance and telecom outperformed, while textiles, paper, and banking underperformed.

On the macro front, despite the 25 basis point reduction in the policy interest rate to 2.0% last month, growth remained soft. Exports continued on a downward trajectory, contracting 1.9% year-over-year in November, well below the estimate for a 1% increase, while imports also continued to decelerate, declining 4% for the month. Inflation remained on a downward trend, falling to just 1% in November. Though HSBC manufacturing PMI rose slightly to 49.0 in November, from 48.7 in October, it remains in contraction territory, and industrial production decreased 3.2% year-over-year in October.

Investment Outlook

OPEC's refusal to curb oil production suggests that oil prices will continue to decline. This will have a damaging impact on materials providers (both raw and processed) as production cost decreases often lead to product price reductions. Many Korean manufacturers are processed material manufacturers (e.g., petrochemicals) and the flagging oil price may weigh on earnings.

The Japanese yen is expected to remain very weak against the US dollar, impacting the competitiveness of Korean exports. We do not anticipate the won to depreciate further unless the Korean government takes additional measures.

The sustainability of the Korean market's rebound is uncertain. While holdings that have experienced sharp declines in their fundamentals are now bargain priced and could rally, the overall market is likely to remain within a narrow range for the rest of the year. We expect market visibility to improve following company announcements regarding their plans in the new year. We continue to pursue a bottom-up approach and focus on individual stock fundamentals. We believe stocks that are less sensitive to global dynamics, but have distinct growth potential, offer the best opportunities, and though overall macroeconomic conditions will affect the earnings of individual companies, we believe the long-term profit trend is likely to be decided by the core competitiveness of each company. We will emphasize long-term profit trends rather than short-term volatility in individual corporate earnings.

The Association of Southeast Asian Nations (ASEAN)

Market Update

Within the ASEAN region, performance diverged significantly between commodity importers and exporters. Indonesia, Thailand and the Philippines, all of which depend on imported oil, delivered modestly positive returns, while Malaysia, the only net oil exporter in the region, fell 4.86% in USD for the month.

The Indonesian market rose as President Joko Widodo (Jokowi) raised the price of fuel by more than 30%. The fuel subsidy cut is expected to save the government $11.5 billion in 2015, which Jokowi has indicated will be put toward infrastructure, education, healthcare and agriculture. Following the fuel subsidy cut, Bank Indonesia raised interest rates by 25 basis points to 7.75% to help mitigate the inflationary impact; however, the CPI rose 6.23% year-over-year in November, up significantly from 4.83% in October. In Thailand and the Philippines, lower oil prices led to declining inflation. Thailand's inflation continues to slow, rising only 1.26% year-over-year in November, its sixth consecutive monthly decrease, while inflation in the Philippines fell to 3.70%, its first reading below 4% since March.

In Malaysia, lower oil prices caused the ringgit to depreciate significantly to its cheapest level since 2010. Economic growth also reflected a downward trend, with third-quarter GDP growth falling to 5.6% driven by the deceleration in exports, and resulting in a significant reduction in the country's current account surplus, which decreased to 2.8% of GDP from 6.1% in the second quarter. Similar to Indonesia, Malaysia's inflation rose slightly to 2.80% year-over-year in October following the announcement of a fuel subsidy cut in September.

Investment Outlook

Looking forward, while we continue to expect volatility in the Indonesian market, the combination of lower oil prices and Jokowi's decisive fuel subsidy cut will make more money available for infrastructure. Even though Bank Indonesia increased the policy rate by 25 basis points to help dampen the effects of the 30% fuel price hike in November, this could mark the end of the country's interest rate hiking cycle. We maintain a positive outlook for the Philippines as its structural growth story remains intact. In Thailand, we are seeing a disconnect between the country's economic growth, which has disappointed, and its stock market, which continues to rise.

We hold a negative view on Malaysia, which will continue to be impacted by the dual factors of lower fiscal revenue and low investment momentum. Given high foreign ownership of Malaysian government bonds, interest rate hikes by the US Federal Reserve could result in a bond sell-off. The Malaysian economy was built on government-led investment and subsidies, fueled by energy exports and inflows into the bond market. Trends in these factors are no longer in the country's favor given falling revenue from the oil industry and the specter of rising interest rates in the US. In Malaysia, we are wary of banks as earnings expectations for this year and next continue to be downgraded, and instead favor defensive sectors, including telecom, utilities and consumer staples.

Across the ASEAN region, at the sector level, we prefer healthcare, tourism, and infrastructure-related names with compelling business models and decent growth outlooks, while we are increasingly cautious of the energy and financials sectors.

Brazil/Latin America

Market Update

The Brazilian market experienced extreme volatility in November, with the MSCI Brazil Index ending the month with a loss of 4.62% in USD terms. Positive news related to the appointment of a market- and reform-friendly finance minister was offset by growing corruption allegations at a major oil producer along with the sharp sell-off in oil. On a sector basis, energy, materials and consumer discretionary underperformed.

The Latin American region as a whole also fell in November, with the MSCI Latin America Index declining 4.74% in USD for the month. Brazil and Colombia led the underperformance, while Peru and Chile, which are both net oil importers, outperformed for the month. Mexico performed in line with the market even though growth and economic reform have been disappointing over the last couple of months.

Investment Outlook

With the election now behind it, Brazil needs to turn its attention to its low growth and high inflation. We foresee a challenging year ahead for the Brazilian consumer in 2015 as difficult adjustments will be needed in the near term to get the economy back on track. Meanwhile, the sell-off in iron ore and oil will put additional pressure on Brazil's fiscal situation and will need to be balanced out by a weaker currency if current commodity prices are maintained. While the appointment of Joaquim Levy as finance minister was viewed positively by the market, it also underscored the post-election reality that fiscal and monetary tightening will need to take place in 2015. The situation will need to be addressed by the new government appointees, providing little room for disappointment in the naming of key people.

Given the challenging economic backdrop in Brazil, we have an increased preference for structural growth stories, including insurance, financial services, and retail. In broad terms, we continue to prefer companies with above-average growth at attractive valuations, especially those with high earnings visibility and proven cash flow generation potential. We are also becoming more positive on export sectors as we expect the real to depreciate in line with other emerging market currencies against the strengthening US dollar. We remain cautious of the utilities sector and less constructive on the telecom sector, where the potential for M&A is fully priced in.

Across the Latin American region, we are constructive on Mexico and Peru. In Chile, lower oil prices have created a more positive scenario. Brazil and Colombia, however, will continue to be negatively impacted by lower oil prices but we do see opportunities in both markets through quality companies that are not directly exposed to the sell-off in oil. In terms of sectors, we hold an optimistic outlook for financials and the consumer sectors, but are much less constructive on utilities and energy.

Eastern Europe, Middle East and Africa (EEMEA)

Market Update

The Russian market continued to decline in November, with the MSCI Russia Index falling 10.76% in USD terms. The ruble also continued on a downward spiral, depreciating 15% against the US dollar in November as oil fell sharply. This led the central bank to intervene towards the end of the month after the OPEC meeting resulted in no production cuts. On a sector basis, financials and energy underperformed, while materials outperformed.

The Eastern European region as a whole also fell for the month. Russia led the underperformance, while Greece and Turkey outperformed. The Middle East/Africa region overall outperformed in November as South Africa benefited from lower oil prices, which, similar to Turkey, reduced pressure on the country's current account deficit and supported its currency. Middle Eastern markets, which rely heavily on oil exports, underperformed during the month.

Investment Outlook

In Russia, the macroeconomic backdrop looks increasingly difficult for 2015. Sanctions, ongoing tensions in Ukraine, current oil prices and a weaker ruble will lead to higher inflation, making us cautious on the Russian market over the short term. Investors are now pricing in lower oil prices for longer as OPEC effectively announced that it will allow the market to determine the price of oil. At current prices, investors will question the government's ability to balance the budget and keep inflation under control. With the ruble hostage to the uncertainty of oil prices, we expect the market to remain very volatile, and current sanctions to remain a medium-term overhang to growth and investor appetite. Although inflation is a primary concern as we enter the new year, exporters should benefit from currency depreciation. We hold a very negative outlook for domestic banks and companies that have high refinancing and funding needs.

Across Eastern Europe, we remain least constructive on Russia, where we continue to prefer high-quality private companies in which state interference is limited and whose owners' interests are aligned with shareholders, a strategy that has proven advantageous in recent months. We also remain positive on certain cheap cyclicals and exporters that are focused on cutting capital expenditures and returning cash to shareholders through increased dividend payouts, and also benefit from the weak ruble. We maintain a constructive outlook for Turkey as we see additional ECB action and lower commodity prices continuing to reduce the country's current account deficit and relieve pressure on its currency, thus supporting growth.

In the Middle East/ Africa region, though South Africa remains vulnerable given its high current account and fiscal deficits, lower oil prices have helped to relieve the pressure of these deficits. Within the country, we remain most positive on structural winners that benefit from the weaker currency and are not significantly impacted by higher inflation. While we continue to see opportunities in the Middle East, we remain cautious as we wait for oil to find a more natural pricing level.